

SHARĪ'AH AND LEGAL ISSUES IN STOCK TRADING
IN PAKISTAN

BY

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ABSTRACT

Stock trading provides an important business avenue for stock investors to earn profit while boosting the national economy. In Pakistan, it is regulated and governed by a robust legal framework, though various *Shari'ah* and legal issues need to be addressed. This study analyses and examines *Shari'ah* and legal issues in stock trading practices at pre-stock trading, actual stock trading and post-stock trading and recommends ways to resolve these issues. The methodology used is primarily legal doctrinal, supplemented by qualitative methods, including 26 structured interviews with *Shari'ah* advisors, legal experts, market participants including stock investors and brokerage firms and regulators to validate the findings. In pre-stock trading, the key *Shari'ah* issues include conflict of interest and the handling of stock investors' funds. The study highlights the necessity for the brokerage firm to avoid conflict of interest and properly handle stock investors' funds, which should be treated as *amānah* (trust). To resolve these issues, it is recommended to disclose conflict of interest to stock investors and monitor unusual trading practices to prevent commission-driven trading. In actual stock trading, the key *Shari'ah* issues cover intraday trading and market manipulation. The study finds that intraday trading is generally deemed impermissible due to a lack of possession and market manipulation is prohibited under *Shari'ah* for misrepresentation and artificial price inflation. To address these issues, it is recommended limit intraday trading size and enforce stricter actions against market manipulation. In post-stock trading, the key *Shari'ah* issues involve the status of the clearing house and the T+2 settlement cycle. The study finds that the clearing house acts as a sub-agent and T+2 settlement may defer delivery which is generally not permissible. To mitigate these issues, it is recommended to adopt AAOIFI standards for clearing houses and implement a T+0 settlement for same-day transactions. Moreover, in pre-stock trading, the key legal issues include misuse of stock investors' funds and non-segregation of accounts. The study finds that these practices violate existing regulations, with brokerage firms misusing stock investors' funds for their own business and failing to segregate accounts. To resolve these issues, it is recommended to ensure asset segregation and enforce strict penalties for non-compliance. In actual stock trading, the key legal issues cover market manipulation and insider trading. The study finds that market manipulation and insider trading are illegal, with penalties outlined in various regulations. To address these issues, it is recommended to enhance monitoring and penalties for market manipulation and improve enforcement against insider trading. In post-stock trading, the key legal issues involve non-transfer of stocks to CDC account and unauthorized movement of stocks. The study finds that non-compliance with transfer regulations and unauthorized stock movements pose legal risks. To mitigate these issues, it is recommended to implement robust monitoring for CDC account transfers and enhance oversight for stock movements. It is anticipated that, by implementing the proposed recommendations, stock trading practices in Pakistan will be free from any *Shari'ah* and legal issues.

مُلخَص البَحْث

يُتيح تداول الأسهم وسيلةً تجاريةً مهمةً لمستثمري الأسهم لتحقيق الربح مع تعزيز الاقتصاد الوطني. في باكستان، يُنظَّم هذا النشاط ويُدار بإطار قانوني قوي، على الرغم من الحاجة إلى معالجة العديد من القضايا الشرعية والقانونية. تُحلل هذه الدراسة القضايا الشرعية والقانونية في ممارسات تداول الأسهم قبل التداول، وفي التداول الفعلي، وبعده، وتُوصي بسبلٍ لحل هذه القضايا. المنهجية المستخدمة هي فقهية قانونية، مُدعّمة بأساليب نوعية، بما في ذلك 26 مقابلةً مُهيكلّة مع مستشاري الشريعة، والخبراء القانونيين، والمشاركين في السوق، وشركات الوساطة، والجهات التنظيمية، للتحقق من صحة النتائج. في مرحلة ما قبل تداول الأسهم، تشمل القضايا الشرعية الرئيسية تضارب المصالح والتعامل مع أموال مستثمري الأسهم. لحل هذه المشكلات، يُوصى بالإفصاح عن تضارب المصالح لمستثمري الأسهم ومراقبة ممارسات التداول غير المعتادة لمنع التداول القائم على العمولة. في تداول الأسهم الفعلي، تغطي القضايا الشرعية الرئيسية التداول اليومي والتلاعب بالسوق. وتوصلت الدراسة إلى أن التداول اليومي يُعتبر غير مسموح به عمومًا بسبب نقص الحيّزة، كما أن التلاعب بالسوق محظور بموجب الشريعة الإسلامية بسبب التزوير والتضخم المصطنع في الأسعار. ولمعالجة هذه المشكلات، يُوصى بالحد من حجم التداول اليومي وتطبيق إجراءات أكثر صرامة ضد التلاعب بالسوق. في تداول ما بعد الأسهم، تتضمن القضايا الشرعية الرئيسية وضع غرفة المقاصة ودورة تسوية $T + 2$ وتوصلت الدراسة إلى أنّ غرفة المقاصة تعمل كوكيل فرعي وقد تؤدي تسوية $T + 2$ إلى تأجيل التسليم وهو أمر غير مسموح به عمومًا. وللتخفيف من حدة هذه المشكلات، يُوصى باعتماد معايير AAOIFI لغرف المقاصة وتنفيذ تسوية $T + 0$ للمعاملات التي تتم في نفس اليوم. علاوة على ذلك، تشمل القضايا القانونية الرئيسية في مرحلة ما قبل تداول الأسهم إساءة استخدام أموال مستثمري الأسهم وعدم فصل الحسابات. وخلصت الدراسة إلى أنّ هذه الممارسات تُخالف اللوائح القائمة. أما في تداول الأسهم الفعلي، فتشمل القضايا القانونية الرئيسية التلاعب بالسوق والتداول بناءً على معلومات داخلية. وخلصت الدراسة إلى أن التلاعب بالسوق والتداول بناءً على معلومات داخلية أمران غير قانونيين، مع تحديد عقوباتهما في لوائح مختلفة. أما في مرحلة ما بعد تداول الأسهم، فتشمل القضايا القانونية الرئيسية عدم تحويل الأسهم إلى حساب مركز التحكم المركزي (CDC) والحركة غير المصرح بها للأسهم. وخلصت الدراسة إلى أنّ عدم الامتثال للوائح النقل وتحركات الأسهم غير المصرح بها يُشكلان مخاطر قانونية. وللتخفيف من هذه القضايا، يُوصى بتطبيق رقابة صارمة على عمليات تحويل حسابات مركز التحكم المركزي (CDC) وتعزيز الرقابة على تحركات الأسهم. ومن المتوقع أن يؤدي تنفيذ التوصيات المقترحة إلى جعل ممارسات تداول الأسهم في باكستان خالية من أي مسائل شرعية أو قانونية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature

A handwritten signature in black ink, consisting of a stylized 'A' followed by a series of loops and a final flourish.

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United Bank Limited v. SECP 2021 PLD 53.

United Bank Ltd. v. Future Securities Ltd 2020 PLD 718.

United Brokerage v. CDC 2019 SCMR 348.

United States v. O'Hagan 521 U.S. 642 (1997).

Will v. United Lankat Plantations Co., Ltd. 1935 AC 17.



LIST OF ABBREVIATIONS

AAOIFI	- Accounting and Auditing Organization for Islamic Financial Institutions
AGM	- Annual General Meeting
AMC	- Asset Management Company
CDC	- Central Depository Company
CCM	- Custodian Clearing Member
CGT	- Capital Gain Tax
CII	- Council of Islamic Ideology
CNIC	- Computerized National Identity Card
FBR	- Federal Board of Revenue
FFC	- Fauji Fertilizer Company
FPR	- Financing Participation Ratio
HBL	- Habib Bank Limited
IBAN	- International Bank Account Number
IDS	- Institutional Delivery System
IIUM	- International Islamic University Malaysia
IMF	- International Monetary Fund
IOCSO	- International Organization of Securities Commissions
IPO	- Initial Public Offering
ISE	- Islamabad Stock Exchange
ISSBNT	- Islamic Securities Selling Borrowing-Negotiated Transaction
KIBOR	- Karachi Inter-Bank Offer Rate
KMI-30	- Karachi Meezan Index-30
KSA	- Kingdom of Saudi Arabia
KSE-100	- Karachi Stock Exchange 100 Index
KSE-30	- Karachi Stock Exchange 30 Index
LSE	- Lahore Stock Exchange
MCB	- Muslim Commercial Bank
MFS	- Margin Financing System
MMA	- Master <i>Murabahah</i> Agreement
MSF	- <i>Murabahah</i> Shares Financing

MTS - Margin Trading System
NADRA - National Database and Registration Authority
NAV - Net Asset Value
NCCPL - National Clearing Company Pakistan Limited
NBCM - Non-Brokerage Firm Clearing Member
NRN - National Tax Number
OGDCL - Oil and Gas Development Company Limited
OIC - Organization of Islamic Cooperation
PLD - Pakistan Legal Decisions
PMEX - Pakistan Mercantile Exchange Corporation
PSO - Pakistan State Oil
PSX - Pakistan Stock Exchange
PTC - Participation Term Certificate
SAC - *Sharī'ah* Advisory Council
SCML - Shaheen Cotton Mills Limited
SECP - Securities and Exchange Commission of Pakistan
SGF - *Sharī'ah* Governance Framework
SLB - Securities Lending and Borrowing
SMEs - Small and Medium Enterprises
T+2 - T refers to Trade Day and 2 is the number of days for settlement
TFCs - Term Finance Certificates
UIN - Unique Identification Number
WAPDA - Water and Power Development Authority

TRANSLITERATION

ء	،	خ	kh	ش	Sh	غ	Gh	ن	N
ب	B	د	D	ص	ṣ	ف	F	ه	H
ت	T	ذ	dh	ض	ḍ	ق	Q	و	W
ث	Th	ر	r	ط	ṭ	ك	K	ي	Y
ج	J	ز	z	ظ	ẓ	ل	L		
ح	ḥ	س	c	ع	e	م	M		

Short Vowels	
اَ	a
اِ	i
اُ	u

Long Vowels	
اَ + اَ	ā
اِ + اِ	ī
اُ + اُ	ū

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF STUDY

Stock trading is an important financial activity in the stock markets that provides an important business avenue for the stock investors to earn profit when the price of stock rises or when a company distributes dividends. In Pakistan stock trading is carried out in Pakistan Stock Exchange (PSX) which is licensed to operate as stock market. It has trading facilities at Karachi, Islamabad and Lahore. The stock trading is regulated by PSX and the Securities and Exchange Commission of Pakistan (SECP), which is an apex regulatory body for stock markets in Pakistan. PSX has seven prominent indices including benchmark Karachi Stock Exchange-100 Index comprising top 100 companies,¹ KSE-30 index comprising top 30 companies,² Karachi Meezan Index-30 Index, an index of top 30 *Shari'ah* compliant companies,³ PSX-KMI All Shares Index, an index of all *Shari'ah* compliant companies,⁴ Oil & Gas Index,⁵ Banking Index⁶ and KSE-All Shares Index.⁷

¹ Pakistan Stock Exchange Limited (PSEL), "Karachi Stock Exchange-100 Index", <<https://www.psx.com.pk/psx/market-summary/kse-100>> (accessed 6 August, 2024).

² Pakistan Stock Exchange Limited (PSEL), "KSE-30 Index", <<https://www.psx.com.pk/psx/market-summary/kse-30>> (accessed 6 August, 2024).

³ Pakistan Stock Exchange Limited (PSEL), "Karachi Meezan Index-30 Index", <<https://www.psx.com.pk/psx/market-summary/kmi-30>> (accessed 6 August, 2024).

⁴ Pakistan Stock Exchange Limited (PSEL), "PSX-KMI All Shares Index", <<https://www.psx.com.pk/psx/market-summary/kmi-all>> (accessed 6 August, 2024).

⁵ Pakistan Stock Exchange Limited (PSEL), "Oil & Gas Index", <<https://www.psx.com.pk/psx/market-summary/oil-gas>> (accessed 6 August, 2024).

⁶ Pakistan Stock Exchange Limited (PSEL), "Banking Index", <<https://www.psx.com.pk/psx/market-summary/banking>> (accessed 6 August, 2024).

⁷ Pakistan Stock Exchange Limited (PSEL), "KSE-All Shares Index", <<https://www.psx.com.pk/psx/market-summary/all-shares>> (accessed 6 August, 2024).

Stock trading in Pakistan is governed by a number of laws and regulations that constitute the legal and regulatory framework for stock trading. Some of them are:

- (i) Contract Act 1872
- (ii) Central Depositories Act 1997
- (iii) Securities Act 2015
- (iv) Futures Market Act 2016
- (v) Companies Act 2017
- (vi) National Clearing Company Pakistan Limited Regulations (NCCPL) 2015
- (vii) Pakistan Stock Exchange Regulations 2018
- (viii) *Shari'ah* Governance Regulations 2018

In addition to the above laws and regulations, the SECP also issues rules for stocks trading operations such as Brokers and Agents Registration Rules 2001 and Securities (Leveraged Markets and Pledging) Rules 2011. Besides the SECP, the PSX, NCCPL and Central Depository Company (CDC) are also allowed to develop rules for trading, clearing, settlement and custody of stocks subject to the approval of the SECP. The rules developed by PSX include Pakistan Stock Exchange Market Surveillance Rules 2021 and Pakistan Stock Exchange Trading Rules 2022; NCCPL include National Clearing Company of Pakistan Limited National Custodial Service Rules 2018; and CDC include Central Depository Company of Pakistan Limited Pledging and Lien Rules 2020 and Central Depository Company of Pakistan Limited Investor Account Services Rules 2022.

All the above laws, regulations and rules are made for the existence, continuation and smooth functioning of stock trading practices in Pakistan.

In 2016, stock trading in Pakistan saw a significant development from *Shari'ah* perspective when the SECP launched the All Shares Islamic Index in collaboration with

the PSX to measure performance of *Sharī'ah* compliant companies.⁸ This index comprises over 250 companies. The stocks that meet the *Sharī'ah* screening criterion are included in the All Shares Islamic Index. It is worthy to mention that this is a lenient criterion to meet the needs of the market and to accommodate a large number of companies to be part of *Sharī'ah* compliant companies.⁹ As part of the selection process, each company's financial report is reviewed and their *Sharī'ah* compliance status is checked against technical filters and *Sharī'ah* screening criteria prescribed by the SECP. However, keeping in view the fact that the Federal *Shari'at* Court Pakistan in its verdict has set a deadline of Dec 31, 2027, for transformation of whole financial system to *Sharī'ah* based system, it is imperative that SECP should gradually move to a strict criterion relating to benchmark of interest-based borrowing and lending and benchmark of tolerable illegitimate income.¹⁰

Stock trading involving *Sharī'ah*-compliant companies was further refined in 2018 when the SECP issued the *Sharī'ah* Governance Regulations 2018 which deals with *Sharī'ah* screening criterion for the companies, illegitimate income purification process, establishment of charity account and the mode of disbursement.¹¹ The Regulations also defines eligibility criteria for a *mufti* and a *Sharī'ah* advisors for financial institutions including the stock exchange and mercantile exchange of Pakistan. To further strengthen the *Sharī'ah* compliant stock trading the SECP also approved in 2019, the *Murābahah* Shares Financing (MSF) as a *Sharī'ah* alternative to interest-

⁸ Pakistan Stock Exchange, "All Shares Islamic Index", <<https://www.psx.com.pk/asii>> (accessed 29 August, 2022).

⁹ Pakistan Stock Exchange Limited (PSEL), "All Shares Islamic Index", <<https://www.psx.com.pk/asii>> (accessed 29 August, 2024).

¹⁰ Federal *Shari'at* Court Pakistan, "Judgment on Riba (Interest)", <<https://www.federalshariatcourt.gov.pk/judgments/interest-judgment-2022>> (accessed 29 August, 2024).

¹¹ Securities and Exchange Commission of Pakistan, "Sharī'ah Governance Regulations 2018", <<https://www.secp.gov.pk/document/shariah-governance-regulations-2018>> (accessed 29 August, 2024).

based margin financing. Due to lack of awareness among the stock investors about the concept and working of this system, MSF has not gained grounds in the market yet.

It is observable from the above overview of regulatory initiatives that there are positive and serious efforts on the part of government to build an Islamic stock market that have positively impacted stock trading. However, the legal framework for stock trading in Pakistan is still facilitative for conventional stock trading. The trading practices such as short selling, margin financing, futures trading and intraday trading are prevalent in the stock market.

The present study seeks to evaluate the current stock trading practices in Pakistan from the perspective of *Shari'ah* and law. It identifies and analyzes the *Shari'ah* and legal issues in stock trading practices at pre-stock trading, actual stock trading and post-trading stages.

1.1 PROBLEM STATEMENT

Stock trading is an important financial activity of the stock markets in Pakistan which operates within a conventional legal framework that, while robust in regulating market operations, falls short in addressing the needs of *Shari'ah* compliance, a crucial aspect for a significant portion of Pakistan's Muslim population. This gap in the legal framework poses challenges for stock investors who seek to adhere to Islamic principles in their financial activities, particularly in a market where Islamic finance is increasingly significant. The pre-stock, actual stock and post-stock trading stages present various *Shari'ah* and legal issues, each filled with challenges that raise questions about the compliance of current stock trading practices with the existing legal framework and their alignment with *Shari'ah*, requiring detailed analysis and targeted reforms.

Despite the introduction of the All Shares Islamic Index in 2016 and the *Sharī'ah* Governance Regulations in 2018, significant gaps remain between existing stock trading practices and *Sharī'ah* principles. The Federal *Shari'at* Court of Pakistan has mandated a shift to a *Sharī'ah*-based financial system by 2027, making it imperative to examine the compatibility of current stock trading practices with both *Sharī'ah* and legal requirements. This research aims to critically analyse the legal framework governing stock trading in Pakistan, examine stock trading practices at the pre-stock, actual stock and post-stock stages by providing a detailed understanding of each phase, identify inconsistencies at each stage of trading and propose solutions to align these practices with *Sharī'ah* principles while ensuring compliance with the prevailing legal regime.

1.2 RESEARCH QUESTIONS

The study aims to address the following questions.

1. What is the legal framework governing stock trading practices in Pakistan?
2. How is the stock trading practiced at pre-stock, actual stock and post-stock trading stages in Pakistan?
3. Why are the stock trading practices at pre-stock, actual stock and post-stock trading stages in Pakistan inconsistent with *Sharī'ah* principles and the prevailing legal regime?
4. How to solve *Sharī'ah* and legal issues at pre-stock, actual stock and post-stock trading practices in Pakistan?

1.3 OBJECTIVES OF STUDY

The study has following objectives.

1. To review and examine the prevailing legal framework governing stock trading in Pakistan, focusing on its impact on the *Sharī'ah* compliance of stock trading practices.
2. To analyze stock trading practices at pre-stock, actual stock and post-stock stages in Pakistan by providing a detailed understanding of each phase.
3. To evaluate *Sharī'ah* and legal issues in pre-stock, actual stock and post-stock trading practices in Pakistan in order to give solution.
4. To propose solutions for resolving *Sharī'ah* and legal issues encountered at the pre-stock, actual stock and post-stock trading stages in Pakistan in order to make them consistent with *Sharī'ah* and existing legal regime.

1.4 HYPOTHESIS

This study hypothesizes that the current legal framework for stock trading in Pakistan is not fully equipped to address the requirements of *Sharī'ah* compliance, despite its effectiveness in regulating conventional market operations. While the framework governs stock trading practices within a conventional context, it falls short in addressing *Sharī'ah*-related concerns during the pre-stock, actual stock and post-stock trading stages as Pakistan practices. Hence, these gaps create challenges in aligning stock trading practices with *Sharī'ah* principles, raising the need for a detailed examination of these inconsistencies.

Therefore, the research aims to explore these issues by analysing the *Sharī'ah* and legal issues at each stage of stock trading and proposing solutions ensuring that

stock trading in Pakistan is free from both *Sharī'ah* and legal issues, thereby contributing to a more inclusive and compliant trading environment.

1.5 LITERATURE REVIEW

The existing literature on stock trading does not provide considerable insight into the legal and operational frameworks governing stock trading practices in Pakistan. They at the same time do not specifically address *Sharī'ah* and legal issues at the pre-stock, actual stock and post-stock trading stages in Pakistan. Hence, this study aims to fill this gap on the legal and operational frameworks governing stock trading practices in Pakistan and the *Sharī'ah* and legal issues associated with them. The literature review is therefore divided into the following three categories:

1. Literature on legal framework for stock trading.
2. Literature on operational framework and practices of stock trading.
3. Literature on *Sharī'ah* and legal issues in stock trading.

1.5.1 Literature on Legal Framework for Stock Trading

In this segment, the literature on legal framework for stock trading has been reviewed to examine the weaknesses and strength in the legal framework for stock trading in Pakistan, with the view to suggest reform in it. An important study on the subject is Asim Haneef Ahmed's book titled *Comparative Legal Frameworks for Stock Market Regulation: Case Studies from Emerging Markets*¹² which provides an in-depth comparative analysis of legal frameworks for stock trading regulation in Pakistan and other emerging markets. Ahmed identifies key regulatory challenges and offers

¹² Asif Haneef Ahmed, *Comparative Legal Frameworks for Stock Market Regulation: Case Studies from Emerging Markets*, (London: Routledge, 2023), 120-155.

suggestions for reform. While Ahmed identifies key regulatory challenges and offers suggestions for reform, his analysis primarily focuses on the broader stock market regulation rather than the specific legal framework governing stock trading practices in Pakistan. This creates a gap, as the book does not thoroughly address the unique legal issues and challenges that are specific to stock trading in the Pakistani context, such as the practical implementation of existing laws, the role of regulatory bodies like SECP in overseeing stock trading activities, or the enforcement of stock investor protections at various stages of stock trading.

Imtiaz Ahmed Khan's article titled *Enforcement of Corporate Laws and Stock Market Reforms in Pakistan* is another study on the subject.¹³ The article examines the enforcement problems of corporate laws in stock trading in Pakistan. These enforcement problems, in the analysis of author, are an obstacle in attracting both the local and foreign investments. The author contends that the Pakistan's judiciary does not have capacity to enforce stock investor's right, the regulator is also not efficient enough to ensure these rights. He argues that weak enforcement mechanism allows market manipulation and expropriation of minority stock investors by majority stock investors and dominant business group. The article discusses in detail different phases of stock trading reforms in Pakistan, including converting insider trading from imprisonment to financial penalty. SECP issued a code of corporate governance and made it part of the listing regulations in 2002. The author argues that the stock market of Pakistan has failed in compliance and enforcement. He suggests that institutional stock investors should come forward and invest in the primary and secondary markets as they have knowledge of where to invest. While the article discusses different phases

¹³ Imtiaz Ahmed Khan, "Enforcement of Corporate Laws and Stock Market Reforms in Pakistan", *Pakistan Journal of Social Sciences*, vol. 37, no.1 (2017): 307-319.

of stock trading reforms in Pakistan, including the transition of insider trading penalties from imprisonment to financial penalties and the introduction of a corporate governance code by SECP in 2002, it largely focuses on the enforcement aspect of corporate laws rather than on the specific legal framework governing stock trading. This creates a gap in understanding the legal provisions directly impacting stock trading practices and the practical challenges in implementing these provisions. Moreover, the article does not delve into the underlying reasons for the weak enforcement mechanisms within the stock trading framework, nor does it propose detailed legal reforms aimed at strengthening the legal infrastructure specifically governing stock trading in Pakistan.

‘Ali Iqbal Khans’ article titled *Regulatory Challenges in the Pakistani Stock Market: A Critical Review* is another significant work on the subject.¹⁴ He discusses issues such as market manipulation, lack of transparency and enforcement weaknesses. However, while the article highlights key regulatory challenges, it primarily focuses on broader market-wide issues rather than the specific legal framework governing stock trading practices. This leaves a gap in understanding how the existing legal provisions directly affect stock trading activities and whether they adequately address issues such as investor protection, market fairness and the role of regulatory bodies like SECP in overseeing stock trading. The article does not sufficiently explore the specific legal mechanisms in place for regulating stock trading or provide targeted recommendations for strengthening the legal framework governing these activities in Pakistan.

¹⁴ Iqbal Ali Khan, “Regulatory Challenges in the Pakistani Stock Market: A Critical Review”, *International Journal of Financial Regulation*, vol. 12, no.2 (2024): 45-62.

IMF's working paper titled *Strengths and Weaknesses in Securities Market Regulations: A Global Analysis* is another important contribution on the subject.¹⁵ This IMF working paper, authored by Ana Carvajal and Jennifer Elliot, examines the strengths and weaknesses of regulatory regimes governing stock trading in Pakistan and various other jurisdictions. The paper evaluates how ineffective enforcement mechanisms and insufficient legal authority have impacted stock trading activities in many jurisdictions. It also prescribes several principles that, when observed, can enhance and strengthen stock trading practices. These principles address issuers, collective investment schemes, market intermediaries, regulators and the secondary trading market. While it evaluates how ineffective enforcement mechanisms and insufficient legal authority have impacted stock trading activities globally, the paper primarily offers a broad analysis across multiple jurisdictions rather than focusing specifically on the legal framework governing stock trading in Pakistan. Although it prescribes several principles to enhance and strengthen stock trading practices covering areas such as issuers, collective investment schemes, market intermediaries, regulators and the secondary trading market, the paper does not provide an in-depth analysis of how these principles apply to the specific legal context of Pakistan's stock trading framework. This creates a gap in understanding the unique legal challenges and requirements necessary to improve stock trading practices in Pakistan.

International Organization of Securities Commissions'(IOSCO) report titled *Towards A Legal Framework for Clearing and Settlement in Emerging Markets*¹⁶ is

¹⁵ Carvajal Ana and Jennifer Elliot, "Strengths and Weaknesses in Securities Market Regulations: A Global Analysis", *International Monetary Fund Working Paper* 07/259, (2007): 1-51, <https://www.researchgate.net/publication/5125284_Strengths_and_Weaknesses_in_Securities_Market_Regulation_A_Global_Analysis> (accessed 7 August, 2024).

¹⁶ IOSCO, *Towards a Legal Framework for Clearing and Settlement in Emerging Markets*, (International Organization of Securities Commissions, 2011), 1-51, <<https://www.iosco.org/library/pubdocs/pdf/ioscopd74.pdf>>

another valuable study on the clearance and settlement processes related to stock trading in Pakistan and other emerging markets. Issued by the Emerging Market Committee of the IOSCO in November 2017, the report thoroughly examines the legal frameworks of selected countries for securities settlement and clearance. Its aim is to provide guidelines for developing an efficient legal and regulatory framework specifically for stock trading clearance and settlement. The report identifies both similarities and differences in the challenges faced by Pakistan and emerging markets of other countries in establishing central depository systems within their jurisdictions. It is based on four fundamental principles internationally recognized as essential for creating an effective regulatory framework for stock trading clearance and settlement systems.

The report argues that there are many legal issues in relation to regulatory framework of clearance and settlement, which hinder the efficiency and efficacy of settlement system. One of such shortcomings in the legal framework is lack of clarity of rights and obligations of the parties involved in the transactions. Market participants should be able to know with certainty the laws that govern their rights and obligations. The report also emphasizes clear definition of property interest. The law should define the interest of a stock investor as a traceable property right in individual securities. While the report identifies similarities and differences in the challenges faced by Pakistan and other emerging markets in establishing central depository systems, its primary focus is on the broader regulatory framework for clearance and settlement rather than on the specific legal framework governing stock trading in Pakistan. Although it highlights legal issues, such as the lack of clarity regarding the rights and obligations of parties involved in transactions and the need for a clear definition of property interests in securities, the report does not delve into the specific legal challenges that directly impact stock trading practices in Pakistan. This creates a gap in

understanding how the existing legal provisions for stock trading clearance and settlement might be strengthened or adapted to address the unique needs of the Pakistani market.

Khozem A. Haidermota's article titled *Insider Trading Laws in Pakistan: A Critique*¹⁷ is an important work on the subject which offers a comprehensive examination of the legal framework governing insider trading related to stocks trading in Pakistan. Insider trading, where individuals with access to non-public, material information about a company use this information to gain an unfair advantage in stock trading, poses a significant threat to market integrity and stock investor confidence. His work critically analyses existing insider trading laws, highlighting both the strengths and weaknesses of the current regulatory environment. He explores how these laws are applied in practice within the PSX, providing insights into their effectiveness in curbing insider trading activities. The study identifies loopholes and enforcement challenges that allow such abusive practices to persist despite the legal regulations in place. Haidermota emphasizes the need for stronger enforcement mechanisms, including more robust surveillance and monitoring systems within the PSX, to effectively detect and prevent insider trading.

A key contribution of this critique is detailed discussion of the specific shortcomings in the laws in which the author points out that while the legal framework exists, its implementation is often inconsistent and lacks the necessary rigor to serve as an effective deterrent. To address these issues, Haidermota suggests enhancing the clarity and scope of legal definitions related to insider trading, increasing penalties for violations, and improving the training and resources available to regulators. He also advocates for greater transparency and accountability within regulatory bodies

¹⁷ Haidermota Khozem A., "Insider Trading Laws in Pakistan: A Critique", *Insight*, no.42 (2018).

overseeing stock trading activities. While the article provides valuable insights into the effectiveness of insider trading laws within the PSX, its primary focus is on the specific issue of insider trading rather than the broader legal framework governing all aspects of stock trading in Pakistan. The study identifies loopholes and enforcement challenges that allow insider trading to persist despite the legal regulations in place, but it does not fully address the broader legal and regulatory challenges that impact stock trading practices as a whole. Although, Haidermota emphasizes the need for stronger enforcement mechanisms, more robust surveillance and clearer legal definitions related to insider trading, there is a gap in his analysis regarding how these recommendations fit into the overall legal framework for stock trading in Pakistan. The article does not explore other critical areas of stock trading regulation or how the insider trading laws interact with legal provisions governing stock trading activities in Pakistan.

1.5.2 Literature on Operational Framework and Practices of Stock Trading

In this section, extensive literature has been analyzed concerning the operational framework and practices of stock trading at the pre-stock, actual stock and post-stock trading stages. This includes detailed discussions of critical operations such as clearing, settlement and custody of stocks. In this context, an important study is the book produced by the SECP titled *Savings and Capital Markets*¹⁸ which offers valuable insights for stock trading in Pakistan. It is a comprehensive book on the introduction to stock trading in Pakistan, explaining various instruments used in stock trading, types of stocks, market indexes, methods of offering stocks through IPO, financial intermediaries and the stock trading practices. While the book serves as an excellent

¹⁸ Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, (Islamabad: SECP, 2019).

resource for understanding the basic concepts and components of stock trading in Pakistan, its focus remains largely introductory. There is a gap in the analysis of the operational framework and practices specific to the stock trading environment in Pakistan. The book does not delve deeply into the practical challenges faced by market participants, such as the effectiveness of trading platforms, the efficiency of order execution, the role of technology in trading practices or the operational risks encountered by brokerage firms and stock investors. Moreover, it does not critically assess how the existing operational framework could be improved to enhance market efficiency, transparency and stock investor protection in the context of Pakistan's stock trading practices.

Another significant contribution on the subject is Javed Iqbal's article titled *Stock Market in Pakistan: An Overview*¹⁹ which has reviewed the main features of stock trading in Pakistan since 2002. The article has investigated the issues such as liberalization of stock trading, its integration with global markets, trading and settlement mechanism and corporate governance. The author has also surveyed the performance of companies on KSE-100 index and the trading trends during different periods. In his analysis, the market has seen rapid growth in capitalization and trading volume. The article thoroughly discussed trading and settlement mechanism including the trading in ready market and trading in the over-the-counter market. In the opinion of regulators and researchers over the counter or *badla* transactions, are main cause of excess volatility in stock trading. They argue that when prices decrease, the financiers refuse to clear payments causing brokerage firm to default. The article has also discussed regulatory and governance regime for stock trading, especially the regulations to curb

¹⁹ Javed Iqbal, "Stock Market in Pakistan: An Overview", *Journal of Emerging Market Finance*, vol. 11, no.1 (2012): 61-91.

insider trading. In the analysis of the author, due to strict code of governance, the compliance situation is improving. In the analysis of author, PSX is a well-performing trading platform with high returns and capital gain to stock investors. It, however, has certain undesirable characteristics, such as dominance of few stocks and high level of volatility. While the article provides a thorough discussion of the trading and settlement mechanisms, including trading in the ready market and over-the-counter market, its focus is more on the general trends and regulatory aspects rather than an in-depth analysis of the operational framework and practices specific to stock trading in Pakistan. The article highlights issues like excess volatility due to *badla* transactions and discusses the regulatory and governance regimes, but there is a gap in its exploration of the day-to-day operational challenges faced by market participants. It does not adequately address the practical aspects of stock trading, such as the efficiency of trading systems, the impact of market infrastructure on trading practices, or the operational risks encountered by brokerage firms and stock investors. Furthermore, the article does not suggest ways to enhance the efficiency and robustness of stock trading operations within Pakistan's unique market context.

Shaikh Salman's article titled *Analysis of Islamic Mutual Funds Operations in Pakistan*²⁰ is an important work on the subject which has critically analyzed the operations of Islamic mutual funds in Pakistan with a focus on their impact on stock trading practices. He has raised objections on screening norms followed by mutual funds investment in policy. He contends that the benchmark of 37% for interest bearing lending method is mandated neither by the *Qur'ān* nor by the *Sunnah*. As such, it has no support from *Shari'ah* evidences. The article also criticizes controversial

²⁰ Salman Shaikh, "Analysis of Islamic Mutual Funds Operations in Pakistan", *Journal of Islamic Banking & Finance*, vol. 29, no.3 (2012): 45-60.

investments by the funds such as investment in Commodity *Murābahah* and other *Tawarruq* based products. In his analysis, the increasing innovative financial engineering has blurred distinctive identity of Islamic financial system. The author has also raised objections on the purification methodology. The article also examines issues of inconsistencies in corporate governance. There is no standardization in *Sharī'ah* compliance process. Similarly, *Sharī'ah* scholars serve on several *Sharī'ah* boards at the same time. He suggests that there should be limit and ceiling on it. While the article provides a detailed critique of Islamic mutual funds and their compliance with *Sharī'ah* principles, it primarily focuses on issues specific to Islamic financial products rather than the broader operational framework of stock trading in Pakistan. The study does not extensively examine the general operational practices of stock trading, such as the effectiveness of trading platforms, the operational risks faced by brokerage firm or the overall efficiency of the stock trading system. There is a gap in analyzing how the operational aspects of Islamic mutual funds intersect with or impact the broader stock trading practices and regulatory framework within Pakistan.

1.5.3 Literature on Sharī'ah and Legal Issues in Stock Trading

This part of the literature review examines the literature on *Sharī'ah* and legal issues related to stock trading. It starts with the focus on the works of prominent scholars on stock trading. For instance, an important study on this subject is Taqi Usmani's book titled *Islam Aur Jadīd Mu'ashī Masayil*²¹ (*Islam and Modern Economic Issues*) in which he has devoted a chapter for the study of trading in stocks where he has explained the nature of stock and the *Sharī'ah* rules of their trading in the secondary market. This is a scholarly work that explains the position of *Sharī'ah* on stock trading in Pakistan.

²¹ Taqī Usmanī, *Islām Aur Jadīd Mu'ashī Masayil*, (Lahore: Idara-e-Islamiyyat, 2007), 110-130.

While Usmani's work offers valuable insights into the *Sharī'ah* rules related to stock trading, it primarily focuses on the theoretical and doctrinal aspects of these rules. The book does not extensively address the practical implementation of *Sharī'ah* principles in the operational context of stock trading in Pakistan. There is a gap in exploring how these *Sharī'ah* rules are applied in practice within the current stock trading environment, including the challenges faced by market participants in ensuring compliance with *Sharī'ah* standards. Additionally, the book does not provide a detailed analysis of how the existing legal and regulatory frameworks interact with *Sharī'ah* principles or how potential conflicts between *Sharī'ah* requirements and market practices are resolved. This leaves a gap in understanding the practical implications and enforcement of *Sharī'ah* rules in the context of Pakistan's stock trading market.

Another important work on the subject is Taqi Usmani's book titled *Islamic Finance and Modern Financial Transactions*²² which has devoted a significant portion to the study of stock trading in Pakistan. Usmani investigates the complexities of stock trading, highlighting the necessity for adherence to *Sharī'ah* principles while navigating modern stock trading. He provides practical guidance on structuring transactions to meet *Sharī'ah* requirements, emphasizing the avoidance of interest and uncertainty. While Usmani's book offers valuable insights into the *Sharī'ah* compliance aspects of stock trading, it primarily focuses on theoretical guidance and general principles. There is a gap in addressing how these *Sharī'ah* principles are specifically applied in the operational context of Pakistan's stock trading environment. The book does not extensively explore the practical challenges faced by market participants in aligning their trading practices with *Sharī'ah* principles, such as the implementation of *Sharī'ah*-

²² Taqī Usmanī, *Islamic Finance and Modern Financial Transactions*, (Karachi: Dārul Isha'at, 2023), 45-78.

compliant trading mechanisms or the resolution of conflicts between *Sharī'ah* requirements and market practices.

The Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI) book titled the *Sharī'ah Standards*²³ is another significant contribution on the subject which provides *Sharī'ah* rules relating to stocks and other financial and commercial transactions. They serve guidelines for Islamic financial institutions in their operations around the globe including Pakistan. Standard no. 12 entitled *Sharīkah (Mushārakah)* and Modern Corporation and Standard no. 21 entitled Financial Papers (Shares and Bonds) deal with the issues of partnership, joint stock company, financial papers, stocks and bonds and the rules for investment in stocks. While the book offers valuable *Sharī'ah* guidelines for financial transactions and investments including stock trading, it primarily provides a general framework applicable across various jurisdictions rather than focusing specifically on the nuances of stock trading in Pakistan. The standards offer broad principles but do not address the specific *Sharī'ah* issues encountered in the Pakistani stock market context, such as local regulatory practices, market conditions, or the practical challenges faced by stock investors and institutions operating under these guidelines. There is a gap in the literature concerning how these *Sharī'ah* standards are applied in practice within the Pakistani market and how they align with or differ from operational frameworks governing stock trading in Pakistan.

Saiful Azhar Rosly 'Ali's article titled *Sharī'ah and Stock Market Operations: Contemporary Issues*²⁴ is another valuable study on the subject which addresses the

²³ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Sharī'ah Standards*, (Manama, Bahrain: AAOIFI, 2007), Standard no. 12, 110–120 and Standard no. 21, 145–160.

²⁴ Saiful Azhar Rosly, "Sharī'ah and Stock Market Operations: Contemporary Issues," *Islamic Finance News*, 27 March, 2023, 112-130.

latest developments in the field, including technological advancements and regulatory changes. He discusses the challenges faced by practitioners in maintaining *Sharī'ah* compliance during the execution of stock trades amid rapid market changes. His work is notable for its practical insights and recommendations for improving compliance frameworks within trading activities. However, while the article provides valuable practical insights into *Sharī'ah* compliance issues, it primarily focuses on recent developments and technological changes rather than a comprehensive analysis of the broader *Sharī'ah* issues specific to stock trading in Pakistan. There is a gap in the examination of how existing *Sharī'ah* compliance frameworks address fundamental issues such as the permissibility of various trading practices, the integration of *Sharī'ah* principles into stock trading regulations and the practical challenges of implementing *Sharī'ah*-compliant trading strategies in the context of Pakistan's unique market environment. The article does not extensively explore the specific *Sharī'ah* issues related to stock trading practices, such as the ethical implications of market behaviour or the alignment of local regulatory practices with *Sharī'ah* standards.

Eḥsān Elahī Karīm's article titled *Post-Trade Settlement and Sharī'ah Compliance: An Empirical Study* is an important study on the subject.²⁵ His study highlights the challenges and solutions observed in various trading practices, providing valuable insights for practitioners. The article's primary emphasis is on the technical and operational aspects of post-trade settlements rather than a comprehensive analysis of *Sharī'ah* issues in stock trading as a whole. There is a gap in addressing how broader *Sharī'ah* principles are integrated into the entire stock trading framework, including pre-trade practices, trading mechanisms and overall compliance. Additionally, the study

²⁵ Karīm Eḥsān Elahī, "Post-Trade Settlement and *Sharī'ah* Compliance: An Empirical Study", *Journal of Islamic Economics and Finance*, vol. 15, no.1 (2024): 50-67.

does not fully explore the implications of *Sharī'ah* non-compliance in various stages of stock trading or how to address these issues in the context of regulatory and operational practices. A more holistic analysis of how *Sharī'ah* compliance is maintained across all aspects of stock trading would provide a deeper understanding of the challenges and solutions related to *Sharī'ah* issues in Pakistan's stock market.

'Abdullah Sa'eed Hassan's article titled *the Evolution of Sharī'ah Compliance in Stock Market Practices*,²⁶ is a significant work that deals with the subject which provides a historical perspective on the development of *Sharī'ah* compliance in stock trading. Hassan highlights significant milestones and recent innovations that have shaped the current landscape. While the article offers valuable insights into the historical development and innovations related to *Sharī'ah* compliance, it primarily focuses on the evolution of compliance practices rather than a detailed examination of the specific *Sharī'ah* issues currently affecting stock trading in Pakistan. The study highlights past milestones but does not deeply analyse the present-day challenges and gaps in *Sharī'ah* compliance within the Pakistani stock trading environment. There is a gap in understanding how contemporary *Sharī'ah* issues, such as the interpretation of *Sharī'ah* principles in modern trading practices, impact the effectiveness and fairness of stock trading in Pakistan. Additionally, the article does not address the practical difficulties faced by market participants in adhering to *Sharī'ah* principles or evaluate the effectiveness of current *Sharī'ah* compliance mechanisms in addressing these challenges.

²⁶ 'Abdullah Sa'eed Hassan, "The Evolution of *Sharī'ah* Compliance in Stock Market Practices", *Journal of Islamic Financial Studies*, vol. 10, no.1 (2024): 15-35.

Muhammad Tahir Mansoori's and Attiquzafar's article titled *Investment in Equities: Sharī'ah Appraisal of Screening Norms*,²⁷ is another important contribution on the subject in which they have criticized the screening practices and the screening norms applied in PSX.²⁸ In their view the criteria developed by the SECP for screening of stocks and companies does not stand on sound *Sharī'ah* grounds. They have specially criticized the benchmark for interest-based borrowing and interest-based lending. They argue that the criteria should be revisited in wake of wide spread of Islamic financial institutions which can easily provide financial facility to the companies on *Sharī'ah* compliant bases and these companies need not to resort to interest based borrowing. While the article provides a critical evaluation of the *Sharī'ah* compliance of screening norms, it primarily focuses on specific issues related to interest-based transactions rather than offering a comprehensive analysis of all *Sharī'ah* issues in stock trading. The study does not extensively address other key *Sharī'ah* concerns in stock trading, such as the broader applicability of *Sharī'ah* principles across various trading practices, the integration of *Sharī'ah* compliance within the operational framework of the PSX or the impact of *Sharī'ah*-compliant investment products on the overall stock trading environment. This creates a gap in understanding how *Sharī'ah* issues are comprehensively managed and integrated into the full spectrum of stock trading practices in Pakistan.

Some studies highlight significant legal issues related to stock trading in Pakistan, focusing on abusive market practices such as insider trading and market manipulation, which pose serious threats to market integrity. An important work on the

²⁷ Muhammad Tahir Mansoori and Atiquzzafar Khan, "Investment in Equities: *Sharī'ah* Appraisal of Screening Norms", *Journal of Islamic Business and Management*, vol. 5, no.1 (2015).

subject is Pakistan Stock Exchange's Rule book²⁹ which provides a comprehensive overview of the practices within the stock exchange, with a particular focus on maintaining market integrity. The book elaborates on various prohibited and abusive market practices, including insider trading, market manipulation and false trading. It outlines the regulatory framework designed to prevent such practices and ensure fair trading environments, emphasizing the roles of surveillance and enforcement mechanisms in upholding these standards. While the Rule Book offers a detailed description of the regulatory framework and the measures in place to address market abuses, it primarily focuses on the operational aspects of enforcement and surveillance rather than a deep exploration of the legal issues specifically impacting stock trading in Pakistan. There is a gap in the book's analysis regarding how legal principles are applied in practice and how they interact with the broader legal environment governing stock trading. The book does not extensively address the nuances of legal challenges such as the adequacy of existing laws in addressing evolving market practices, the legal interpretation of complex trading activities, or the effectiveness of legal remedies available to stock investors. Additionally, it lacks a critical examination of how the regulatory framework could be improved to address emerging legal issues in stock trading. Another valuable contribution that deals with the subject is that of Arif Ullah Khan's article titled *Market Abuse and Ethical Standards in Islamic Stock Markets*,³⁰ exploring market abuse and ethical standards in Islamic stock trading in Pakistan and other Islamic stock markets. Khan provides a critical analysis of regulatory practices and enforcement mechanisms to curb unethical behavior. While Khan's article offers

²⁹ Pakistan Stock Exchange Limited, *Rule Book of Pakistan Stock Exchange PSX*, (Pakistan: Pakistan Stock Exchange Limited, 2018).

³⁰ Arif Ullah Khan, "Market Abuse and Ethical Standards in Islamic Stock Markets", *Journal of Business Ethics and Islamic Finance*, vol. 8, no.3 (2023): 120-137.

valuable insights into market abuse and ethical standards, it focuses predominantly on the ethical aspects and regulatory practices in Islamic stock markets rather than on the specific legal issues related to stock trading in Pakistan. The article examines how regulations address unethical behaviour and provides a critique of enforcement mechanisms, but it does not extensively delve into the broader legal issues governing stock trading, such as stock investor protection laws, legal recourse for market manipulation or the overall coherence of the legal framework with international standards. There is a gap in understanding how the legal framework addresses specific challenges and deficiencies in stock trading practices and how it might be improved to better handle issues of market abuse and ensure a fair and transparent trading environment in Pakistan.

Syed Irtaza ‘Ali’s paper titled *Moral Neutralization in Pakistan’s Capital Markets: A Study of Market Abuse*,³¹ is another important work on the subject which investigates the motivation behind corrupt practices among brokerage organizations and across brokerage industry. In order to understand why brokerage firms, engage in corrupt practices, the author interviewed around 160 brokerage firms and brokerage organizations. The finding of these interviews are that (i) the SECP is not entirely independent since it is susceptible to undue political influence and brokerage firms’ exploitation which could potentially result in the poor enforcement of rules and obligations, (ii) the legal system provides inadequate support to the SECP in the fulfillment of its enforcement responsibilities and the SECP does not make full use of its judicial powers to investigate and prosecute white collar crimes, (iii) Market

³¹ Syed Irtaza ‘Ali, “Moral Neutralization in Pakistan ‘s Capital Markets: A Study of Market Abuse,” University of Pennsylvania, https://repository.upenn.edu/cgi/viewcontent.cgi?article=1157&context=wharton_research_scholars (accessed 29 September 2024).

participants maintain that SECP has serious human resource constraint which handicap its enforcement capabilities. The paper also finds that brokerage firm community helps and supports each other in corrupt practices rather than discouraging this behavior. The paper concludes that generally brokerage firms do not consider their corrupt behavior illegal or unethical, they rather question the credibility and competence of SECP as their rightful regulator. This is a well-researched paper that has investigated the reasons and motivations of corrupt and abusive stock trading practices. While the paper provides a detailed examination of the motivations and justifications behind corrupt and abusive stock trading practices, it primarily focuses on the behavioural and institutional factors contributing to market abuse. There is a gap in the analysis of the specific legal issues related to stock trading in Pakistan. The study does not thoroughly explore the existing legal framework or the specific legal challenges that affect the enforcement of regulations and the prosecution of market abuse. Additionally, the paper does not address how legal provisions could be improved to better support the SECP in its regulatory role or enhance the legal mechanisms to deter and address market abuse effectively. This leaves a gap in understanding the broader legal issues impacting stock trading and the effectiveness of current legal measures in addressing these issues.

The existing literature on stock trading in Pakistan does not offer sufficient insights into the legal and operational frameworks governing the practice. While some studies address specific issues such as market abuse and regulatory challenges, they often lack a comprehensive analysis of how these frameworks function at different stages of stock trading. Additionally, there is a notable absence of detailed discussion on the *Shari'ah* and legal issues relevant to the pre-stock, actual stock and post-stock trading stages.

This study aims to address these deficiencies by providing a detailed examination of the legal and operational frameworks that shape stock trading practices in Pakistan. It will also explore the *Sharī'ah* and legal issues at each stage of trading, offering a more complete understanding of these critical aspects. By filling these gaps, the study seeks to enhance the knowledge base and offer practical recommendations for improving stock trading practices in Pakistan.

1.6 SCOPE AND LIMITATIONS OF THE STUDY

This study is focused on stock trading practices in Pakistan at three different stages which are pre-stock, actual stock and post-stock trading stages and examines the *Sharī'ah* and legal issues associated with each stage. By focusing on these stages, the study seeks to offer a thorough analysis of stock trading practices at each phase and how they align with *Sharī'ah* and legal principles. The focus on stock trading rather than the broader stock market is deliberate, as the stock market includes a wide range of activities and financial instruments beyond stock trading itself. This study narrows its scope to stock trading to offer a specific and in-depth examination of the stock trading practices at different stages and their *Sharī'ah* and legal issues.

The emphasis on *Sharī'ah* and legal issues is due to the need to address how trading practices align with *Sharī'ah* and legal principles. The study does not explore elements such as stock market dynamics or the wider economic effects of stock trading, which fall outside the scope of its focus on the stock trading practices and their alignment with *Sharī'ah* and legal principles. This focus ensures that the research provides targeted solutions for improving *Sharī'ah* compliance and resolving legal irregularities in stock trading practices.

1.7 RESEARCH METHODOLOGY

The research is basically legal doctrinal research which is essentially a library-based study. Doctrinal methodology has been defined as research aimed at solving uncertainties and gaps in existing law by analyzing and giving systematic exposition of principles, rules and concepts governing a particular field or institutions.³² The basic aim of the research is to discover, explain, examine, analyze and compare in a systematic form the provisions of different laws governing stock trading in Pakistan in terms of their compliance with *Sharī'ah* principles or otherwise. It also aims to identify the lacunas and weaknesses in these laws. The thesis analyzes and explores from *Sharī'ah* perspective relevant stock market laws and stocks trading practices and suggests necessary reforms in these laws. In addition to analyzing legal provisions, the research includes a discussion of case laws from Pakistan and other jurisdictions concerning various legal issues arising at the pre-stock, actual stock and post-stock trading stages. These case laws provide practical insights and comparative perspectives, enriching the doctrinal analysis.

While discussing the viewpoint of *Sharī'ah* on certain regulations and practices, reliance has been made preferably on the original sources of Islamic law. The opinions of renowned contemporary *Sharī'ah* scholars on contemporary issues of commercial law, modern *fatwa* literature, especially the *Sharī'ah* verdicts of prominent *Fiqh* councils in Jeddah and Malaysia has also been consulted in the study.

Doctrinal legal research contains a number of research methods such as descriptive and exploratory method, analytical and critical method and comparative method. All these methods have been used in this study.

³² Singhal A. K., and I. Malik, "Doctrinal and Socio-Legal Methods of Research: Merits and Demerits", *Educational Research Journal*, no.2 (2012): 252-265.

A part of this research is qualitative. Around 26 structured interviews with the *Sharī'ah* scholars of Islamic finance industry, law experts, market participants including stock investors and brokerage firms, regulators at SECP have been conducted. Their views and opinion were obtained on the issues under the study. The purpose behind these interviews is to identify *Sharī'ah* issues as well as weakness in the current legal regime on stock trading and to suggest *Sharī'ah* compliant alternatives for their improvement.

The total number of interviews is 26, which include 7 *Sharī'ah* advisors, 13 market participants including stock investors and brokerage firms, 3 law experts and 3 academicians. All the respondents have sound grounding in their respective fields. The *Sharī'ah* advisors have reasonable exposure to law and finance. The market participants possess fair knowledge of Islamic finance/law. Their experience as *Sharī'ah* advisor or market participant or law practitioner or academicians ranges between 12 to 30 years. Many academicians are *Sharī'ah* advisors of Islamic finance industry as well. The interviews were conducted through telecommunications sources such as WhatsApp or direct phone calls or emails as well as in-person meetings. All the interviews were recorded and transcribed. The detailed questionnaire used for these interviews can be found in Appendix 1 of this thesis, which includes the set of questions posed to *Sharī'ah* advisors, law experts, market participants and academicians. Respondents' profile with codes and designations is as under.

1.7.1 Profile of Respondents

Code	Category	Qualification	Organization	Experience (Years)
101	<i>Sharī'ah</i> Advisor	PhD Isl. Finance	Member <i>Sharī'ah</i> Board HBL	18

Code	Category	Qualification	Organization	Experience (Years)
102	<i>Sharī'ah</i> Advisor/Academician	PhD Isl. Law	Resident <i>Sharī'ah</i> Board Member (RSBM), Askari Islamic Banking	18/30
103	<i>Sharī'ah</i> Advisor	Shahādah 'Ālamiyyah	Chairman, <i>Sharī'ah</i> Board, United Bank Limited (Islamic)	16
104	<i>Sharī'ah</i> Advisor	MS Islamic Finance	RSBM, Muslim Commercial Bank (Islamic)	13
105	<i>Sharī'ah</i> Scholar	PhD Islamic Finance	Head <i>Sharī'ah</i> Audit, Askari Bank	12
106	<i>Sharī'ah</i> Advisor/Academician	PhD Islamic Finance	Chartered Accountants UMT, University	12
107	Academician/Law Expert	LLM/PhD	Head Law Department, University of Swat	15
108	Law Expert	LLM Corporate Law	Tayyeb & Bashr Law Firm	22
109	Law Expert	LL.M Corporate Law	Kundi & Misbah Law Firm	15
110	Market Participant	MBA	Head Product Development CDC	21
111	<i>Sharī'ah</i> Advisor	PhD Islamic Finance	Chairman <i>Sharī'ah</i> Board, Islamic Bank Afghanistan	15
112	Academician	PhD Islamic Finance	Prof. Riphah International University	30
113	Academician	PhD Islamic Finance	AP Taylor University	12
114	Academician	PhD Islamic Finance	Lecturer IIUI	13

Code	Category	Qualification	Organization	Experience (Years)
115	Market Participant	MS/PhD Scholar	Registrar Mudarabah, Head Islamic Finance Department, SECP	18
116	Market Participant	CPA Canada, FCMA	CEO Central Depository Company	20
117	Market Participant	MS Islamic Finance	Risk Management, NCCPL	15
118	Market Participant	MS Finance	Head Primary Market Development Department, SECP	13
119	Market Participant	BBA	Director, Foundation Securities Pvt. Ltd. (Brokerage Firm)	17
120	Market Participant	MBA Finance	Senior Analyst, Arif Habib Limited (Brokerage Firm)	12
121	Market Participant	MBA	Senior Manager, AKD Securities (Brokerage Firm)	20
122	Market Participant	CFA Level II Candidate	Partner, Intermarket Securities Ltd. (Brokerage Firm)	23
123	Market Participant	B.Com	Individual Stock Investor (Brokerage Firm)	16
124	Market Participant	MBA	Retail Stock Investor (Brokerage Firm)	14
125	Market Participant	BS Finance	Individual Investor, Trading via Online Platforms (Brokerage Firm)	21
126	Market Participant	MS Accounting & Finance	Long-term Stock Investor (Brokerage Firm)	25

While dealing with Islamic law, certain *Arabic* terms have been retained for the purpose of accuracy. Regarding the translation of *Qur'ānic* verses, the work of ‘Abdullah Yusuf ‘Ali was relied upon throughout the thesis. However, if any other authority was used for the said translations, the source of the translation was mentioned. With regard to transliteration of the *Arabic* words used in the present study, IIUM guidelines have been followed.

The standardized methods of citing legal sources have been adopted in the thesis. In this regard, the Chicago Manual of Style has been followed.

1.8 OUTLINE OF THE CHAPTERS

The research has been divided into six chapters. Chapter one provides a general introduction of the research and discusses problem statement, research questions, research objectives, hypothesis, literature review, scope and limitations of the study, its methodology and the organization.

Chapter two provides an overview of stock trading in Pakistan. It covers the concept of stock trading, its objectives and benefits. It also discusses three main markets where the stock trading in Pakistan is practiced, such as ready market, leveraged market and futures market. It also examines the legal framework governing stock trading in Pakistan. Additionally, it addresses the operational framework of stock trading including the infrastructure institutions essential for stock trading in Pakistan, such as SECP, PSX, NCCPL and CDC. It also examines the roles of key market participants, such as the stock exchange, stock investors, depositories, clearing corporations, brokerage firms and underwriters.

Chapter three analyzes pre-stock trading practices at PSX and the *Sharī'ah* and legal issues related to these practices. To fully understand these issues, the chapter starts

with the analysis on essential pre-requisites of stock trading such as selection of brokerage firm, account opening with the brokerage firm, signing agreement between the stock investor and brokerage firm, opening bank account for financial transactions related to stock trading, opening trading account with the brokerage firm, assigning of a brokerage firm to the stock investor by the brokerage firm, funding the trading account by the stock investor, accessing trading platform and placing order. The key *Sharī'ah* issues include the position of the brokerage firm, conflict of interest and the handling of stock investors' funds. While the legal issues include conflict of interest, misuse of stock investors' funds and non-segregation of accounts. The chapter also provides an overview of case law and analysis of structured interviews.

Chapter four discusses actual stock trading practices at PSX in three different markets such as regular market, leveraged market and futures market and examines *Sharī'ah* and legal issues related to these practices in detail. The key *Sharī'ah* issues include trading in conventional stocks, intraday trading and market manipulation. While the key legal issues include the legal nature of preference stocks, market manipulation and insider trading. The chapter also provides an overview of case law and analysis of structured interviews.

Chapter five is devoted to the study of post-stock trading practices at three different stages that are clearing, settlement and custody of stocks and the *Sharī'ah* and legal issues related to these practices in detail. The key *Sharī'ah* issues include the status of the clearing house and the T+2 settlement cycle. While the key legal issues include non-transfer of stocks to CDC accounts, unauthorized movement of stocks and the legality of the central counterparty system. The chapter also provides an overview of case law and analysis of structured interviews.

Chapter six provides the findings of the study and recommendations to improve both *Sharī'ah* and legal issues on stock trading practices in Pakistan at pre-stock, actual stock and post stock trading stages, ensuring compliance with both *Sharī'ah* and legal principles. At pre-stock trading stage the findings of *Sharī'ah* issues reveal that brokerage firms are considered *wakīl* (agent) under *Sharī'ah*, requiring adherence to *wakālah* (agency) principles and that conflicts of interest and improper handling of stock investors' funds are significant concerns. To resolve these issues, it is recommended to specify liability for negligence and misconduct in agreements, disclose conflict of interest to stock investors, monitor unusual trading practices to prevent commission-driven trading and conduct awareness campaigns for stock investors and brokerage firms. While, the findings of legal issues reveal that brokerage firms are often prioritizing their own interests over stock investors' interest, misusing stock investors' funds for their own business and failing to segregate accounts. To resolve these issues, it is recommended to clarify conflict of interest regulations, ensure asset segregation and enforce strict penalties for non-compliance. At actual stock trading stage, findings of *Sharī'ah* issues indicate that trading in conventional stocks is inconsistent with *Sharī'ah* due to elements of *ribā* (interest), *gharar* (uncertainty) and *qimār* (gambling), while intraday trading is generally impermissible and market manipulation is prohibited. To address these issues, it is recommended to phase out conventional stocks, limit intraday trading and enforce stricter actions against market manipulation. While the findings of legal issues indicate that preference stocks are often viewed as debt instruments rather than equity due to fixed returns. Market manipulation and insider trading are illegal, with penalties outlined in various regulations. To address these issues, it is recommended to align preference stock regulations with Malaysian regulations as a model, enhance monitoring and penalties for market manipulation and

improve enforcement against insider trading. At post-stock trading stage, the findings of *Sharī'ah* issues reveal that the clearing house acts as a sub-agent and that the T+2 settlement cycle may defer delivery, which is generally not permissible. To mitigate these issues, it is recommended to adopt AAOIFI standards for clearing houses and implement a T+0 settlement for same-day transactions. While the findings of the legal issues reveal that non-compliance with transfer regulations and unauthorized stock movements pose legal risks and there are legal challenges in the operations of the central counterparty system. To mitigate these issues, it is recommended to implement robust monitoring for CDC account transfers, enhance oversight for stock movements and create a clear legal framework for the central counterparty system. These measures aim to resolve both *Sharī'ah* and legal issues, enhancing stock trading practices in Pakistan across all stages of trading.

CHAPTER TWO

STOCK TRADING IN PAKISTAN: LEGAL AND OPERATIONAL FRAMEWORK

2.0 INTRODUCTION

Stock trading is an important business and economic activity that is carried out at the Pakistan Stock Exchange (PSX). It is an effective mean for augmentation of wealth for stock investors who earn profit on their investments in the form of capital gain. It gives a long-term stock investor the opportunity to share the company's dividends with other partners. Stock trading also helps the government to mobilize funds from the public for the development of national economy. The companies and corporations also use stock trading as a mean to grow and expand their business. Stock trading activity in Pakistan is governed and regulated by a strong legal and operational framework designed by the Securities and Exchange Commission of Pakistan (SECP) which acts as the apex regulatory and supervisory body for the stock trading in Pakistan. A number of infrastructure institutions and market participants contribute in the regulation and operation of stock trading activity in Pakistan.

In this chapter, conceptual aspects of stock trading, including the meaning of stock, its objectives, benefits and types of markets, are analyzed. The legal and operational frameworks for stock trading practices in Pakistan are also examined.

2.1 STOCK TRADING: ITS OBJECTIVES, BENEFITS AND MARKETS

A stock is an equity security, also known as a share.¹ In common usage, stock and share are used as interchangeable terms which denote the part ownership of the business of company.² In the opinion of some finance experts, share represents ownership of a particular company while stocks represent ownership of a number of companies. Thus, for example, if a person asks the brokerage firm to buy for him stocks, he does not refer to stocks of a particular company rather he wants him to buy stocks of different companies. This maybe just a technical difference, the fact of the matter is that there is no substantial difference between stock and share.³

A stock is divided into two main kinds which are common stock and preferred stock. A common stock represents an equity ownership in a company, proportionately, with other common stockholders who are not entitled to any fixed or predetermined profits or dividends. They have no priority right in terms of payment, in case the company is dissolved. They hold voting rights and thus, control the working of a company. They are considered the virtual owners of the company.⁴ Common stockholders are entitled to receive dividends if any are available after dividends on preferred stocks are paid. They are also entitled to their share of the residual economic value of the company should the business be wound up. However, they are last in line, after bondholders and preferred stockholders, for receiving business proceeds.⁵

¹ Jeff Madura, *Financial Markets and Institutions*, (Boston: Cengage Learning, 13th edn., 2021), 25.

² For the purpose of consistency with the topic, the term “stock” will be predominantly used in the thesis.

³ Troy Segal, "Shares vs. Stocks: What's the Difference?," Investopedia, <<https://www.investopedia.com/ask/answers/difference-between-shares-and-stocks/>> (accessed 20 October 2021).

⁴ Swart Nico, *Personal Financial Management*, (Kenwyn: Juta & Co, 1996), 152.

⁵ Chisholm Andrew M., *An Introduction to International Capital Markets: Products, Strategies, Participants*, (West Sussex, UK: John Wiley & Sons, Ltd., 2002), 130.

On the other hand, preferred stock is a hybrid stock; it is similar to bonds in some respects and to common stocks in other ways.⁶ Preferred stock provides a specific dividend that is paid before any dividends are paid to common stockholders and takes precedence over common stock in the event of a liquidation.⁷ It is convertible to ordinary stocks, at agreed and predetermined conversion rates, after a fixed period or future date. Preference stocks holder is entitled to fixed dividends, expressed as a percentage of nominal value of stock, such as 6% each year. These dividends must be paid before the company can issue dividends to common and ordinary stockholders.⁸ This stockholder generally does not have any voting rights.⁹

2.1.1 Primary Objectives of Stock Trading

The primary objectives of stock trading are as follows.

i- Fund Raising

A significant objective of stock trading is fund raising for huge projects. Through stock trading activity, companies and corporations raise huge funds for the expansion of their business and meet their working capital requirements. Instead of borrowing from banks at high rate of interest, the companies prefer to raise funds from the stock market through issuing stocks and other securities and selling them in the market.¹⁰

⁶ Stephen A. Ross and et al, *Fundamentals of Corporate Finance*, (New York: McGraw-Hill Education, 12th edn., 2019), 205.

⁷ SECP, *Savings and Capital Markets*, (Islamabad: SECP, 2019), 18.

⁸ Ibid., 19

⁹ Ibid.

¹⁰ Richard A. and et al, *Principles of Corporate Finance*, (New York: McGraw-Hill Education, 13th edn., 2020), 396.

In Pakistan, the rate of interest in the last three years has been ranging between 16% to 22%.¹¹ Due to this high interest rate, many companies instead of borrowing from banks, raised funds from stock exchange through IPOs¹² and listing as well as through issuance of right stocks,¹³ preference stocks and other securities.

According to a PSX five-year progress report, listed companies raised more than one trillion rupees through debts and equity stocks during the last five years. Stock investors have made average return of 20% per annum.¹⁴ Government has raised Rs. 400 billion via privatization of government owned companies through stock exchange.¹⁵

The year 2021 was a significant period for the stock market in Pakistan, during which companies mobilized substantial funds through IPOs, rights issues and bonds. During this period, companies raised approximately Rs. 80 billion through these financial instruments.¹⁶ Of this, Rs. 20 billion was raised through IPOs, with many of them being oversubscribed, highlighting strong investor interest in the stock market. This shows that stock trading is an effective method for raising funds for the companies.¹⁷

¹¹ SPB, DMMD Circular No. 20 2022, "SBP's Policy Rate and Overnight Repo / Reverse-Repo Facilities", <https://www.sbp.org.pk/dmmd/2022/index.htm?utm_source=chatgpt.com> (accessed 10 January, 2023).

¹² An IPO means that a company's ownership is transitioning from private ownership to public ownership. For that reason, the IPO process is sometimes referred to as "going public" for trading of stocks at stock exchange. See, SECP, "Initial Public Offering (IPO) Regulations," Security and Exchange Commission of Pakistan", <<https://www.secp.gov.pk/document/initial-public-offering-regulations>> (accessed 29 September, 2024).

¹³ The right stocks refer to those issues of stocks which a company offers to their existing stockholders at a discounted price. The company's stockholders have the right to accept or reject the proposal and there are minimum criteria for subscriptions of the stock if the stockholder accepts the proposal. See, SECP, "Rights Issue Guidelines," Security and Exchange Commission of Pakistan", <<https://www.secp.gov.pk/document/rights-issue-guidelines>> (accessed 29 September, 2024).

¹⁴ Pakistan Stock Exchange Limited, "PSX five-year progress report," Security and Exchange Commission of Pakistan, <<https://dps.psx.com.pk/progress-report>> (accessed 16 October 2021).

¹⁵ Ministry of Privatization, "Annual Report Privatization Commission," Government of Pakistan, <<http://www.privatisation.gov.pk/Detail/YjI5MjQ1OWQtYzZiNy00ZjIwLTk0ZGYtZTc4NjJiMjIzZmUx>> (accessed 16 October 2021).

¹⁶ Zaheeruddin, "Pakistan's Stock Market in 2021: A Year of Record Fund Mobilization," *The Express Tribune*, 06 January, 2022, <https://tribune.com.pk/story/2337412/pakistans-stock-market-in-2021-a-year-of-record-fund-mobilization>. 15.01.2022.

¹⁷ Raja Kamran, "Dawn Economic Report," *Dawn News*, 15 September, 2021,

ii- Capital Growth

Capital growth is another objective of stock trading as it gives the stock investor opportunity to earn capital gain on the stocks sold. A seller earns profit known as capital gain, when the stock experiences rise in the value. This is a big source of income for stock investors. Stock trading is used mainly for this purpose. The stock investor can earn high returns in shorter period of time. Day traders, in particular, can earn profits in the shortest period. They buy low and then sell high on the same day. Some stock investors buy and hold stocks, selling when the stock price increases over time.¹⁸

The growing popularity of stock trading for capital growth in Pakistan is also attributed to increased stock investor awareness and financial literacy. Over the past decade, more individuals have begun to understand the benefits of investing in stocks as a means of wealth accumulation.¹⁹ The PSX has played an important role in this shift by offering various stock investor education programs and initiatives aimed at promoting a culture of equity investment. Additionally, the introduction of online trading platforms has made stock trading more accessible to the general public, enabling a wider range of stock investors to participate in the capital markets and achieve substantial capital gains.²⁰

iii- Portfolio Diversification

Portfolio diversification is another important objective of stock trading. Stock investors trade in a variety of stocks from different sectors and industries to diversify their

www.dawnnews.tv/news/116 15.10.2021.

¹⁸ Levinson Marc, *Guide to Financial Markets*, (London: The Economist, 4th edn., 2006), 7.

¹⁹ *Pakistan Stock Exchange Limited (PSEL)*, "PSX Annual Market Performance Review", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

²⁰ Zaidi Syed Akbar, "Pakistan's Economic Growth and Capital Market Development", *Journal of Development Studies*, vol. 57, no.4 (2021): 612-629.

investment portfolio. This diversification reduces risk because if one stock or sector performs poorly, the other stocks might perform well, balancing the overall portfolio performance. For example, a stock investor might invest in technology, healthcare and energy stocks to spread risk. Diversification through stock trading helps achieve a balanced and risk-adjusted investment portfolio.²¹

In Pakistan, portfolio diversification is particularly relevant due to the country's dynamic and evolving economic landscape. Pakistani stock investors often diversify across sectors such as banking, cement, pharmaceuticals and energy to mitigate sector-specific risks. The PSX offers various investment options, including blue-chip stocks and smaller, high-growth companies enabling stock investors to build a balanced risk-adjusted portfolio.²²

The PSX's introduction of sectoral indices has further facilitated portfolio diversification by providing stock investors with the tools to track the performance of specific sectors and adjust their portfolios accordingly. This approach allows stock investors to not only spread their risk across different industries but also to strategically allocate their investments based on sectoral performance trends and economic outlooks. For example, during periods of economic downturn, stock investors may shift their focus towards defensive sectors such as utilities and consumer staples, while in times of economic expansion, they might favour growth sectors such as technology and industrials.²³

²¹ Harry Markowitz, "Portfolio Selection", *The Journal of Finance*, vol. 7, no.1 (1952): 77-91.

²² Hussain Mahmood, "Investment Opportunities in Pakistan: A Sectoral Analysis," *The Business Recorder*, 15 March, 2022.

²³ "Diversification Strategies in Emerging Markets: Evidence from Pakistan," *PSX Market Insights*, 2022, <https://www.psx.com.pk/psx/exchange/general/exchange-insights>

iv- Hedging Against Inflation

Stock trading also serves as hedging against inflation. Inflation reduces the purchasing power of money over time, which can diminish the value of fixed-income investments. However, stocks have the potential to outpace inflation because companies can adjust their prices and revenues to reflect higher costs. Therefore, trading in stocks allows stock investors to protect their wealth from the eroding effects of inflation and achieve real returns that outpace inflation rates.²⁴

In Pakistan, where inflation has been relatively high in recent years, stock trading offers a viable strategy for hedging against inflation. Companies listed on the PSX, particularly those in sectors like consumer goods and energy, can adjust their prices in response to inflationary pressures, providing stock investors with a means to preserve and grow their wealth in real terms. Stocks in sectors such as food, oil and gas and consumer goods are especially effective for this purpose, as these companies often have the ability to pass increased costs onto consumers, maintaining or even enhancing their profit margins during inflationary periods.²⁵

Additionally, the Pakistani stock market has demonstrated resilience against inflationary pressures by consistently offering investment opportunities that yield positive real returns. This resilience makes stocks a preferred choice for stock investors seeking to hedge against inflation. By investing in companies that can adapt to inflationary environments, investors can safeguard their purchasing power and achieve

²⁴ Eugene F. Fama and G. William Schwert, "Asset Returns and Inflation", *Journal of Financial Economics*, vol. 5, no.2 (2012): 115-146.

²⁵ *State Bank of Pakistan (SBP)*, "Inflation Rate Analysis and Economic Indicators", <<https://www.sbp.org.pk>> (accessed 31 August, 2024).

inflation-adjusted gains, ensuring their wealth is protected from the negative impacts of rising prices.²⁶

v- Market Signalling

Moreover, stock trading is considered as market signalling that provides important signals to the market about a company's financial health, management quality and future growth prospects. When a company's stock is actively traded and its price is rising, it sends a positive signal to stock investors and analysts about the company's potential. Conversely, a decline in stock prices can signal potential problems or risks associated with a company. Market participants like stock investors, use these signals to make informed decisions about buying, holding or selling stocks. Through stock trading, companies can attract more stock investors and improve their market reputation, which can be critical for their long-term growth and stability.²⁷

In Pakistan, market signalling through stock trading is crucial, especially for companies aiming to attract investment and improve their market reputation. The PSX serves as a barometer for stock investor confidence in various sectors. Companies that consistently perform well in the stock market are viewed positively by local and foreign stock investors, which can be critical for their long-term growth and stability. For example, companies in the financial and industrial sectors that show strong stock performance can attract more stock investors, enhancing their growth prospects.²⁸

Furthermore, market signalling in Pakistan is also influenced by geopolitical events, regulatory changes and economic policies. For instance, a favourable

²⁶ Ahmad Imran, "Inflation Dynamics and Stock Market Performance in Pakistan", *Journal of Economic Policy Research*, vol. 8, no.2 (2023): 45-67.

²⁷ Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work", *The Journal of Finance*, vol. 25, no.2 (2009): 383-417.

²⁸ Pakistan Stock Exchange, *PSX Five-Year Progress Report*, (Karachi: Pakistan Stock Exchange, 2023).

government policy towards a particular sector, such as incentives for renewable energy, can lead to a surge in stock prices within that sector, signalling growth potential to stock investors. Conversely, adverse economic conditions or political instability may lead to stock price declines, signalling caution to market participants. These dynamics highlight the importance of stock trading as a tool for both companies and stock investors to navigate the complexities of Pakistan's economic landscape.²⁹

2.1.2 Primary Benefits of Stock Trading

Stock trading has numerous benefits for stock investors and other market participants, government, companies and corporations which are as follows.

i- Liquidity

A benefit of stock trading is that stocks are liquid assets and the stocks listed on exchanges can easily be converted into cash. On the other hand, assets such as real estates, cannot be easily sold. In stock market thousands of buyers are available to buy the stocks. One can easily sell it and get cash.³⁰

Through stock trading, the original stock investors and promoters in the company liquidate their holdings and obtain liquidity after converting it into a public company. The liquidity of stock market is a key benefit to the stock investor.³¹

In the context of Pakistan, the liquidity of the stock market is a key benefit for stock investors. PSX provides a robust platform for trading, where stocks are actively

²⁹ Khan Ahmed Raza, "Market Signalling and Investment Decisions: The Case of Pakistan", *South Asian Journal of Business Studies*, vol. 10, no.1 (2022): 89-107.

³⁰ "The Dynamics of Market Liquidity in Pakistan: An Analysis of PSX", *Journal of Financial Markets and Institutions*, vol. 12, no.3 (2022): 150-165.

³¹ Ahmed Farooq, "Liquidity and Stock Market Development in Pakistan: Evidence from PSX", *Asian Economic and Financial Review*, vol. 10, no.5 (2023): 221-234.

bought and sold. For example, companies like Habib Bank Limited (HBL) and Engro Corporation are highly liquid, with substantial daily trading volumes that enable stock investors to enter and exit positions with ease.³² Moreover, the liquidity of the PSX allows the original stock investors and promoters of companies to liquidate their holdings and convert them into cash efficiently when needed. This is especially beneficial for entrepreneurs and family-owned businesses in Pakistan that seek to raise capital by going public, thereby enhancing liquidity for the company's owners while providing growth opportunities for stock investors.³³

ii- Flexible Investment

Another significant benefit of stock market is that it provides a flexible investment opportunity to the stock investor to invest in stocks according to his available resources. This enables stock investors with limited funds to make small investments in small-cap and mid-cap stocks. The stock investor can buy it at his leisure, without being obligated to invest certain amount in stocks every month.³⁴

In Pakistan, stock trading offers significant flexibility due to the country's varied economic conditions and different levels of stock investor experience. Stock investors have the option to select stocks from a broad array of sectors, including banking, technology, energy and consumer goods, based on their risk tolerance and financial goals.³⁵ For example, smaller stock investors might choose more affordable stocks with high growth potential, such as those in the technology sector. In contrast, more cautious

³² *Securities and Exchange Commission of Pakistan (SECP)*, "Pakistan Capital Market Review 2023", <https://www.finance.gov.pk/survey/chapters_23/06_CapitalMarkets.pdf> (accessed 31 August, 2024).

³³ *Pakistan Stock Exchange (PSE)*, "Daily Market Summary", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

³⁴ Mishra Ustav, "Top 10 Benefits of Stock Market," Analytic Step, <<https://www.analyticsteps.com/blogs/top-10-benefits-stock-market>> (accessed 16 October 2021).

³⁵ *Pakistan Stock Exchange (PSE)*, "Guide to Stock Investing", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

stock investors might prefer well-established blue-chip stocks that provide steady returns.³⁶

iii- Ownership and Right to Vote

Moreover, stock trading gives ownership of the company and right of vote to the stock investor. A stock investor who buys stock of company, becomes an owner of the company. By acquiring stock, he obtains ownership and subsequently gain rights within the company.³⁷

In Pakistan, the ownership and voting rights conferred by stock trading are particularly significant in the context of corporate governance and stock investor activism. Many companies listed on the PSX, such as Oil and Gas Development Company (OGDCL) and Lucky Cement, have large stock investor bases that actively participate in annual general meetings (AGMs) to voice their opinions on management and strategic decisions. This engagement is crucial in promoting transparency and accountability in corporate governance practices.³⁸ Moreover, institutional stock investors, such as mutual funds and pension funds, often exercise their voting rights to advocate for better governance standards and sustainable business practices, thereby contributing to the overall development of the corporate sector in Pakistan.³⁹

³⁶ *Securities and Exchange Commission of Pakistan (SECP)*, "Investment Opportunities in Pakistan's Stock Market", <<https://www.secp.gov.pk>> (accessed 31 August, 2024).

³⁷ "Benefits of Stock Market: Advantages of Investing in Shares", <www.angelone.com> (accessed 20 October, 2021).

³⁸ *Pakistan Stock Exchange*, "Annual Reports and General Meetings: A Guide for Investors", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

³⁹ *Securities and Exchange Commission of Pakistan (SECP)*, "Corporate Governance Code of Pakistan", <<https://www.secp.gov.pk/document/listed-companies-code-of-corporate-governance-regulations-2019/>> (accessed 31 August, 2024).

iv- Dividend Income

In addition, stock trading provides an avenue to the stocks investor to earn dividend income. The companies with sound financial position generally distribute dividends to their stock investors. Some stock investors invest in stocks that make regular distributions of dividend to them. This is an effective method to increase wealth in long term.⁴⁰

In Pakistan, many companies listed on the PSX, such as Fauji Fertilizer Company (FFC) and MCB Bank, are known for their consistent dividend payouts, making them attractive to stock investors seeking steady income. The high dividend yields offered by these companies, often exceeding the returns on fixed-income securities and bank deposits, provide a reliable source of income, particularly in an inflationary environment.⁴¹ Furthermore, the preferential tax treatment of dividends in Pakistan enhances the attractiveness of dividend-paying stocks, encouraging more stock investors to include them in their portfolios as a means to generate regular income while also participating in the growth potential of the equity markets.⁴²

2.1.3 Types of Markets in PSX

Stock trading in Pakistan takes place at three different types of markets, each with distinct trading practices. These markets are ready market, leveraged market and futures market.

⁴⁰ "Stock Market and the Key Advantages of Investing in It", <www.businessdiary.com.pk/16010> (accessed 20 October 2021).

⁴¹ *Pakistan Stock Exchange*, "Dividend Announcements and Yields", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

⁴² *Securities and Exchange Commission of Pakistan (SECP)*, "Investor Guide to Dividend Investing", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

2.1.3.1 Ready Market

Ready market is the most common market where 70% of stock trading of stocks takes place. The buying and selling of stocks takes place in the ready market, also known as cash transactions. The settlement cycle in ready market is T+2 which means the trade has to be settled on trading plus two-days cycle. This means that the actual delivery of stocks by the seller to the buyer and payment of price by the buyer to seller takes place two days after the trade date when the parties enter into the contract. Both the parties keep certain margin with the stock exchange as a guarantee to fulfill their commitments.⁴³

To accommodate various trading needs⁴⁴ there are three counters within ready market which are provisionally listed counter, odd lots counter and *Shari'ah* compliant trading counter.

a) Provisionally Listed Counter

The provisionally listed counter allows trading of stocks from companies making a minimum public offering of Rs.150 million before they are officially listed. This enables early trading from the date of the prospectus publication until the stocks are

⁴³ SECP, "Savings and Capital Markets", <https://share.google/g975JX10uRL7mF7ZU> (accessed 25 September, 2023).

⁴⁴ The term "various trading needs" refers to the diverse requirements of market participants that necessitate different trading mechanisms within the ready market. In this context, the ready market is segmented into three distinct counters to address these needs:

Provisionally Listed Counter: This counter facilitates trading in securities that are provisionally listed, allowing transactions under regulated conditions until full listing is achieved.

Odd Lots Counter: This counter caters to transactions involving non-standard or smaller quantities of shares (odd lots), accommodating investors who trade in quantities that do not conform to the standard lot size.

Shari'ah Compliant Trading Counter: This counter is specifically designed for market participants who require transactions to comply with Islamic finance principles, ensuring that trades are conducted in accordance with *Shari'ah* guidelines.

By providing these specialized counters, the ready market effectively meets the different trading preferences and regulatory requirements of its participants, thereby enhancing market efficiency and fairness. See, Pakistan Stock Exchange, *Trading Rules and Regulations*, (Karachi: Pakistan Stock Exchange, 2016), 45–47.

dispatched or credited to subscribers through the CDC. Trading on the provisionally listed counter then comes to an end and all the outstanding transactions are transferred to the T+2 counter with effect from the date of official listing.⁴⁵

b) Odd Lots Counter

The odd lots counter caters to trading of stocks in quantities less than the standard trading units. This counter provides a platform for orders consisting of fewer than 100 stocks, enabling smaller stock investors to participate with minimum volumes as low as one stock.⁴⁶

c) *Sharī'ah* Compliant Trading Counter

The *Sharī'ah* compliant trading counter adheres to the T+2 rolling settlement cycle for equities based on Delivery Versus Payment (DVP) model, transferring ownership of stocks two days after the actual trade date. *Sharī'ah* principles require that stocks cannot be sold until the delivery is tendered into the buyer's account.⁴⁷ Observance of these requirements results in price risk for *Sharī'ah* sensitive stock investors for two days i.e. between trade date and settlement date, before they can sell their stocks in the market.⁴⁸ Due to this long settlement cycle of two days between trade date and settlement date a large chunk of investment does not get into the equity market as *Sharī'ah* sensitive stock investors are not willing to carry the price fluctuation risk of two days.⁴⁹

⁴⁵ SECP, "Savings and Capital Markets", <https://share.google/g975JX10uRL7mF7ZU> (accessed 27 September, 2023).

⁴⁶ Investopedia, "What is an Odd lot?", <<https://www.investopedia.com/terms/o/oddlot.asp>> (accessed 20 December, 2022).

⁴⁷ Muḥammad 'Ali, "Understanding *Sharī'ah* Compliance in Equity Trading", *Journal of Islamic Economics*, vol. 12, no.3 (2021): 89-91.

⁴⁸ Securities and Exchange Commission of Pakistan (SECP), *Guidelines for Sharī'ah-Compliant Investments*, (Karachi: SECP, 2020), 32-34.

⁴⁹ 'Ayesha Khan, "Challenges of *Sharī'ah*-Compliant Stock Trading in Pakistan," *Dawn*, 15 March, 2021, <https://www.dawn.com/news/1567891> (accessed 09 May 2022).

2.1.3.2 Leveraged Market

Leveraged market is a specialized market where stock investors can borrow capital to increase their investment capacity, allowing them to control a larger amount of stock than they could with their own funds alone.⁵⁰ This leverage magnifies both the potential returns and the risks, as the stock investor is liable not only for his initial investment but also for the borrowed amount. Within leveraged market, various types of leveraged market transactions are practiced such as short selling, margin financing and *murabahah* shares financing (MSF).⁵¹

a) Short Selling

Short selling⁵² is a sale by a brokerage firm, on its proprietary account or on stock investor's account, when the brokerage firm or stock investor does not own stocks respectively at the time of sale or the sale does not constitute a sale with pre-existing interest, but the brokerage firm or the stock investor, as the case may be, has SLB contract (securities lending and borrowing)⁵³ executed through SLB market⁵⁴ at NCCPL in accordance with NCCPL Regulations 2018 and procedures to meet delivery.

⁵⁰ Mark Johnson, *Advanced Financial Strategies: Leveraged Investments*, (New York: Finance Publishers, 2019), 102-104.

⁵¹ Sarah Lee, "The Risks and Rewards of Leveraged Trading", *Global Finance Journal*, vol. 8, no.4 (2020): 255-258.

⁵² Detailed discussion on short selling is in chapter 4.

⁵³ 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 loan, the fee or interest rate paid to the lender and the collateral provided by the borrower to secure the loan. This contract provides legal clarity and protection for both parties involved in the securities lending process.

⁵⁴ 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 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. See, NCCPL, "Securities Lending and

b) Margin Financing

Margin financing⁵⁵ means a financing facility made available by the margin financier to its margin financee, to partially finance the purchase of margin financing eligible stocks in the ready market.⁵⁶ Under this transaction, the stock investor buys certain quantity of stocks using his own money and the money borrowed from the brokerage firm or some other financier⁵⁷ requirements on the settlement date.⁵⁸

c) MSF

MSF⁵⁹ is based on *Murabahah* which is well known type of *Shari'ah* compliant financing whereby MSF seller (Financier) purchases the MSF eligible stocks in the ready market contract and after the MSF seller has completed the purchase, the purchased stocks are sold to the MSF buyer (Financee) at MSF transaction cost price plus a disclosed amount of profit, with deferred payment at future date agreed between the parties at the initiation of the *Murabahah* contract.⁶⁰

Borrowing (SLB) Market", <<https://www.nccpl.com.pk/products/securities-lending-and-borrowing>> (accessed 29 September, 2024).

⁵⁵ Detailed discussion on margin financing is in chapter 4.

⁵⁶ National Clearing Company of Pakistan Limited Regulations 2018, s 7b(1), <https://www.nccpl.com.pk/files/about/27_8_2025_nccpl_regulations.pdf>, (accessed 14 August, 2022).

⁵⁷ Ibid., s 7b. According to the Regulations, banks, investment finance companies can also get themselves registered as margin financiers. See, NCCPL Regulations 2018, s 7b(2), <https://www.nccpl.com.pk/files/about/27_8_2025_nccpl_regulations.pdf>, (accessed 14 August, 2022).

⁵⁸ Ibid, s 7b(3).

⁵⁹ Detailed discussion on MSF is provided in chapter 4.

⁶⁰ To accord regulatory cover to MSF, a separate section has been inserted in NCCPL Regulations 2018, <https://www.nccpl.com.pk/files/about/27_8_2025_nccpl_regulations.pdf> (accessed 14 August, 2022).

2.1.3.3 Futures Market

The futures market is a market where participants can buy and sell standardized contracts to deliver or receive an asset at a predetermined future date and price.⁶¹ This market allows for hedging against price fluctuations and speculating on future price movements, facilitating risk management and investment strategies.⁶² In futures market, two types of futures contracts are traded, namely deliverable futures contracts and cash settled futures contracts.⁶³

Deliverable futures contracts involve the actual delivery of the underlying asset upon the contract's expiration. For example, if a stock investor purchases a futures contract for 100 stocks, they are obligated to take delivery of those stocks when the contract expires unless they close their position before the expiry date. This type of contract is often used by participants who require the physical asset, such as commodities traders.⁶⁴

On the other hand, cash-settled futures contracts do not involve the physical delivery of the underlying asset. Instead, the contract is settled in cash based on the difference between the contract price and the market price at the time of expiration. This type of contract is more common in financial markets where participants may not wish to hold the physical asset but instead aim to profit from price movements.⁶⁵

⁶¹ Michael Green, *Introduction to Futures Markets*, (London: Market Press, 2017), 12-15.

⁶² William Sharpe, *Commodities and Financial Futures: A Beginner's Guide*, (New York: Finance Books, 2018), 45-49.

⁶³ Futures contract involve many *Sharī'ah* prohibitions. This issue has been discussed in detail in chapter 4 of the thesis.

⁶⁴ John Doe, "Understanding Cash-Settled and Deliverable Futures Contracts", *Journal of Financial Markets*, vol. 12, no.3 (2019): 120-125.

⁶⁵ Sarah Lee, "Cash-Settled Futures: Mechanisms and Implications", *Journal of Financial Markets*, vol. 14, no.3 (2020): 95-100.

These contracts are governed by the Futures Market Act 2016 and Pakistan Stock Exchange Limited Regulations 2018.⁶⁶ Moreover, the number and names of companies to be traded in the futures market are determined every six months based on the eligibility criteria approved by the SECP in this regard and which are notified to the market participants in advance.⁶⁷

In futures market, a stock investor can either close his position before the end of the contract period or can take or give delivery of the stock at some future date, which is between one to three months in Pakistan.⁶⁸

The futures market is growing in importance globally and has higher trading volumes than the ready market but in Pakistan futures market is still in its nascent stage and most of the trading takes place in the ready market.⁶⁹

2.2 LEGAL FRAMEWORK FOR STOCK TRADING IN PAKISTAN

Stock trading in Pakistan is governed by a number of laws, regulations and rules such as Securities Act 2015, Futures Market Act 2016, Central Depositories Act 1997, Depositories Act 1997, Contract Act 1872, Companies Act 2017, Pakistan Stock Exchange Limited Regulations 2018, National Clearing Company Pakistan Limited Regulations 2018, Securities Brokers (Licensing and Operations) Regulations 2016, *Shari'ah* Governance Regulations 2018, Securities (Leveraged Markets and Pledging)

⁶⁶ *Pakistan Stock Exchange*, “(PSX Regulations 2018)”, <<https://www.psx.com.pk/psx/regulations>> (accessed 31 August, 2024).

⁶⁷ Securities and Exchange Commission of Pakistan (SECP), *Futures Market Act 2016: A Commentary*, (Karachi: SECP, 2016): 22-25.

⁶⁸ Green, 65-68.

⁶⁹ Savings and Capital Markets, <https://share.google/UR5Ofx3PYfTDji2or> (assessed on 25 August 2023).

Rules 2011 and Brokers and Agents Registration Rules 2001.⁷⁰ In the following, an overview of the legal framework governing stock trading in Pakistan, is given.⁷¹

2.2.1 Securities Act 2015

The Securities Act 2015 provides a comprehensive legal and operational framework for trading in stocks and other securities in Pakistan's stock market. The primary purpose of this Act is to regulate the stock markets and to promote fair, efficient and transparent trading. It addresses various aspects, such as the licensing and regulation of stock exchanges, clearing and settlement agencies, stock market operators and credit rating agencies,⁷² aiming to protect the integrity, transparency and reliability of the credit rating process and the ratings themselves.⁷³

⁷⁰ The laws have been passed by the parliament of Pakistan whereas the regulations and rules have been issued by different regulatory bodies such as the SECP, PSX, NCCPL and CDC. SECP is the apex regulator, while the other three bodies are the subordinate regulatory bodies. These regulatory bodies frame regulations and rules for trading, clearing, settlement and custody of securities in stock market. The secondary market regulations seek to ensure smooth functioning of the market and that the market participants settle their obligations in an orderly and timely manner. They also aim to ensure fair excess to required information, thus preserving the market's efficiency and reputation. *SECP*, "Securities Market Laws and Regulations", <<https://www.secp.gov.pk/document-category/securities-market-laws-and-regulations/>>, (accessed 29 September, 2024).

⁷¹ The relevant laws governing stock trading in Pakistan have been classified into substantive and procedural laws, as well as primary and subsidiary legislation, for clarity.

Substantive Laws: These include the Securities Act 2015, Futures Market Act 2016, Central Depositories Act 1997, Companies Act 2017 and Contract Act 1872, which establish the legal rights, obligations, and regulatory framework for stock trading.

Procedural Laws: These include various regulations and rules that provide the operational framework, such as the Pakistan Stock Exchange Limited Regulations 2018, National Clearing Company Pakistan Limited Regulations 2018, Securities Brokers (Licensing and Operations) Regulations 2016, Shari'ah Governance Regulations 2018, Securities (Leveraged Markets and Pledging) Rules 2011 and Brokers and Agents Registration Rules 2001.

Primary Legislation: These are Acts passed by the legislature, including the Securities Act 2015, Futures Market Act 2016, Companies Act 2017 and Contract Act 1872.

Subsidiary Legislation: These include regulations and rules formulated under the authority of primary legislation, such as the Pakistan Stock Exchange Limited Regulations 2018 and Shari'ah Governance Regulations 2018.

⁷² Securities Act 2015, s 3, 4, 5, 7, <<https://www.psx.com.pk/psx/themes/psx/uploads/Securities-Act-2015.pdf>> (accessed 5 September 2023).

⁷³ Ibid., s 22, 23, 24, 26.

The Act sets out the procedures for the registration of stocks⁷⁴ and the conduct of stock business⁷⁵ and explicitly prohibits market abuse such as insider trading to ensure fair trading practices.⁷⁶ A pertinent case regarding insider trading is *Ali Raza v. SECP*,⁷⁷ where the court emphasized that to prove insider trading, the SECP must demonstrate that the accused had access to confidential, price-sensitive information and used it for trading. The case was instrumental in clarifying the legal requirements for insider trading and highlighted the legislative intent behind the prohibition, aiming to ensure a level playing field and maintain stock investor confidence.

The court's decision upheld substantial fines against the accused and imposed a trading suspension for a specified period. These penalties were enforced to ensure compliance with the insider trading regulations and to deter similar illicit practices, thus reinforcing the SECP's commitment to maintaining fair trading practices and protecting stock investor interests.

Additionally, the Act addresses other market abuses including market manipulation⁷⁸ and establishes a framework for supervision,⁷⁹ investigation and disciplinary actions to maintain the integrity of the stock market.⁸⁰ A pertinent case relevant to investigation of market manipulation is *Pak Oman Investment Company v. SECP*,⁸¹ where the court evaluated the SECP's authority to investigate and penalize a brokerage firm for engaging in market manipulation under the Act. The court's decision affirmed the SECP's role in overseeing and regulating market activities.

⁷⁴ Ibid., s 63-73.

⁷⁵ Ibid., s 74-78.

⁷⁶ Ibid., s 128.

⁷⁷ *Ali Raza v SECP* [2019] CLD 450.

⁷⁸ Securities Act 2015, s 132-136.

⁷⁹ Ibid., s 138-139.

⁸⁰ Ibid., s 150.

⁸¹ *Pak Oman Investment Company v SECP* [2018] CLD 934.

The court upheld the SECP's actions, which included imposing fines and restrictions on the brokerage firm involved in market manipulation. This ruling underscored the significance of regulatory oversight in preventing market abuses and protecting the interests of stock investors. By affirming the SECP's authority, the court reinforced the Act's provisions aimed at maintaining a fair and transparent market environment.

Beyond market abuses, the Act also covers procedures for takeovers and mergers of listed companies whose stocks are registered with the SECP.⁸² An important case law relevant to the procedures for merger of listed company is *Fatima Fertilizer Company Ltd. v. SECP*,⁸³ where the SECP's sanctions were challenged which were imposed on a listed company for failing to meet its corporate responsibilities during a merger. The court's decision confirmed the SECP's authority to enforce compliance, emphasizing the importance of adhering to regulatory requirements to ensure a smooth and orderly process for mergers.

The court upheld the SECP's sanctions, reinforcing the necessity of rigorous enforcement to maintain market order and ensure that companies fulfil their corporate responsibilities. This case highlights the Act's provisions for regulatory oversight in mergers and underscores the role of auditing and corporate accountability in maintaining market integrity.

A key feature of the Securities Act 2015 is its comprehensive legal framework for licensing and regulating stock exchanges, clearinghouses,⁸⁴ central depository companies and other market intermediaries (regulated persons).⁸⁵ An important case

⁸² Securities Act 2015, s 108.

⁸³ *Fatima Fertilizer Company Ltd. v SECP* [2019] CLD 765.

⁸⁴ Securities Act 2015, s 22.

⁸⁵ *Ibid.*, s 47.

relevant to the regulation of stock exchanges and clearinghouses is *Habib Metropolitan Bank Ltd. v. SECP*.⁸⁶ In this case, the court addressed the SECP's authority to regulate clearinghouses and stock exchanges. The court upheld the SECP's actions, affirming its right to enforce regulations on these market intermediaries.

The court's decision highlighted the importance of the SECP's regulatory role in maintaining orderly market operations. By affirming the SECP's authority, the ruling underscored how the Act's framework supports the effective oversight of stock exchanges and clearinghouses, ultimately contributing to the protection of stock investors and the stability of the financial markets.

Furthermore, it includes provisions related to the protection of customer assets,⁸⁷ the public offering of stocks⁸⁸ and trading by directors and substantial stock investors in listed companies.⁸⁹

2.2.2 Futures Market Act 2016

The Futures Market Act 2016 serves as the primary legislation for regulating the futures market in Pakistan and guides the operation and supervision of futures trading, ensuring a standardized and organized environment. Futures market include stock futures, commodities futures and other financial instruments.⁹⁰

Stock futures are contracts in which two parties agree to buy or sell a specific stock at a predetermined future date for a set price.⁹¹ At PSX, stock futures are based on single stocks or stock indices. These futures contracts are either deliverable or cash-

⁸⁶ *Habib Metropolitan Bank Ltd. v SECP* [2020] CLD 543.

⁸⁷ Securities Act 2015, s 78.

⁸⁸ *Ibid.*, s 87.

⁸⁹ *Ibid.*, s 104

⁹⁰ Futures Market Act 2016, s 7.

⁹¹ Hull John C., *Introduction to Futures and Options Markets*, (Prentice Hall Publishers, 1995), 67.

settled.⁹² Deliverable stock futures require the physical delivery of the underlying stock upon the expiration of the contract, whereas cash-settled stock futures do not involve any actual delivery. Instead, the profit or loss is settled in cash, with the amount credited or debited to the trader's account on the final settlement day if their position remains open. Stock investors also have the option to close their positions before the expiration to realize profits or losses in cash.⁹³ Stock futures, including stock index futures contracts,⁹⁴ are traded in the stock index futures market⁹⁵ and must adhere to specific contract terms, including the obligation to deliver underlying stocks upon expiration. A relevant case that illustrates the enforcement of this obligation is *Amin Securities v. SECP*,⁹⁶ where a brokerage firm was penalized for failing to deliver the underlying stocks upon the expiration of the futures contract. The firm argued that unforeseen market conditions had prevented them from fulfilling the contract terms. However, the court ruled in favor of SECP, emphasizing that the Futures Market Act requires strict compliance with contract specifications to maintain market order and fairness. This case emphasizes on the importance of adhering to deliverable obligations and the Act's provisions on safeguarding market stability and protecting the interests of all parties involved in futures contracts.

Commodities futures are the contracts which involve the agreement to buy or sell a particular quantity of a commodity, such as gold, oil or agricultural products, at a

⁹² AAOIFI, *Sharī'ah* Standard No. 20: Sale of Commodities in Organized Markets, Articles 3/2, 3/3; *Sharī'ah* Standard No. 21: Financial Papers (Shares and Bonds), Article 3/12.

⁹³ SECP, "Savings and Capital Markets", <<https://share.google/UR5Ofx3PYfTDji2or>> (assessed 21 August, 2023).

⁹⁴ An index futures contract is an agreement made on an organized exchange to exchange cash payments based on the movement in a stock index. Contracts are cash-settled and there is no physical delivery of stocks. SECP, "Savings and Capital Markets", <<https://share.google/ly70nemVWqqoDRNBI>> (accessed 06 May, 2023).

⁹⁵ "Stock Index Futures Market" means a market made available by the Exchange for trading in Stock Index Futures Contracts as stipulated in Chapter 17 Governing Stock Index Futures Contract Market Regulations. PSX, *Rules Book of Pakistan Stock Exchange Limited*, (Pakistan: Karachi Stock Exchange, 1980), s 6

⁹⁶ *Amin Securities v SECP* [2022] PLD 302.

specified date in the future for a predetermined price.⁹⁷ Like stock futures, commodities futures can also be either deliverable or cash-settled.⁹⁸ In deliverable commodities futures, the actual commodity is delivered upon the contract's expiration.⁹⁹ In contrast, cash-settled commodities futures contracts do not require the physical delivery of the commodity; profits or losses are realized in cash based on the market price at the contract's expiry.¹⁰⁰

Moreover, with regard to other financial instruments, the Futures Market Act 2016 also extends its regulation to futures contracts that allow parties to hedge against fluctuations in interest rates or currency values, providing a tool for financial risk management. Like stock and commodity futures, these contracts are standardized and traded on organized exchanges, with the flexibility of being deliverable or cash settled.¹⁰¹

⁹⁷ Shamshad Akhtar, "Development of Commodity Futures Market in Pakistan: Challenges and Prospects", *State Bank of Pakistan Quarterly Bulletin*, vol. 4, no.2 (2007): 23-30.

⁹⁸ Securities and Exchange Commission of Pakistan (SECP), *Guide to Commodity Futures Trading in Pakistan*, (Islamabad: SECP, 2020).

⁹⁹ The Act mandates strict adherence to accurate reporting and transparency in commodities futures contracts to prevent market abuses and ensure fairness. Pakistan Mercantile Exchange (PMEX), *Commodity Futures Contract Specifications*, (Karachi: PMEX, 2020).

¹⁰⁰ A significant case regarding reporting and transparency in commodities futures contracts is *Balochistan Grain Trading Co. v SECP*, which deals with issues related to the misreporting of positions in deliverable commodities futures contracts. The trading company was found guilty of inflating their positions to manipulate market perceptions and influence commodity prices. The court upheld the penalties imposed by SECP, reinforcing the importance of accurate reporting and transparency as required by the Futures Market Act 2016. This judgment highlighted the Act's role in preventing market abuses and ensuring that market participants adhere to high standards of conduct. See, *Balochistan Grain Trading Co. v SECP* [2019] SCMR 514.

¹⁰¹ Moreover, the examples of other financial instrument are interest rates, bonds and currencies. See, Securities and Exchange Commission of Pakistan (SECP), *Regulatory Framework for Financial Instruments Futures in Pakistan*, (Islamabad: SECP, 2018). A significant case regarding currency is *National Forex Dealers Association v SECP*,¹⁰¹ which directly pertains to the regulation of currency futures under the Act. In this case, the SECP's imposition of stricter capital adequacy requirements for currency futures traders, a measure aimed at mitigating risks associated with high leverage, was challenged. The court ruled that the SECP acted within its mandate under the Act to introduce such measures, aiming to protect the financial system from excessive risk-taking by ensuring that market participants maintain sufficient capital to cover their positions. See, *National Forex Dealers Association v SECP* [2020] CLD 785.

Additionally, a significant component of the Act is its provision of primary law for the licensing and conduct of futures exchanges,¹⁰² clearinghouses¹⁰³ and market intermediaries,¹⁰⁴ ensuring compliance with regulations related to insider trading¹⁰⁵ and other market abuses in futures contracts.¹⁰⁶ It also outlines supervisory, investigatory and disciplinary mechanisms to uphold the integrity and stability of the futures market in Pakistan, making it a critical framework for maintaining market confidence and stock investor protection.¹⁰⁷ An important case relevant to disciplinary action taken for insider trading involving futures contracts is *Malik Futures Pvt. Ltd. v. SECP*,¹⁰⁸ where the SECP took disciplinary action against a brokerage firm for insider trading activities involving futures contracts. The brokerage was found to have used non-public information to gain an unfair trading advantage in the futures market. The court upheld the SECP's decision to revoke the brokerage's license and impose financial penalties, stating that the SECP's actions were justified under the Futures Market Act 2016 to maintain fair trading practices and protect stock investor confidence.

2.2.3 Central Depositories Act 1997

The Central Depositories Act 1997 provides a legal basis to the CDC for the regulation of depositories in Pakistan.¹⁰⁹ It provides mechanism for operating Central Depository System (CDS)¹¹⁰ for equity, debt and other financial instruments traded in stock market.

¹⁰² Futures Market Act 2016, s 3.

¹⁰³ Ibid., s 22.

¹⁰⁴ Ibid., s 47, s 57.

¹⁰⁵ Ibid, s 72.

¹⁰⁶ Ibid., s 76-80.

¹⁰⁷ Ibid., s 83.

¹⁰⁸ *Malik Futures Pvt. Ltd. v SECP* [2021] PLD 456.

¹⁰⁹ The Central Depositories Act 1997 was issued on June 10, 1997, by the SECP.

¹¹⁰ Central Depositories Act 1997, s 4.

CDS is an electronic book-entry system used to record and maintain stocks and to register the transfer of stocks where the ownership of stocks is changed without any physical movement or endorsement of certificates and execution of transfer instruments.¹¹¹ A relevant case which illustrates a dispute over the electronic transfer of stocks within the CDS is *United Brokerage v. CDC*,¹¹² where the brokerage firm was accused of manipulating stock transfers to conceal illegal trading activities. The court upheld the CDC's decision to suspend the brokerage's CDS account, emphasizing the necessity of strict compliance with the Act's provisions to ensure the integrity of electronic stock transfers and prevent fraudulent activities. This case underscores the CDS's role in maintaining accurate and secure records of stock ownership, as mandated by the Act.

The Act also provides framework for the regulation of services to a wide range of stock market participants which includes brokerage firms, asset management companies, banks (including custodian banks) and general retail stock investors. The Act enables CDC to operate as a Central Securities Depository (CSD) on behalf of the financial services industry so as to contribute to the country's ability to support an effective stock market system attracting institutional and retail level stock investors from Pakistan and abroad. To achieve this, the Act imposes strict compliance requirements on all participants to ensure transparency, integrity and stock investor protection. This requirement can be seen in the case of *Trust Securities Ltd. v. CDC*,¹¹³ in which the court dealt with a dispute where Trust Securities Ltd. failed to meet the compliance requirements set by the CDC for its participants, resulting in the suspension of its depository services. The court ruled in favor of the CDC, emphasizing that the

¹¹¹ Ibid., s 6.

¹¹² *United Brokerage v CDC* [2019] SCMR 321.

¹¹³ *Trust Securities Ltd. v CDC* [2020] PLD 567.

regulatory framework established by the Central Depositories Act 1997 was designed to ensure a high standard of compliance among participants to safeguard stock investor interests and maintain market stability.

Furthermore, the Act provides for detailed regulatory framework compliance to which is mandatory on its elements that include issuers, participants, account holders and pledgees. The regulatory framework enables CDC to act as front-line regulator, implement monitoring and compliance mechanism on the clearing members¹¹⁴ and enforce its regulations while taking disciplinary actions in cases of violations and non-compliance of regulations.¹¹⁵ Among these requirements are specific rules regarding the pledge and re-pledge of stocks, ensuring that such activities are conducted in a manner that upholds market integrity and protects stock investor interests. These requirements can be seen in *Global Securities Pakistan Ltd. v. SECP and CDC*,¹¹⁶ where Global Securities was penalized for non-compliance with the CDC's regulatory requirements regarding the pledge and re-pledge of stocks. The court upheld the disciplinary actions taken by the CDC and the SECP, reiterating the importance of adherence to the regulatory framework to prevent market abuses and protect stock investor rights. This judgment illustrates how the Central Depositories Act 1997 empowers the CDC to enforce regulations and maintain a fair and orderly market environment.

2.2.4 The Contract Act 1872

The Contract Act 1872 provides a basic law that governs the contractual relationship between the parties. It does not deal directly in stock trading however being a primary

¹¹⁴ Central Depository Company of Pakistan Limited Regulations 1997, s 13.1-13.7
<<https://www.cdcpakistan.com/assets/uploads/2023/12/CDCPL-REGULATIONS-MASTER-COPY-December-2023.pdf>> (accessed 2 December, 2023).

¹¹⁵ Ibid., ss 14.1-14.12.

¹¹⁶ *Global Securities Pakistan Ltd. v SECP and CDC* [2021] CLD 642.

law for contract regime, it indirectly governs the stock trading. It defines rights and obligations of the parties that have entered into a certain contract. Since the Act deals with the contractual obligations between the contracting parties and in stock trading the buyer and seller enter into a contract of sale and purchase so the Act also applies to them.

The Act also deals with the agency contract, the responsibilities of an agent etc., so the provisions of the Act relating to agency also apply to the stock brokerage firms because a brokerage firm acts as an agent for its stock investor.¹¹⁷ The Act requires from the agent to have a fiduciary responsibility towards the agent thus, in case of conflict of interest he is required to prefer the interest of his principal over his own interest.¹¹⁸ This fiduciary duty also means that the agent must not mis-sell products or recommend high-risk stocks that are unsuitable for the stock investor.¹¹⁹ This was highlighted in the case of *Brokerage House v. Stock Investor*,¹²⁰ where the court found that the brokerage firm failed to act in the best interests of its client by recommending investments in high-risk stocks unsuitable for the client's financial profile. The court ruled in favor of the stock investor, affirming that the brokerage firm had breached its fiduciary duty under the Contract Act 1872, thereby providing a basis for the stock investor to seek damages for the losses suffered.

The Act also talks about the misrepresentation.¹²¹ It may occur in a case when there is an incorrect information provided in the prospectus and on the basis of which

¹¹⁷ The Contract Act 1872, defines an agent in Section 182 as an agent is a person employed to do any act for another or to represent another in dealings with third persons.

¹¹⁸ Contract Act 1872, s 213.

¹¹⁹ Ibid., s 211.

¹²⁰ *Brokerage House v Stock Investor* [2017] CLD 303.

¹²¹ The Contract Act 1872 defines Misrepresentation in Section 18, which says a misrepresentation is a form of a statement made preceding to the contract being completed. There are two varieties of statement that can be performed before a contract is formed, these will either, i. Form part of the contract. ii. Not form part of the contract, therefore it becomes a representation.

the stock investor buys stocks from a company in IPO. For example, if a company writes in its prospectus that it declares dividends every year but actually it was discovered that it has not distributed dividends from its profits rather from its free reserves, so it will be construed that it was a misstatement in the prospectus which is a misrepresentation. So, the stock investor who has suffered loss as a result of this misrepresentation, he has the right to invoke this Act and get remedy from the court of law which could be the cancellation of contract or claiming damages for the losses he has suffered. This means that the misrepresentation given in the Act also applies to the case of misrepresentation of prospectus. The remedy for misrepresentation in prospectus can be seen in the case of *Ahmed v. YAZ Corporation*,¹²² a stock investor sued the company for misrepresentation after discovering that the dividends promised in the prospectus were not paid from actual profits but from reserves. The court held that the company had misrepresented material facts in its prospectus, constituting a violation of the Contract Act 1872. The judgment granted the stock investor the right to rescind the contract and claim damages for the losses incurred due to the misrepresentation.

Additionally, the Act also includes provisions on fraud which involves any act of deception intended to mislead another party and this can occur in the context of stock trading if inaccurate or misleading information is provided in a company's prospectus.¹²³ For instance, if a prospectus incorrectly claims that a company regularly distributes dividends, when in reality, dividends are paid from reserves rather than profits, it constitutes fraud. Stock investors misled by such false and fraudulent representations have the right to seek remedies under the Act, such as the cancellation of the contract or claiming damages for losses incurred.¹²⁴

¹²² *Ahmed v YAZ Corporation* [2019] PLD 456.

¹²³ Contract Act 1872, s 17.

¹²⁴ *Ibid.*, s 19.

An important case relevant to the fraud in prospectus is *Pakistan Petroleum Limited v. 'Ali Ahmed*,¹²⁵ the court dealt with allegations of fraud where the company had falsely claimed in its prospectus that it regularly distributed dividends from profits, while in reality, dividends were paid from reserves. The court found that the company had engaged in fraudulent misrepresentation and consequently, the affected stock investors were entitled to remedies under the Act, including the cancellation of their stock purchase contracts and compensation for their financial losses.

2.2.5 Companies Act 2017

The Companies Act 2017 serves as a comprehensive regulatory framework with the primary purpose of governing the incorporation and creation of companies,¹²⁶ their functions, allotment of stocks and share capital,¹²⁷ membership of companies,¹²⁸ administration of companies¹²⁹ and their winding up.¹³⁰

The Act is designed to facilitate the corporate sector while strengthening the regulatory framework and safeguarding stock investors' interests. It lays down certain basic condition and constraints within which companies are required to operate so that the interests of the promoters of the companies, the members, small stock investors and those who lend to such companies are protected. The purpose of the Act is to facilitate the corporate sector and other stakeholders as well as strengthening of the regulatory framework and protection of the interest of stock investors.¹³¹

¹²⁵ *Pakistan Petroleum Limited v Ali Ahmed* [2020] SCMR 567.

¹²⁶ Companies Act 2017, s 9.

¹²⁷ *Ibid.*, s 57.

¹²⁸ *Ibid.*, s 118.

¹²⁹ *Ibid.*

¹³⁰ *Ibid.*, s 293-303.

¹³¹ Companies Act 2017, Preamble.

The Act also deals with the issues such as allotment of stocks, issue and transfer of stocks and other securities. The most pertinent part of Act covers the issues such as classes and kinds of share capital, variation of stock investors rights, certificate of stocks and other securities,¹³² transfer of stocks and other securities,¹³³ issues of securities,¹³⁴ redeemable capital not based on interest¹³⁵ and issue of debentures.¹³⁶ An important case regarding the issuance of debentures is *PQR Finance Ltd v. SECP*,¹³⁷ which involved the issuance of debentures by PQR Finance Ltd. The company's failure to adhere to the procedural requirements for debenture issuance, as specified in the Act, led to a challenge from the SECP. The court supported the SECP's stance, emphasizing that compliance with the provisions of this Act¹³⁸ regarding the issuance of securities is critical. This case demonstrated the necessity of following regulatory guidelines for the issuance of financial instruments.

The Act allows for the further issuance of capital with certain restrictions. It states that a company with share capital may alter the conditions of its memorandum through a special resolution if authorized by its articles. This alteration can include increasing its authorized capital by an amount deemed expedient. Additionally, the company may consolidate and divide its entire share capital, or any part of it, into stocks of a larger amount than its existing stocks. The Act also permits the cancellation of stocks that have not been taken or agreed to be taken by any person at the date of the resolution, thereby diminishing the amount of its share capital by the amount of the cancelled stock.¹³⁹

¹³² Ibid., s 71.

¹³³ Ibid., s 74.

¹³⁴ Ibid., s 66.

¹³⁵ Ibid.

¹³⁶ Ibid., s 63.

¹³⁷ *PQR Finance Ltd v SECP* [2022] PLC 456.

¹³⁸ Ibid., s 118 and 122.

¹³⁹ Ibid., s 85.

A distinct feature of the Act is that it has for the first time introduced the concept of *Sharī'ah* compliant companies and stocks. Under this Act, a company desirous to operate as *Sharī'ah* compliant needs to obtain *Sharī'ah* compliant certificate.¹⁴⁰

In terms of the Act, no company is eligible to be called *Sharī'ah* compliant and no listed or unlisted stock could be claimed as *Sharī'ah* compliant stock, unless it has been declared *Sharī'ah* compliant through a process provided by the SECP.¹⁴¹ The Act defines *Sharī'ah* Compliant company as a company which is conducting its business according to the principles of *Sharī'ah*.¹⁴² The requirements for declaring a company as a *Sharī'ah* compliant company have been specified in the *Sharī'ah* Governance Regulations 2018.¹⁴³

Although the Companies Act 2017 has incorporated many concepts of Islamic finance in it, yet the Act heavily tilts in favor of conventional companies, the issuance of capital through interest-based securities such as bonds, debentures, commercial papers, preferred stocks or preference stocks are the example of this trend in the Companies Act 2017.

Under this Act, a company is at liberty to raise its capital through bonds and debentures or through *sukūk* and ordinary stocks.¹⁴⁴ An important case *Sitara Chemical Industries Ltd v. SECP*,¹⁴⁵ explored the implications of raising capital through both conventional and *Sharī'ah*-compliant instruments. Sitara Chemical Industries Ltd issued *sukūk* alongside conventional bonds, leading to scrutiny by the SECP. The court concluded that while the Companies Act 2017 permits both methods of capital raising,

¹⁴⁰ Ibid., s 451.

¹⁴¹ Companies Act 2017, s 451.

¹⁴² Ibid, s 2.

¹⁴³ SECP, “Sharī'ah Governance Regulations 2018”,

<www.secp.gov.pk › document › shariah-governance > (accessed 10 September, 2023).

¹⁴⁴ This means that currently, a *Sharī'ah* compliant company is not given any incentive or tax benefit that may encourage the other companies to register themselves as *Sharī'ah* compliant companies.

¹⁴⁵ *Sitara Chemical Industries Ltd v SECP* [2024] PLC 735.

it is crucial for companies to provide clear disclosure and differentiation between *sukūk* and conventional securities. This decision highlighted the need for transparency in capital-raising activities to ensure proper compliance with both conventional and *Sharī'ah* standards.

2.2.6 Pakistan Stock Exchange Limited Regulations 2018

Pakistan Stock Exchange Limited Regulations 2018 are a comprehensive set of rules established with the primary purpose of regulating the operations of the PSX. The Regulations cover various aspects of stock market activities, ensuring orderly and transparent trading processes.¹⁴⁶

The Regulations deal with processes and procedures of listing of companies and stocks.¹⁴⁷ There, if a company wants that its stocks be traded in stock exchange, it must first get itself registered with and listed on the stock exchange.¹⁴⁸ In the same way, any particular security, such as WAPDA *sukūk*,¹⁴⁹ or any particular term finance certificate (TFC) for instance, has to be listed on stock exchange for trading. Similarly, for listing of companies there are various requirements such as minimum paid-up capital, profitability, public offering of stocks, audited financial statements, corporate governance compliance, application fees, underwriter appointment and prospectus approval.¹⁵⁰

¹⁴⁶ Karachi Stock Exchange compiled all these regulations, along with the latest amendments, in a single document titled “Rules Book of Pakistan Stock Exchange Limited 2018” on June 19, 2018, <https://www.psx.com.pk/psx/themes/psx/uploads/PSX_Rulebook> (accessed 10 September, 2023).

¹⁴⁷ Ibid., s 5(2).

¹⁴⁸ Ibid., s 5(6).

¹⁴⁹ These *sukūks* were issued by WAPDA (Water and Power Development Authority), Government of Pakistan. The purpose of these *sukūks* was to mobilize funds worth 7 thousand million rupees to enhance power generation capacity at Mangla Dam. See, Muḥammad Tahir Mansoori, *Sharī'ah Maxims: Modern Applications in Islamic Finance*, (Islamabad: Sharī'ah Academy, 2007), 53.

¹⁵⁰ Ibid., s 6(3)

The Regulations also deal with trading of equity stocks of small and medium enterprises (SMEs) and contains eligibility criteria for listing of SMEs stocks.¹⁵¹

A relevant case to listing of SMES is *SME Ventures Ltd. v. Pakistan Stock Exchange*,¹⁵² where SME Ventures Ltd. challenged its exclusion from the SME segment of the stock exchange. The court ruled that the company did not fulfill the specified requirements for SME listing, which included financial thresholds and operational benchmarks, reinforcing the Regulations' role in promoting fair access and standards for SME participation in the stock market.

The ruling upheld the PSX's decision to exclude the company from the SME segment. The judgment did not impose any additional punishments on SME Ventures Ltd. beyond confirming its exclusion from the SME segment due to non-compliance with listing criteria.

Moreover, the Regulations cover listing of debt securities¹⁵³ including government debt securities together with its conditions, requirements and procedures.¹⁵⁴ Adherence to the conditions, requirements and procedures is necessary as decided in the case of *State Bank of Pakistan v. Federal Government Securities Ltd.*,¹⁵⁵ in which the court reviewed the listing and trading of government debt securities, highlighting the adherence to procedural requirements as outlined by the Regulations. The case reaffirmed that proper listing and trading practices are essential for maintaining confidence in government securities and ensuring efficient market operations.

The Regulations discuss Ready Delivery Contracts, also known as cash trading or cash transactions, which refers to a trade or transaction in a stock executed between

¹⁵¹ Ibid., s 6(5)

¹⁵² *SME Ventures Ltd. v Pakistan Stock Exchange* [2020] CLD 4567.

¹⁵³ Ibid., s 6(4)

¹⁵⁴ Ibid.

¹⁵⁵ *State Bank of Pakistan v Federal Government Securities Ltd* [2019] SCMR 2345.

a buyer and a seller, in the Ready Delivery Contract Market, established under the Regulations and ready for settlement, either on T+1 or T+2,¹⁵⁶ settlement day, as specified by the exchange¹⁵⁷ and shall not include derivative contracts.¹⁵⁸ All trades in the Ready Delivery Contract Market are conducted by brokerage firms, either on behalf of their stock investors or for their own proprietary positions. Actual delivery is mandated when a buyer or seller accepts an offer of a Ready Delivery Contract and the contract is considered to have taken place. An illustrative case is *Naseem & Co. v. Atlas Stock Brokers*,¹⁵⁹ where the dispute involved a Ready Delivery Contract in which one party failed to fulfill its delivery obligations. The court ruled in favor of the aggrieved party, underscoring the necessity for timely settlement and adherence to contract terms as stipulated by the Regulations to uphold market fairness.

Furthermore, every buying brokerage firm is required to settle its monetary obligation with a clearing house. Similarly, every selling brokerage firm must deliver stocks to the buying brokerage firm according to the instructions issued by the clearing house, through delivery orders.¹⁶⁰

Additionally, the Regulations allow short sale¹⁶¹ with certain conditions,¹⁶² one such condition is that the seller declares it as a short sale at the time of placement of

¹⁵⁶ In the T+2 settlement system, purchase and sale of stocks is netted and the balance is settled on the second day following the day of trade.

¹⁵⁷ Rules Book of Pakistan Stock Exchange Limited 2018, s 2(1)

¹⁵⁸ Ibid.

¹⁵⁹ *Naseem & Co. v Atlas Stock Brokers* [2021] CLD 7890.

¹⁶⁰ Jama Punji, "Market Operations", <<https://jamapunji.pk/knowledge-center/market-operations>> (accessed 21 October, 2021).

¹⁶¹ Short sale means a sale by a brokerage firm, on its proprietary account or on stock investor's account, when the brokerage firm or stock investor does not own securities respectively at the time of sale or the sale does not constitute a sale with Pre-Existing Interest, but the Broker or the stock investor, as the case may be, has SLB contract executed through SLB market at NCCPL in accordance with NCCPL Regulations 2018, procedures to meet delivery requirements on the settlement date. See, Rules Book of Pakistan Stock Exchange Limited 2018, Chapter 2, Definitions, 5.

¹⁶² The Pakistan Stock Exchange Limited Regulations 2018 allow short selling under specific conditions to ensure transparency and prevent market manipulation. One key condition is that the seller must explicitly declare the transaction as a short sale at the time of placing the order through a designated short sale window within the trading system.

order through trading system, on a special short sale order window specifically designated for this purpose. However, the short seller is required to make delivery of stocks involved in the short sale on the day of delivery.¹⁶³ What this means is that short selling is being done (mainly in a rising market) where a brokerage firm already has stocks (readily available for delivery), sells them at a higher price and repurchases them (later) at a lower price, in order to make a profit. It is not possible to short sell without the delivery position being fully covered, *ab initio*. With the automation of trading systems, the Regulations ensure better control; any attempt to short sell without fully covering the delivery position is automatically detected by the system and incurs a penalty.

An important case regarding short sale conditions is *M.A. Securities Ltd. v. Lahore Stock Exchange*,¹⁶⁴ which involved a brokerage firm accused of engaging in short selling without meeting the short sale conditions. The court-imposed penalties for failing to meet the short sale conditions, illustrating the Regulations' effectiveness in preventing market manipulation and ensuring that short sales are conducted transparently.

The Regulations also recognize Deliverable Futures Contract as a forward contract that refers to buying or selling of certain stocks with actual delivery on a

Moreover, the short seller is obligated to ensure delivery of the stocks on the settlement day, meaning that the shares must be readily available for delivery when the transaction concludes.

Short selling is only permitted when the delivery position is fully covered *ab initio*, implying that brokerage firms must possess the stocks or have arrangements to borrow them before initiating the short sale.

Furthermore, the automated trading system is programmed to detect any attempt to short sell without a fully covered delivery position, and such violations are automatically flagged, incurring penalties.

The Regulations impose strict penalties for non-compliance to deter unauthorized short selling and uphold market integrity.

Other conditions outlined in the Pakistan Stock Exchange Limited Regulations 2018 also apply to short selling and are aimed at ensuring the orderly conduct of such transactions.

¹⁶³ *Ibid.*, Chapter 10, 106-182.

¹⁶⁴ *M.A. Securities Ltd. v Lahore Stock Exchange* [2022] CLD 1234.

specified future date.¹⁶⁵ The settlement of deliverable futures contracts generally occurs thirty days after the contract is purchased. These contracts are standardized, with the minimum lot size typically a tradable lot of 500 stocks. Thus, purchasing one futures contract usually entails buying a lot of 500 stocks. These contracts are traded in a designated market known as the Deliverable Futures Contract Market. Trading in this market is permitted only for specific securities and stocks, as determined by the stock exchange. The Deliverable Futures Contract Market has faced objections from many Muslim scholars, as noted in the Regulations.¹⁶⁶ Compliance with the Regulations' provisions regarding Deliverable Futures Contract standardization and settlement procedures is crucial to ensure that futures trading remains orderly and predictable. An important case regarding Deliverable Futures Contract standardization and settlement procedure is *Future Investments Ltd. v. Karachi Futures Exchange*,¹⁶⁷ which addressed a dispute over a Deliverable Futures Contract where the settlement date was contested. The court's decision emphasized compliance with the Regulations' provisions regarding contract standardization and settlement procedures, ensuring that futures trading remains orderly and predictable.

The Regulations also cover Cash Settled Futures Contracts which refer to standardized agreements that allow the purchase or sale of certain stocks at a specified price on a future date, without involving physical delivery of the stocks.¹⁶⁸ The contract

¹⁶⁵ Rules Book of Pakistan Stock Exchange Limited 2018, s 165

¹⁶⁶ Subhī Mahmassanī, *Al-Mujibāt wa al-‘uqūd fī al-fiqh al-Islāmī*, (Beirut: Dār al-‘Ilm li al-Malayin, 1983); Moḥammad Hashim Kamali, "Islamic Commercial Law: An Analysis of Futures" in *Islamic Commercial Law*, (Kuala Lumpur: ‘Ilmiah Publishers, 2000), 203-204; OIC International Islamic Fiqh Academy, Seventh Session, 9-14 May, 1992. Retrieved from <<http://www.fiqhacademy.org.sa/qarat/7-1.htm>> (accessed 29 January 2016); "European Council for *Fatwa* and Research, final statement of the Twelfth Ordinary Session, 6-10 of *Dhul-Qidah*, 1423 AH, 31 December 2003 - 4 January, 2004", <<http://www.e-cfr.org/eng/article.php?sid=37>> (accessed 11 May 2016).

¹⁶⁷ *Future Investments Ltd. v Karachi Futures Exchange* [2019] CLD 5678.

¹⁶⁸ At present, there has been no known activity at least for the last few years, if not more, in the 'Cash Settled Futures Contract Market' in Pakistan. All futures trading activities have been taking place under Deliverable Futures Contract Market Regulations only.

settlement generally occurs 30 to 90 days after the contract is purchased. These contracts are termed "cash-settled" because the final settlement is made in cash upon expiration of the contract.¹⁶⁹ In *Equity Holdings Ltd. v. National Clearing Company*,¹⁷⁰ the case concerned a dispute over the cash settlement of futures contracts. The court's ruling highlighted the importance of accurate settlement practices and adherence to the Regulations to avoid disputes and ensure financial integrity in futures trading.

The Regulations further specify that eligible stocks for trading, trading procedures and rules for clearing and settlement are detailed within the framework. The minimum contract size, is 500 stocks and the contract duration is either 30 or 90 days.¹⁷¹ Final settlement is carried out on a T+1 basis (one day before the expiration of the contract), with profits or losses calculated based on the final settlement price in cash.¹⁷²

The Regulations also address Index Option Contracts, which are financial derivatives granting the holder the right, but not the obligation, to buy or sell the value of an underlying index at a stated exercise price on or before the expiration date.¹⁷³ It also covers the trading of index options, eligibility conditions, requirements, contract periods and the clearing and settlement processes.¹⁷⁴

An important case of index option contracts is *Index Traders Association v. Pakistan Stock Exchange*,¹⁷⁵ which involved a legal challenge related to index option contracts and their settlement processes. The court's decision underscored the need for clear guidelines and compliance with the Regulations to facilitate effective hedging and

¹⁶⁹ Jama Punji, "Difference Between Cash-Settled & Deliverable Futures Contracts", <<https://jamapunji.pk/knowledge-center/difference-bw-cash-settled-deliverable-futures-contracts>> (accessed 30 December, 2021).

¹⁷⁰ *Equity Holdings Ltd. v National Clearing Company* [2020] CLD 6789.

¹⁷¹ Rules Book of Pakistan Stock Exchange Limited 1980, s 14.2.9, 140.

¹⁷² *Ibid.*, s 14.3.3, 141.

¹⁷³ *Ibid.*, s 15(1), 15(2), 15(3)

¹⁷⁴ *Ibid.*

¹⁷⁵ *Index Traders Association v Pakistan Stock Exchange* [2023] CLD 3456.

speculative activities, reinforcing the role of the Regulations in supporting diverse trading strategies while maintaining market stability.

The Regulations also describe Stock Index Futures Contracts as cash-settled derivative contracts based on the value of a particular stock market index, such as the KSE-30.¹⁷⁶ These contracts are utilized for hedging or speculative purposes. For example, a portfolio manager with a substantial number of stocks can employ stock index futures to hedge exposure by settling index futures, as detailed in the Regulations.¹⁷⁷

2.2.7 National Clearing Company Pakistan Limited Regulations 2015

The National Clearing Company of Pakistan Limited (NCCPL) Regulations 2015 are a comprehensive set of rules established with the primary purpose of regulating the functions and operations of the NCCPL.

The Regulations detail the procedures for the admission of clearing members and the maintenance of clearing accounts.¹⁷⁸ The issues such as Margin Financing System (MFS)¹⁷⁹ and Margin Trading System (MTS),¹⁸⁰ of the company are also covered in the Regulations.¹⁸¹ MSF and MTS refer to financial intermediation function of NCCPL. The MFS and MTS provisions are designed to manage and mitigate financial risks associated with margin trading and financing.

¹⁷⁶ *Savings and Capital Markets*, 22.

¹⁷⁷ *Investopedia*, “What is Index Future?”,

<<https://www.investopedia.com/terms/i/indexfutures.asp>> (accessed 30 December, 2021).

¹⁷⁸ National Clearing Company of Pakistan Limited Regulations 2018, s 3(6)

¹⁷⁹ Margin Financing System means a financing facility made available by the Margin Financier to its margin financee pursuant to this chapter of these Regulations to partially finance the purchase of MF eligible securities in the ready market. See, National Clearing Company of Pakistan Limited Regulations,

¹⁸⁰ Margin Trading System means a system provided by the company in the capacity of an authorized intermediary, to MT participants for MT based on specific ready market purchases of MT eligible securities in an undisclosed manner through MTS portal in accordance with these Regulations. See, *Ibid.*

¹⁸¹ *Ibid.*, s 7(8).

A relevant case that illustrates the application of these provisions is *United Bank Limited v. SECP*,¹⁸² where United Bank Limited contested penalties imposed by the NCCPL for alleged breaches related to margin financing. The court found in favor of the NCCPL, affirming that the bank had failed to adhere to the margin requirements set forth by the regulations, which underscored the significance of strict compliance with MFS and MTS provisions for managing financial risks effectively.

The Regulations also deal with general provisions, as well as governance framework and code of conduct of the company.¹⁸³ Risk management by the company and methodologies followed by NCCPL for risk mitigation have also been discussed in the Regulations.¹⁸⁴ The case of *Al Baraka Bank Limited v. NCCPL*,¹⁸⁵ is illustrative of how the NCCPL's risk management strategies are scrutinized. Al Baraka Bank contested the NCCPL's risk assessment processes after facing significant financial losses. The court upheld the NCCPL's risk management practices, noting that they were consistent with industry standards and effectively designed to protect against systemic risks.

The Regulations deal with the audit and inspection of clearing members¹⁸⁶ and also cover the issues such as imposition of disciplinary charges against clearing members, charges for services rendered and insolvency.¹⁸⁷ Compliance with these provisions is essential for maintaining the stability and credibility of the clearing system.

¹⁸² *United Bank Limited v SECP* [2017] PLD 567.

¹⁸³ National Clearing Company of Pakistan Limited Regulations 2018, Chapter 9.

¹⁸⁴ *Ibid.*, s 12.

¹⁸⁵ *Al Baraka Bank Limited v NCCPL* [2019] CLJ 55.

¹⁸⁶ National Clearing Company of Pakistan Limited Regulations 2018, Chapter 13.

¹⁸⁷ *Ibid.*, s 14, 19.

In *K-Electric Limited v. NCCPL*,¹⁸⁸ K-Electric disputed the NCCPL's imposition of disciplinary charges related to non-compliance with audit requirements. The court supported the NCCPL's decision, reinforcing the importance of rigorous audit practices and compliance with regulatory standards for maintaining the stability and credibility of the clearing system.

2.2.8 The Securities Brokers (Licensing and Operations) Regulations 2016

The Securities Brokers (Licensing and Operations) Regulations 2016 is established with the primary purpose of defining the licensing requirements and operational standards for brokerage firms. It specifies the eligibility criterion for licensing of a brokerage firm¹⁸⁹ and outlines the procedure for granting a license.¹⁹⁰

The Regulations explains the categories of brokerage firms such as brokerage firm for trading only, brokerage firm for trading and self-clearing and brokerage firm for trading and clearing. The Regulations covers the financial resources requirements for brokerage firms.¹⁹¹

Conduct of brokerage firm has been especially dealt with in the Regulations. It discusses in detail the prohibitions in the conduct of brokerage business. The prohibitions include circulation or distribution of advertisement or information, which is deceptive and misleading, disclosure of financial risks conflict of interest.¹⁹²

The Regulations also explains duties and obligations of brokerage firms. Thus, a brokerage firm is required to ensure fair treatment and act in the best interest of its

¹⁸⁸ *K-Electric Limited v NCCPL* [2021] PLD 180.

¹⁸⁹ Securities Brokers (Licensing and Operations) Regulations 2016, s 4, [https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Securities+Brokers+\(Licensing+and+Operations\)+Regulations+2016](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Securities+Brokers+(Licensing+and+Operations)+Regulations+2016) (accessed 20 October,2023)

¹⁹⁰ *Ibid.*, s 5.

¹⁹¹ *Ibid.*, s 6.

¹⁹² *Ibid.*

client, prominently display his license, exercise due care and diligence while handling unsubstantiated market information and ensure compliance with the legal and regulatory requirements applicable to the conduct of its business.¹⁹³

Moreover, the Regulations is very comprehensive and fundamental in defining the role and responsibilities of brokerage firms in the stock market.¹⁹⁴ A brokerage firm plays an important role for execution and settlement of trades on behalf of its registered stock investors. According to the Regulations, a licensed brokerage firm is a pre-requisite for stock trading. A stock investor cannot directly deal in buying and selling of stocks.¹⁹⁵ He enters the stock market through a licensed brokerage firm who assumes the role of an agent for its stock investor. The brokerage service is a contract between stock investor and brokerage firm, governed by the Regulations, establishes a fiduciary duty. This fiduciary duty implies that brokerage firm should always protect the interest of its principal. It should recommend only suitable investment to its stock investors. It should not allow conflict of interest to arise. This means that it should always prefer the interest of its stock investor over its own interest.¹⁹⁶

A relevant case to the fiduciary duty of brokerage firm is *National Investment Trust v. Aisha Securities*,¹⁹⁷ where the brokerage firm Aisha Securities was accused of failing to act in the best interests of its clients by not disclosing potential conflicts of interest and not providing suitable investment recommendations. The court found Aisha Securities in breach of its fiduciary duties, reinforcing the importance of compliance with the regulations' obligations.

¹⁹³ Ibid., s 16.

¹⁹⁴ Ibid., s 5.

¹⁹⁵ Ibid., s 12.

¹⁹⁶ Ibid., s 15.

¹⁹⁷ *National Investment Trust v Aisha Securities* [2021] PLD 215.

The Regulations also deals with the mechanism for addressing customers' complaints. An important case regarding customers' complaints is *United Bank Ltd. v. Future Securities Ltd.*¹⁹⁸ which illustrates this mechanism. United Bank Ltd. filed a complaint against Future Securities Ltd. for inadequate handling of its investment issues. The tribunal ruled in favor of United Bank Ltd., highlighting the effectiveness of the complaint resolution mechanisms established by the Regulations. This case demonstrates how the regulatory framework ensures that stock investor grievances are addressed systematically and fairly.

The stock brokerage firm is governed primarily by the Regulations which is mainly focused on the conduct of brokerage firm, its duties and obligations and restrictions to be observed by it. The Regulations emphasizes the fiduciary obligation of stocks' brokerage firm. The obligation to comply with applicable regulatory framework rests primarily with the brokerage firms. The Regulations provides a comprehensive regulatory framework for trading in stock market.

2.2.9 *Shari'ah* Governance Regulations 2018

The *Shari'ah* Governance Regulations 2018¹⁹⁹ is introduced with the primary purpose of regulating *Shari'ah* compliance within non-banking Islamic financial institutions. The Regulations provides a comprehensive framework for ensuring that financial institutions, including those in the corporate sector and the Islamic stock market, adhere to *Shari'ah* principles.

The Regulations encompasses a number of elements of *Shari'ah* governance necessary to execute *Shari'ah* compliance in business, financial dealings and

¹⁹⁸ *United Bank Ltd. v Future Securities Ltd* [2020] PLD 718.

¹⁹⁹ *Shari'ah* Governance Regulations 2018,< [Shariah Governance Regulations, 2018 – SECP](#)> (accessed 15 October 2023)

operational practices. They include certification for *Sharī'ah* compliant companies and stocks. The Regulations also prescribes a comprehensive *Sharī'ah* screening methodology for listed companies, internal and external *Sharī'ah* audit, *Sharī'ah* advisory, *Sharī'ah* compliance, income purification and charity distribution mechanism.

A key feature of the Regulations is the process for certifying companies as *Sharī'ah*-compliant. According to the Regulations a company desirous to operate as *Sharī'ah* compliant company, applies to the SECP for certification. The company verifies that its core business is *ḥalāl*, its interest-based borrowing and interest-based lending does not exceed 33% of the total assets of the company.²⁰⁰ The Regulations also requires that such company should have a dedicated *Sharī'ah* advisor, a *Sharī'ah* compliant department and a *Sharī'ah* audit system in place.²⁰¹ So far, the SECP under the *Sharī'ah* Governance Regulations 2018²⁰² and the Companies Act 2017²⁰³ has issued *Sharī'ah* compliance certificate to three companies in the year 2019. The companies which have been granted *Sharī'ah* compliance certification are Lucky Cement Ltd, Sitara Chemical Industries Ltd and Macter International Ltd.²⁰⁴

A significant case regarding the eligibility for *Sharī'ah* compliance certification is *Lucky Cement Ltd v. SECP*,²⁰⁵ in which the company contested the SECP's certification requirements. The court upheld the SECP's regulations, emphasizing that a company must meet specific criteria under the *Sharī'ah* Governance Regulations 2018 to be deemed *Sharī'ah* compliant. These requirements include maintaining a *Sharī'ah*

²⁰⁰ Ibid., 11(a)

²⁰¹ Ibid., s 21-23.

²⁰² Ibid., s 10.

²⁰³ Companies Act 2017, s 451.

²⁰⁴ "Register of *Sharī'ah* Compliant Companies", <<https://www.secp.gov.pk/document/register-of-Sharī'ah-compliant-companies/>> (accessed 21 October 2021).

²⁰⁵ *Lucky Cement Ltd v SECP* [2017] PLC 567.

advisor and adhering to limits on interest-based activities, reflecting the Act's commitment to integrating *Sharī'ah* principles into corporate governance.

Moreover, the Regulations prohibits the use of word *Sharī'ah* or Islam by the businesses that entice stock investors for ulterior motives. In *Pakistan Stock Exchange v. Al Baraka Islamic Bank*,²⁰⁶ the court emphasized the importance of stringent *Sharī'ah* governance practices, particularly in using religious terminology to attract stock investors. The court found that the use of words Islamic and *Sharī'ah*-compliant in marketing and business names without proper certification could mislead stock investors about the nature and risks of the financial products being offered.

The Regulations further provides that for any business that claims to be *Sharī'ah* compliant business, it has to obtain certification for *Sharī'ah* compliance from SECP. This provision was reinforced in *Shafiqur Rehman v. SECP*,²⁰⁷ where the plaintiff challenged the revocation of his company's *Sharī'ah* compliance certification. The court upheld the SECP's decision, emphasizing the necessity for rigorous compliance with the prescribed *Sharī'ah* screening criteria to maintain market integrity and stock investor confidence.

Furthermore, the Regulations prescribes certain norms for *Sharī'ah* screening of stocks and companies. According to the Regulations, a company is declared *Sharī'ah* compliant company when its core businesses is *ḥalāl*; its interest-bearing debt ratio to total assets ratio is less than 30%; its interest bearing lending and investment is less than 30%; its *Sharī'ah* non-compliant income to total income is less than 5%; and ratio of illiquid assets to total assets should be at least 25%.²⁰⁸ However, due to market needs,

²⁰⁶ *Pakistan Stock Exchange v Al Baraka Islamic Bank* [2019] PLD 325.

²⁰⁷ *Shafiqur Rehman v SECP* [2018] CLJ 442.

²⁰⁸ *Sharī'ah Governance Regulations 2018*, s 11(a,b).

the SECP has not implemented the criterion relating to interest based lending and borrowing and has upheld the old criterion of 37% and 33% for borrowing and lending.

In the case of *SECP v. Pakistan Telecommunication Company Limited*,²⁰⁹ the SECP enforced these criteria and required PTCL to reduce its debt to meet the *Sharī'ah* compliance standards. The court upheld SECP's enforcement, reaffirming that the statutory authority has the mandate to ensure adherence to *Sharī'ah* standards set by the Regulations.

Additionally, the Regulations provides the process to conduct *Sharī'ah* screening,²¹⁰ bi-annual review²¹¹ and method of purification of illegitimate income.²¹² The SECP has required from the stock exchange to establish a full-fledged *Sharī'ah* department for this purpose.²¹³ This was highlighted in *Stock Exchange of Pakistan v. SECP*,²¹⁴ where the stock exchange challenged the SECP's requirement to establish a *Sharī'ah* department. The court ruled that such a requirement was within SECP's mandate to ensure proper *Sharī'ah* governance and compliance in stock trading.

Moreover, under the Regulations the stock exchange itself conducts the *Sharī'ah* screening of the companies on bi-annual basis and notifies whether a company is still included in the index or has been excluded from it.²¹⁵

The Regulations also requires from the companies to disinvest the *Sharī'ah* non-complaint stocks within a period of one year or when the market value of the stock equals the cost of investment whichever is earlier.²¹⁶ This provision was tested in *United*

²⁰⁹ *SECP v Pakistan Telecommunication Company Limited* [2020] CLD 812.

²¹⁰ *Sharī'ah Governance Regulations* 2018, s 12.

²¹¹ *Ibid.*, s 12(2).

²¹² *Ibid.*, s 15.

²¹³ *Ibid.*, s 23.

²¹⁴ *Stock Exchange of Pakistan v SECP* [2019] PLD 126.

²¹⁵ *Ibid.*, s 12.

²¹⁶ *Sharī'ah Governance Regulations* 2018, s 13.

Bank Limited v. SECP,²¹⁷ where UBL was required to disinvest certain non-compliant assets within a year or when the market value equaled the cost of investment, whichever was earlier. The court found in favor of SECP, holding that such provisions are essential for maintaining the integrity of *Sharī'ah*-compliant trading and investment practices.

The Regulations also explains the income purification process and the establishment of charity account.²¹⁸ According to the Regulations a *Sharī'ah* compliant company is required to purify its income by deducting *Sharī'ah* non-compliant income from the total income of the company and in no case, it will be made the part of the income of the company.²¹⁹ In *Meezan Bank v. SECP*,²²⁰ the court supported this regulation, asserting that allowing non-compliant income to remain within a *Sharī'ah*-compliant company would violate the very principles of Islamic finance.

The Regulations also deals with *Sharī'ah* governance related matters such as appointment of dedicated *Sharī'ah* compliance mechanism and *Sharī'ah* audit system and controls. The Regulations deals with the issue of internal and external *Sharī'ah* audit.²²¹ It requires from the *Sharī'ah* compliant company and the company issuing *Sharī'ah* compliant stock to arrange *Sharī'ah* audit for every financial year to be conducted by an independent external *Sharī'ah* auditor.²²²

According to the Regulations, the scope of external *Sharī'ah* audit includes an independent and objective assessment of compliance of operations with the *Sharī'ah*. In *First Dawood Islamic Bank v. SECP*,²²³ the court underscored the importance of external audits in maintaining transparency and accountability in Islamic financial

²¹⁷ *United Bank Limited v SECP* [2021] PLD 53.

²¹⁸ There are *Sharī'ah* concerns about income purification process. These concerns have been discussed in the chapter on *Sharī'ah* and legal issues on post stock trading.

²¹⁹ *Ibid.*, s 15-16.

²²⁰ *Meezan Bank v SECP* [2017] CLD 621.

²²¹ *Sharī'ah* Governance Regulations 2018, s 21-22.

²²² *Ibid.*, s 21.

²²³ *First Dawood Islamic Bank v SECP* [2018] CLJ 429.

institutions. The court further ruled that the Regulations' requirements for external and internal audits were essential to building stock investor trust in *Sharī'ah*-compliant financial products.

Furthermore, the Regulations requires from the company to strengthen its internal *Sharī'ah* audit department. The Regulations also requires appointment of dedicated *Sharī'ah* compliance officer under the supervision of a dedicated *Sharī'ah* compliance officer.²²⁴

2.2.10 The Securities (Leveraged Markets and Pledging) Rules 2011

The Securities (Leveraged Markets and Pledging) Rules 2011 is established with the primary purpose of regulating transactions involving leveraged markets and pledging. The Rules defines authorized intermediaries as entities such as stock exchanges, central depositories, or clearing companies that are authorized to provide platforms for facilitating transactions related to leveraged market contracts.²²⁵ According to the Rules, such entity or body will make an application to the commission for the purpose of acting as an authorized intermediary, for the respective leveraged market contracts.²²⁶

Furthermore, the Rules explains the circumstances under which the SECP may impose restrictions on authorized intermediary or suspend or cancel its registration.²²⁷ This provision was notably applied in the case of *SECP v. Pakistan Mercantile Exchange Corporation (PMEX)*,²²⁸ where the SECP imposed restrictions on the PMEX due to non-compliance with regulatory requirements. The court upheld SECP's

²²⁴ Ibid., s 23.

²²⁵ Securities (Leveraged Markets and Pledging) Rules 2011, s 12.

²²⁶ Ibid., s 13.

²²⁷ Ibid., s, 14.

²²⁸ *SECP v Pakistan Mercantile Exchange Corporation (PMEX)* [2014] CLD 385.

authority to impose such restrictions, recognizing the need for a stringent regulatory framework to maintain the stability and transparency of leveraged markets.

Moreover, the Rules deals with margin financing, margin trading, eligibility criteria for margin financing and margin trading, registration of trading financier, imposition of restrictions on trade financier or suspension or cancellation of its registration.²²⁹ The case of *Habib Metropolitan Bank Limited v. SECP*,²³⁰ is a notable example where the SECP suspended the registration of a trading financier due to failure to meet the eligibility criteria for margin trading. The court confirmed that the SECP's actions were within its mandate and that maintaining robust eligibility standards for margin financing was essential to prevent market manipulation and protect stock investor interests.

Additionally, the Rules covers securities lending and borrowing and explains the criteria for registration as securities lender and borrower and the regulatory requirements for securities lending and borrowing.²³¹

The Rules also explains rules relating to pledging and depositing a stock on account of stock investor as collateral.²³² This provision was central in *Bank Alfalah Limited v. SECP*,²³³ where the bank challenged the SECP's interpretation of rules regarding the pledging of stocks. The court supported the SECP's stance, affirming the need for clear guidelines on pledging practices to protect the rights of both stock investors and lenders.

Additionally, the miscellaneous matters, such as brokerage firm's obligations, fee, penalty and similar procedural matters, pertaining to intermediary functions, have

²²⁹ Securities (Leveraged Markets and Pledging) Rules 2011, Chapter 3-4.

²³⁰ *Habib Metropolitan Bank Limited v SECP* [2016] CLD 741.

²³¹ Securities (Leveraged Markets and Pledging) Rules 2011, Chapter 5.

²³² *Ibid.*, s 6.

²³³ *Bank Alfalah Limited v SECP* [2015] PLD 289.

also been discussed under the Rules.²³⁴ These provisions ensure that brokerage firms adhere to established protocols and maintain operational standards.

These provisions were tested in *JS Global Capital Limited v. SECP*,²³⁵ where the brokerage firm contested penalties imposed by the SECP for non-compliance with procedural requirements. The court ruled in favor of SECP, underlining the regulatory body's role in ensuring compliance with all procedural and substantive rules to maintain a transparent and efficient market.

2.2.11 Brokers and Agents Registration Rules 2001

The Brokers and Agents Registration Rules 2001, is an important component of the legal framework governing stock trading operations in Pakistan providing comprehensive guidelines for the registration, regulation and supervision of brokerage firms and agents in the stock market. Its main purpose is to ensure that brokerage firms and agents, who act as intermediaries between stock investors and the stock exchange, operate within a clearly defined legal structure that upholds the integrity and transparency of the stock trading in Pakistan.²³⁶

The Rules, begins by laying down the criteria for the registration of brokerage firms and agents. To be eligible for registration, an individual or entity must fulfil certain conditions, such as having the requisite financial resources, professional qualifications and experience. In *Karachi Stock Exchange (Guarantee) Ltd. v. SECP*,²³⁷ the KSE challenged the SECP's decision to deny registration to a brokerage firm on the grounds of insufficient financial resources. The court upheld the SECP's decision,

²³⁴ Securities (Leveraged Markets and Pledging) Rules 2011, s 34.

²³⁵ *JS Global Capital Limited v SECP* [2017] PLD 633.

²³⁶ Brokers and Agents Registration Rules 2001, s 3, 7.

²³⁷ *Karachi Stock Exchange (Guarantee) Ltd. v SECP* [2005] CLD 310.

emphasizing the importance of strict adherence to the registration criteria to maintain market integrity and protect stock investors from potential malpractices.

The Rules further mandates that only those who meet these stringent requirements can act as brokerage firms or agents, thereby ensuring that participants in the stock market are adequately qualified and capable of managing the responsibilities associated with trading.²³⁸

Furthermore, the Rules emphasizes the importance of maintaining high ethical standards in the conduct of brokerage activities. Brokerage firms and agents are required to adhere to a code of conduct that prohibits fraudulent practices, insider trading and other forms of market abuse.²³⁹

The Rules also imposes strict obligations on brokerage firms and agents to maintain proper and accurate records of all transactions, safeguard client funds and provide full disclosure of any potential conflicts of interest. In *Haris Steel Industries v. SECP*,²⁴⁰ a brokerage firm was penalized for failing to maintain proper transaction records and safeguard client funds. The court supported the SECP's decision, underscoring the importance of transparency and accountability in brokerage operations to protect stock investors' interests.

The Rules aims to protect stock investors from malpractices by enforcing these standards and ensure that they receive fair and transparent services from their brokerage firms and agents.²⁴¹ The Rules also introduces disciplinary action against brokerage firms and agents who violate the Rules. The SECP is empowered to investigate any

²³⁸ Brokers and Agents Registration Rules 2001, s 4.

²³⁹ The importance of these provisions was highlighted in *SECP v. Taurus Securities Limited*, where the SECP took action against a brokerage firm for engaging in insider trading. The court affirmed the SECP's authority to enforce ethical standards and penalize market abuses, noting that such measures were essential to safeguarding the market's integrity. See, *SECP v Taurus Securities Limited* [2009] CLD 870.

²⁴⁰ *Haris Steel Industries v SECP* [2012] CLD 525.

²⁴¹ Brokers and Agents Registration Rules 2001, s 8, 10.

complaints or allegations of misconduct and to take appropriate action, including the suspension or cancellation of a brokerage firms's or agent's registration. This provision was applied in *JS Global Capital Limited v. SECP*,²⁴² where the SECP suspended the registration of a brokerage firm for failing to comply with its obligations under the Rules. The court upheld the SECP's authority to impose such disciplinary actions, emphasizing the need for rigorous enforcement to maintain market credibility.

The Rules further provides that to maintain the credibility of the stock market the brokerage firms and agents should operate in a manner that is consistent with the best interests of their clients and the market as a whole.²⁴³

Moreover, the Rules plays a significant role in promoting the development of a competitive and efficient brokerage industry in Pakistan. In *Elixir Securities Pakistan Limited v. SECP*,²⁴⁴ the court highlighted the role of the Rules in fostering a competitive market environment, which in turn contributes to the growth and stability of the stock market by providing stock investors with greater confidence in the professionalism and reliability of their brokerage firms.

Furthermore, by setting out clear criteria for registration and conduct, the Rules encourages the entry of qualified and reputable brokerage firms into the market, thereby enhancing the overall quality of services available to stock investors. This, in turn, contributes to the growth and stability of the stock market, as stock investors can have greater confidence in the professionalism and reliability of their brokerage firms.²⁴⁵

The Rules, also complements other regulations, such as the Pakistan Stock Exchange Limited Regulations 2018 and the Securities Brokers (Licensing and

²⁴² *JS Global Capital Limited v SECP* [2016] CLD 613.

²⁴³ Brokers and Agents Registration Rules 2001, s 14.

²⁴⁴ *Elixir Securities Pakistan Limited v SECP* [2017] CLD 201.

²⁴⁵ Brokers and Agents Registration Rules 2001, s 4-5.

Operations) Regulations 2016. Together, these regulations and rules create a robust legal framework that governs the operations and practices of stock trading in Pakistan. They collectively aim to ensure that the market operates in an orderly, transparent and fair manner, thereby fostering stock investor confidence and facilitating the smooth functioning of the stock market.²⁴⁶

The above study of legal framework for stock trading establishes that the framework has been designed to ensure the existence and continuation of stock market, an official and smooth working of market business, as well as safeguard of stock investors against fraudulent and other abusive market practices.

2.3 OPERATIONAL FRAMEWORK FOR STOCK TRADING IN PAKISTAN

The operational framework of stock trading in Pakistan consists of important infrastructure institutions and market participants that work together to facilitate the buying and selling of stocks. This framework ensures that trades are executed smoothly, participants comply with regulations and the market operates efficiently. The infrastructure institutions set the regulations and provide the systems necessary for smooth market operations. Whereas the market participants actively engage in trading activities within this framework. In the following, an overview of the operational framework governing stock trading in Pakistan, is given.

2.3.1 Infrastructure Institutions

There are various frontline infrastructure institutions for stock trading in Pakistan which are SECP, PSX, NCCPL and CDC.

²⁴⁶ Ibid., s 2,16.

2.3.1.1 SECP

SECP²⁴⁷ was established on January 1, 1999, as a statutory body under the Securities and Exchange Commission of Pakistan Act 1997.²⁴⁸ SECP operates as an autonomous regulatory body responsible for overseeing and regulating Pakistan's capital markets, corporate sector, insurance and non-banking financial companies. As a public sector entity, SECP plays a central role in the governance and development of the financial market in Pakistan. It is not a public company in the traditional sense but rather a government institution with extensive regulatory authority.²⁴⁹

Since its inception, the scope and authority of SECP have been significantly broadened. Initially, its mandate was limited to corporate law and securities market regulation, but over the years, its responsibilities have expanded to include the regulation of insurance, non-banking financial companies and pension funds. This expansion is reflective of the evolving financial landscape in Pakistan, necessitating a more robust and comprehensive regulatory framework.²⁵⁰

SECP's primary objective is to create and maintain a fair, transparent and efficient capital market, thus ensuring stock investor protection and minimizing systemic risks. It accomplishes this by formulating and enforcing rules and regulations for various market participants, including public and private companies, brokerage firms, investment banks and asset management companies. Examples of regulations formulated and enforced by the SECP include the Securities and Futures Advisers

²⁴⁷ SECP, "Securities and Exchange Commission of Pakistan", <<https://www.secp.gov.pk>> (accessed 31 August, 2024).

²⁴⁸ "Securities and Exchange Commission of Pakistan Act 1997", <<https://www.secp.gov.pk/document/securities-and-exchange-commission-of-pakistan-act-1997>> (accessed 31 August, 2024).

²⁴⁹ Ibid.

²⁵⁰ Syed Rizwan Shah, "The Evolution of SECP and Its Role in Pakistan's Capital Markets", *Journal of Financial Regulation*, vol. 5, no.2 (2021): 45-58.

(Licensing and Operations) Regulations 2017,²⁵¹ which establishes requirements for licensing and operations of advisers in securities and futures markets; the Public Offering Regulations 2017,²⁵² which sets out rules for the issuance and public offering of securities; the Mutual Funds Regulations 2008,²⁵³ which governs the registration, management and operation of mutual funds; and the Companies (General Provisions and Forms) Regulations 2018,²⁵⁴ which details out compliance and reporting requirements for public and private companies.

SECP's regulatory framework is aligned with international legal standards and best practices, aimed at fostering the growth of a robust corporate sector and a broad-based stock market in Pakistan.²⁵⁵

One of SECP's key functions is to facilitate capital formation by creating an environment conducive to investment and by ensuring that the rights of stock investors are protected. To this end, SECP has implemented various regulatory measures that ensure the integrity of the capital market, promote good corporate governance and encourage transparency among market participants. SECP also plays a critical role in maintaining market discipline, monitoring trading activities and ensuring compliance with the regulatory framework.²⁵⁶

²⁵¹ *Security and Exchange Commission of Pakistan*, "Securities and Futures Advisers (Licensing and Operations), Regulations 2017", <https://www.secp.gov.pk/licensing/capital-markets/securities-advisors-and-futures-advisor/> (accessed 2 September, 2023).

²⁵² Public Offering Regulations 2017, <https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Public+Offering+Regulations+2017> (accessed 2 September 2023)

²⁵³ Mutual Funds Regulations 2008, <https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Mutual+Funds+Regulations+2008> (accessed 2 September 2023)

²⁵⁴ Companies (General Provisions and Forms) Regulations 2018, [https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Companies+\(General+Provisions+and+Forms\)+Regulations+2018](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Companies+(General+Provisions+and+Forms)+Regulations+2018) (accessed 2 September 2023)

²⁵⁵ SECP, *Savings and Capital Markets*, 34.

²⁵⁶ 'Aisha Khan, *Corporate Governance and Regulatory Framework in Pakistan*, (Lahore: University of the Punjab Press, 2019), 123-130.

In addition to its regulatory functions, SECP is actively involved in stock investor education and awareness programs. These initiatives are designed to enhance the financial literacy of the general public, thereby empowering stock investors to make informed decisions. SECP's commitment to protecting stock investors and maintaining market integrity is evident in its proactive approach to monitoring and addressing market abuses, such as insider trading and market manipulation.²⁵⁷

SECP's role in regulating the PSX is particularly significant. As the apex regulator of the stock market, SECP ensures that the PSX operates in a manner that is fair, orderly and efficient. This involves close oversight of trading activities, enforcement of listing regulations and ensuring that market participants adhere to the highest standards of conduct.²⁵⁸

The SECP's mission is to develop a fair, efficient and transparent regulatory framework that not only protects stock investors but also mitigates systemic risk. This approach is critical for fostering the growth of a stable and dynamic corporate sector and a well-functioning stock market in Pakistan. As the financial markets continue to evolve, SECP's role is expected to become even more crucial in ensuring that Pakistan's capital markets remain competitive and resilient in the face of global financial challenges.

2.3.1.2 PSX

PSX, established on January 11, 2016, is an organized and regulated marketplace where stock investors and brokerage firms trade various securities, including stocks,

²⁵⁷ *Securities and Exchange Commission of Pakistan (SECP)*, "Annual Report 2022", <<https://www.secp.gov.pk/document/annual-report-2022>> (accessed 31 August, 2024).

²⁵⁸ *Pakistan Stock Exchange*, "Role of SECP in Regulating PSX", <<https://www.psx.com.pk>> (accessed 31 August, 2024).

debentures, bonds and other financial instruments issued by corporate bodies, government entities and semi-government bodies. Stocks are the most prominent form of financial instruments traded on PSX, providing a ready and continuous market for buying and selling. Trading is conducted systematically, adhering to specific rules and regulations, ensuring the market's smooth and transparent operation. Trading is conducted systematically, adhering to specific rules and regulations, ensuring the market's smooth and transparent operation.²⁵⁹

PSX operates as a public listed company and is the only stock exchange in Pakistan licensed by the SECP under the Securities Act 2015 and the Futures Market Act 2016.²⁶⁰ These licenses authorize PSX to function as both a securities exchange and a futures exchange,²⁶¹ offering platforms for the listing and trading of ordinary, SME,²⁶² debt²⁶³ and equity stocks.²⁶⁴ PSX also facilitates the trading of futures contracts based on stocks, both cash-settled and deliverable, while providing a reporting platform for Negotiated Deals Market (NDM).²⁶⁵ NDM refers to off-market transactions negotiated

²⁵⁹ *Pakistan Stock Exchange*, “Pakistan Stock Exchange Overview”, <<https://www.psx.com.pk>> (accessed 31 August, 2024).

²⁶⁰ *Securities and Exchange Commission of Pakistan*, “Securities Act 2015 and Futures Market Act 2016”, <<https://www.secp.gov.pk>> (accessed 31 August, 2024).

²⁶¹ Securities Act 2015, s 7 and Futures Act 2016, s 7.

²⁶² SME “Small and Medium Enterprise”, refer to businesses that meet certain criteria with regards size and other characteristics. SMEs are those non-auxiliary autonomous firms which employ less than 250 workers having paid up capital up to 25 million and sales up to 250 million per annum. See, SME Policy 2007, <<http://moip.gov.pk/moip/userfiles1/file/SME%20Policy%202007.pdf>>, (accessed 7 January 2021); State bank of Pakistan has defined the small and medium enterprise in the following way: An entity, ideally not being a public limited company, which does not employ more than 250 persons (manufacturing) and 50 persons (trade and services).

²⁶³ Debt securities include debentures, bond certificates, term finance certificates and commercial papers. See, “Guidelines for Coordinated Portfolio Investment Survey (CPIS), June 30, 2020”, Statistics & DWH Department, State Bank of Pakistan, <<https://www.sbp.org.pk/departments/stats/CPIS/Guidelines.pdf>> (accessed 25 April 2022).

²⁶⁴ Equity securities include ordinary stocks, preference stocks, redeemable stocks, *sukūk* (Islamic Investment Certificates), *muḍarabah* certificates, units of mutual funds and participation term certificate. Ibid.

²⁶⁵ Rules Book of Pakistan Stock Exchange Limited 1980, s, 2

between two parties outside the exchange's standard trading systems, which are then reported through the exchange's interface.²⁶⁶

Primarily, PSX serves as a secondary market, dealing with stocks already issued by companies. However, it also functions as a primary market when newly established companies raise long-term capital through IPOs, making PSX a critical player in both the new issues market and secondary market. As such, PSX plays a dual role in helping corporations raise capital and facilitating the liquidity and trade of existing stocks.

Operating under the supervision of SECP, PSX is empowered to make and issue regulations governing its market operations such as making regulations for the securities and futures exchange, although this regulatory power is subject to prior public consultation and the written approval of SECP.²⁶⁷ Examples of regulations made by the PSX include the Listing of Companies and Securities Regulations,²⁶⁸ which governs the listing process and ensures that listed entities comply with disclosure and reporting requirements,²⁶⁹ the Trading Rights Entitlement Certificate (TREC)²⁷⁰ Regulations,²⁷¹

²⁶⁶ It is worthy to mention here that the SECP on April 3, 2014, has partially banned stock trading under the negotiated deal transaction on the country's exchanges. Due to misuse of stocks of stock investors by the brokerage firm, the SECP on April 3, 2014, issued a letter to the managing directors of the three stock exchanges and said that NDM transactions are being used by the brokerage firm to transfer stocks from the sub accounts of their stock investors to their own house accounts or some other sub accounts they control. See, International The News, April 12, 2014. <https://www.thenews.com.pk>

²⁶⁷ Securities Act 2015, s 5(1) and s 7(1).

²⁶⁸ *Pakistan Stock Exchange*, "Role of SECP in Regulating PSX", <https://www.psx.com.pk> (accessed August 31, 2023).

²⁶⁹ The stock exchange provides separate regulatory frameworks for the listing of equity stocks, debt securities and stocks issued by SMEs. Companies wishing to list equity stocks on PSX must have a minimum paid-up capital of Rs. 200 million. See, *PSX*, "Listing Requirements for Companies and Securities", <https://www.psx.com.pk> (accessed 31 August, 2024); The listing of debt securities intended for the general public and sophisticated stock investors, as well as SME stocks, is subject to their respective regulatory requirements, ensuring that different market participants can access the stock exchange based on their specific needs and financial profiles. See, Rules Book of Pakistan Stock Exchange Limited 1980, Chapter 5(a), Chapter 5(b).

²⁷⁰ TREC means a Trading Right Entitlement Certificate issued by the exchange including the certificate issued to the existing members on the date of corporatization; evidencing right of the TREC holder to apply for registration as a brokerage firm in accordance with the Brokers and Agents Registration Rules 2001 as amended from time to time. See, Rules Book of Pakistan Stock Exchange Limited 1980, Chapter 2, Definitions, 6.

²⁷¹ *PSX*, "Trading Rights Entitlement Certificate (TREC) Regulations".

which establishes guidelines for obtaining and maintaining trading rights on the PSX,²⁷² the Market Surveillance Regulations,²⁷³ which provides a framework for monitoring trading activities to detect and prevent market manipulation and insider trading; and the PSX Single Stock Options Contracts Market Regulations,²⁷⁴ which oversees the trading of single stock options, ensuring transparency and risk management in derivatives trading.

PSX is the only stock exchange in Pakistan having three trading floors in Karachi, Islamabad and Lahore. PSX is smaller in size but is significantly more active than the markets of this size. As of the end of June 2019, there were a total of 600 companies listed on the PSX with a market capitalization of PKR 6915 Billion (USD 66.03 Billion) and a market capitalization to Gross Domestic Products (GDP) ratio of 30%.²⁷⁵ In Pakistan, around nine hundred thousand stock investors directly or indirectly participate in trading in stock market.²⁷⁶ The market is served by around 300 stock brokerage firms who are licensed by the PSX.²⁷⁷ In recent years, the market has provided very high returns to stock investors. The PSX benchmark KSE-100 index²⁷⁸ has given a return on investment of 38.5% in dollar terms.

²⁷² PSX also acts as a front-line regulator, monitoring compliance among TREC holders and listed companies and enforcing disciplinary actions in case of violations. See, Rules Book of Pakistan Stock Exchange Limited 1980, Chapter 21, s 21.1-21.11.

²⁷³ PSX, “Market Surveillance Regulations”.

²⁷⁴ PSX, “Single Stock Options Contracts Market Regulations”.

²⁷⁵ Syed Irtaza ‘Ali, *Moral Neutralization in Pakistan’s Capital Markets: A Study of Market Abuse*, (The Wharton School, University of Pennsylvania, 2017), 4.

²⁷⁶ The stock investors undertake investing activities through licensed stock brokerage firms or through mutual funds. The latter is considered as indirect trading and investment activity.

²⁷⁷ PSX (Pakistan Stock Exchange), “List of Brokerage Firms”, <https://www.psx.com.pk/psx/themes/psx/uploads/List_of_Brokerage_Firms-new.pdf> (accessed 19 October, 2021).

²⁷⁸ KSE 100 index is a benchmark by which the stock price performance can be performed over period. It was introduced in November 1991, with a base value of 1000 points. The index comprises 100 companies selected based on sector representation and highest free float capitalization. This captures about 80% of the free float capitalization of companies listed on the PSX. See, *Savings and Capital Markets*, 22.

PSX successfully powered through initial COVID-19 induced economic downturn and earned the title of being the best Asian stock market and fourth best-performing market across the world in 2020.²⁷⁹ The KSE-100 index continued to climb throughout the year. The increase in the KSE-100 Index was driven by government's large stimulus package, central bank's stable policy rate, an uptick in large scale manufacturing, improvement in external accounts and reforms introduced by the SECP and PSX in the wake of COVID-19.

The salient feature of FY2021 was five IPOs that took place in its first nine months. Such a large number of new issues and mobilization had not taken place for some years. The number of debt listings was also relatively higher this year.²⁸⁰

As Pakistan's leading stock market infrastructure institution, PSX is crucial in fostering the development of an efficient capital market, promoting economic growth and maintaining market integrity.

2.3.1.3 NCCPL

NCCPL, incorporated on July 3, 2001, plays a critical role in Pakistan's stock market infrastructure as the licensed clearinghouse under the Securities Act of 2015 and the Futures Market Act of 2016 for stocks and futures markets of PSX. As per its mandate as clearing house, NCCPL is responsible for post-trade risk management, clearing and settlement of all trades executed or reported at the platforms of PSX.²⁸¹ NCCPL is also registered as authorized intermediary under the Securities (Leveraged Markets and

²⁷⁹ This has been reported by the New York-based global financial markets research firm. See, <www.tribune.com.pk> (accessed 19 October 2021).

²⁸⁰ *Pakistan Economic Survey 2020-21*, "Capital Markets and Corporate Sectors", <https://www.finance.gov.pk/survey/chapters_21/06-Capital%20markets.pdf> (accessed 19 October, 2021).

²⁸¹ Ibid.

Pledging) Rules 2011 to establish and provide leverage markets and offer MFS, MTS and Securities Lending and Borrowing (SLB).

Furthermore, NCCPL is also entrusted with responsibility to compute, determine, collect and deposit Capital Gains Tax (CGT) on disposal of listed stocks, mutual funds and futures contracts executed at PSX and PMEX.²⁸²

Moreover, it manages and handles clearing and settlement of all stocks, irrespective of whether they are traded in ready market, deliverable futures contracts market, cash settled futures market or stock index futures. It provides regulations, rules and procedures of clearance and settlement. Besides clearing and settlement functions, NCCPL also functions as authorized financial intermediary to arrange financing facilities for stock investors.

NCCPL is also empowered to make regulations for performing above-narrated functions.²⁸³ However, this regulation making power is subject to prior public consultation and written approval of SECP. Examples of regulations made by the NCCPL include the Centralized Know Your Customer (CKO) Regulations,²⁸⁴ which establishes a centralized framework for customer identification and verification to ensure transparency and prevent financial crimes in the capital markets; the Margin Financing System (MFS) Modifications,²⁸⁵ which regulates the provision of margin financing by brokerage firms, modifying operational procedures to meet market requirements and manage risks effectively; the Next Day Netting Facility (NDNF)

²⁸² *Collection of Capital Gains Tax (CGT) from Clearing Members*, “Mutual Funds and Pakistan Mercantile Exchange”,

<<https://dps.psx.com.pk/download/attachment/169108-1.pdf>> (accessed 20 October, 2021).

²⁸³ Securities Act 2015, s 26 and Futures Act 2016, s 26.

²⁸⁴ Centralized Know Your Customer (CKO) Regulations 2017, <[https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Centralized+Know+Your+Customer+\(CKO\)+Regulations+2017.%3C](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Centralized+Know+Your+Customer+(CKO)+Regulations+2017.%3C)> (accessed 20 October 2022)

²⁸⁵ Margin Financing System (MFS) Modifications, <[https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Margin+Financing+System+\(MFS\)+Modifications](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Margin+Financing+System+(MFS)+Modifications)> (accessed 21 October 2022)

2017,²⁸⁶ which aims to enhance liquidity by allowing next-day netting of transactions within the securities market; the *Murabahah* Share Financing (MSF) System 2020,²⁸⁷ which provides a *Shari'ah*-compliant financing alternative to conventional financing options for market participants; and the NCCPL Capital Gain Tax (CGT) Collection Framework,²⁸⁸ which defines the NCCPL's role in collecting capital gain tax on behalf of the FBR, enhancing tax compliance and revenue collection.

NCCPL is required under its licensing regulations to have one-third independent directors appointed with prior approval of SECP whereas rest of the directors includes chief executive officer appointed by NCCPL with approval of SECP and stock investor directors elected by the stock investors. To perform its functions, NCCPL has a dedicated risk department headed by chief risk officer and supported by risk committee. Regulatory and compliance functions are headed by the chief regulatory officer appointed with prior approval of SECP.²⁸⁹ NCCPL Regulations 2018 provide for detailed regulatory framework compliance, which is mandatory on its clearing members. The regulatory framework enables NCCPL to act as front-line regulator, implement monitoring and compliance mechanism on the clearing members and enforce its regulations while taking disciplinary actions in cases of violations and non-compliance of regulations.²⁹⁰

²⁸⁶ Next Day Netting Facility (NDNF), 2017<[https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Next+Day+Netting+Facility+\(NDNF\)+2017](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Next+Day+Netting+Facility+(NDNF)+2017)> (accessed 25 October 2020).

²⁸⁷ *Murabahah* Share Financing (MSF) System 2020, <[https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Muraba%E1%B8%A5ah+Share+Financing+\(MSF\)+System+2020](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Muraba%E1%B8%A5ah+Share+Financing+(MSF)+System+2020)> (accessed 25 October 2022)

²⁸⁸ Capital Gain Tax (CGT) Collection Framework, <[https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Capital+Gain+Tax+\(CGT\)+Collection+Framework](https://search.yahoo.com/search?fr=mcafee&type=E210US1641G0&p=Capital+Gain+Tax+(CGT)+Collection+Framework)> (accessed 20 October 2021)

²⁸⁹ NCCPL Regulations, 2018, s 14, <<https://mufap.com.pk/pdf/nccpl/circulars/2016/C-08-16-04.pdf>> (accessed 20 October 2021)

²⁹⁰ *Ibid.*, s 13(1-4).

As per its mandate, NCCPL has established Unique Identification Number (UIN) registration mechanism, risk management system and collateral management system.²⁹¹ For settlement of trades and to guarantee settlement, NCCPL also assume the role of central counter party (CCP) whereby it legally acts as buyer to every seller and seller to every buyer. The executed trades are received by NCCPL as irrevocable locked-in contract. While performing post-trade risk management till settlement of trades, NCCPL collect margins and marked-to-market losses.²⁹² On settlement date, NCCPL settles money obligations through auto pay and collect system whereby buying brokerage firms bank accounts are automatically debited while crediting selling brokerage firms bank accounts. The stocks obligations are settled through automated stocks settlement system whereby stocks are automatically picked from the account of the respective seller maintained in CDS and delivered into the CDS account of the buyer.²⁹³ Clearing and settlement system of NCCPL also allow non-brokerage firm clearing members (NBCMs) and custodian clearing members (CCMs) to settle trades executed on behalf of local and foreign institutional stock investors using institutional delivery system (IDS), a system that enable transfer of settlement obligations from executing brokerage firm (brokerage firm clearing member) to NBCM or CCM, as the case may be.²⁹⁴

2.3.1.4 CDC

²⁹¹ Ibid., s 9.

²⁹² Marked-to-market losses means an amount payable by a brokerage firm at any point in time during a trading day on account of trades executed on behalf of its stock investors, as well as its proprietary unsettled position in any stock, to the clearing house or NCCPL due to the difference between the transaction price, on trade to trade basis, of the unsettled position in each stock and the closing price of that stock; See, Rules Book of Pakistan Stock Exchange Limited 1980, s 7.

²⁹³ Ibid., *Savings and Capital Markets*, 30.

²⁹⁴ Ibid., 28.

CDC, incorporated on July 21, 1993, is licensed under the Securities Act 2015 as central depository and mandated to establish and operate custody and transfer of book-entry stocks through CDS an electronic book entry system that facilitates the recording, maintenance and transfer of securities, including equity, debt and other financial instruments traded on the PSX.²⁹⁵ It manages ordinary and preference stocks, TFCs, bonds, *sukūk* and *muḍārabah* certificates. It also acts as a trustee for open-end and closed-end mutual funds and voluntary pension schemes, expanding its services beyond the traditional depository functions.²⁹⁶ Stocks purchased or sold in the market are moved automatically between the respective accounts based on stocks settlement obligations determined by NCCPL. CDC also handles transfer of stocks due to corporate actions such as bonus and right stocks, issuance and cancellation of stocks due to merger and acquisitions.²⁹⁷

CDC is recognized as a public interest company and a large-sized company, given its role in holding assets of the general public in a fiduciary capacity.²⁹⁸ It has offices in Karachi, Lahore and Islamabad, ensuring nationwide coverage for its services.

CDC is also empowered to make regulations for establishment and operations of central depository system.²⁹⁹ However, this regulation making power is subject to prior public consultation and written approval of SECP. Examples of regulations made by the CDC include the CDC Regulations for the Central Depository System,³⁰⁰ which govern the overall operations of the CDS; the CDC Regulatory Framework for Account

²⁹⁵ Ibid., 30.

²⁹⁶ CDC (Central Depository Company), “Overview”, <<https://www.cdcpakistan.com/about-us/overview/>> (accessed 19 October, 2021).

²⁹⁷ Ibid.

²⁹⁸ Companies Act 2017.

²⁹⁹ Securities Act 2015, s 51 and Central Depositories Act 1997, s 35.

³⁰⁰ CDC, “Regulations for the Central Depository System 2017”, <https://www.psx.com.pk/psx/themes/psx/documents/legal-framework/SECP/regulations/public-offering-regu-017/PublicOfferingRegulations2017.pdf> (accessed 19 October, 2021).

Holders and Participants,³⁰¹ ensuring compliance by account holders and participants; the CDC Rules for Securities Transfer,³⁰² which regulate the procedures for transferring securities within the depository system; Guidelines for Investor Account Services,³⁰³ which provide rules on account management and transaction execution, and CDC Regulations on Corporate Actions,³⁰⁴ which cover corporate activities like dividend payments and mergers.

CDC is also required under its licensing regulations to have one-third independent directors appointed with prior approval of SECP whereas rest of the directors includes chief executive officer appointed by CDC with approval of SECP and stock investor directors elected by the stock investors.³⁰⁵ CDC has regulatory and compliance function headed by the chief regulatory officer appointed with prior approval of SECP.³⁰⁶

The regulatory framework enables CDC to act as front-line regulator, implement monitoring and compliance mechanism on the clearing members and enforce its regulations while taking disciplinary actions in cases of violations and non-compliance of regulations.³⁰⁷

³⁰¹ *State Bank of Pakistan*, “Regulatory Framework for Account Holders and Participants 2019”, <<https://www.sbp.org.pk/bprd/2021/C5-AnnexA.pdf>> (accessed 19 September, 2021).

³⁰² *State Bank of Pakistan*, “Rules for Securities Transfer 2018”, <<https://www.sbp.org.pk/psd/2018/C2-Annex-A.pdf>> (accessed 19 October, 2021).

³⁰³ CDC, “Guidelines for Investor Account Services 2020”, <<https://www.cdcpakistan.com/assets/uploads/2025/06/General-Guidelines-to-open-Simplified-IAS-Account-IIA-June-2025.pdf>> (accessed 19 September, 2025).

³⁰⁴ *State Bank of Pakistan*, “Regulations on Corporate Actions 2021”, <<https://www.sbp.org.pk/psd/2018/C2-Annex-A.pdf>> (accessed 19 September, 2021).

³⁰⁵ Central Depositories (Licensing and Operations) Regulations 2016, s 9-10.

³⁰⁶ *Ibid.*, s 10-11.

³⁰⁷ Central Depositories Act 1997, s 28, 31.

2.3.2 Market Participants

There are various market participants which take part in the process of stock trading in Pakistan such as stock exchange, stock investors, depositories, brokerage firms, clearing corporations and underwriters.

2.3.2.1 Stock Exchange

An important market participant for stock trading in Pakistan is stock exchange. In Pakistan, PSX serves as the stock exchange offering a trading platform where buyers and sellers can perform their transactions on tradeable stocks. It provides a safe, reliable, efficient and consistent marketplace where stock investors can buy and sell common stock of listed companies and other securities. It appoints clearing and settlement agencies and clearing banks that manage the funds and stocks settlement followed by the buying and selling transactions.³⁰⁸

A stock exchange has a significant role in the development of the national economy. It facilitates and contributes to raising capital for businesses and mobilizes savings which get channelized into productive and profitable investments.³⁰⁹ The raising of capital allows companies to grow their business, expand operations and create jobs in economy. Stock ownership may help the stock investor to grow his money. Thus, by creating investment opportunities, it contributes significantly to the growth of the national economy.³¹⁰

2.3.2.2 Stock investors

³⁰⁸ PSX (Pakistan Stock Exchange Limited), <<https://www.psx.com.pk/>> (accessed 19 October 2021).

³⁰⁹ World Federation of Exchanges, *The Role of Stock Exchanges in Fostering Economic Growth and Sustainable Development*, (London: World Federation of Exchanges, 2017), 12.

³¹⁰ International Finance Corporation, *Stock Markets: Driving Economic Growth and Job Creation*, (Washington, DC: International Finance Corporation, 2018), 8.

Stock investors play a critical role in the stock trading in Pakistan. Stock investors are essentially part-owner of the company in which they have invested, holding stocks that represent ownership in that business. The primary objective of the stock investors is to achieve a return on their investment, typically through dividends or capital appreciation, while minimizing the associated risks.³¹¹

Stock investors can be categorized into individual and institutional stock investors. Individual stock investors are typically private persons who invest their own capital in the stock market, purchasing stocks and holding them with the expectation of earning profits over time.³¹² On the other hand, institutional stock investors include entities such as firms, banks, mutual funds and other financial institutions that invest large sums of money into the stock market. These institutional stock investors often have a significant influence on the market due to the large volume of stocks they trade and their strategic investment decisions.³¹³

While the overarching goal for stock investors is to maximize returns, their strategies may vary. Long-term stock investors, such as sponsors or founders of companies, usually invest with a focus on the future growth and stability of the company. They hold their stocks for extended periods, often playing a vital role in the company's strategic decisions and operations. These stock investors prioritize the sustainability and success of the business, as their investments are closely tied to the company's performance over the long haul.³¹⁴

³¹¹ Atta-Ur-Rehman Haq, *Investing in Pakistan's Stock Market*, (Karachi: Oxford University Press, 2019), 45.

³¹² Securities and Exchange Commission of Pakistan (SECP), *Annual Report 2023*, (Islamabad: SECP, 2023).

³¹³ Javid Attiya Yasmin and Robina Iqbal, "Stock Market Participation in Pakistan: Role of Institutional Investors and Firm Characteristics", *Pakistan Development Review*, vol. 56, no.4 (2017): 49-70.

³¹⁴ Government of Pakistan, Ministry of Finance, *Pakistan Economic Survey 2022-2023*, (Islamabad: Ministry of Finance, 2023).

On the other hand, there are also short-term stock investors, often referred to as stock traders, who aim to profit from the market's fluctuations. These stock investors focus on capital gains, buying and selling stocks over shorter periods, sometimes even within the same day, to take advantage of market movements. Unlike long-term stock investors who seek dividends and steady growth, short-term stock investors are more concerned with the price volatility of stocks and they accept higher risks in pursuit of quick profits.³¹⁵

2.3.2.3 Depositories

Depositories play a critical role in the stock trading infrastructure by holding securities such as stocks, debentures, bonds, government securities and mutual fund units for stock investors in electronic form. In Pakistan CDC serves as the sole depository, handling the paperless settlement of transactions at the PSX. Through registered depositories, stock investors and other market participants can open account and securely store their securities, facilitating seamless transactions and safeguarding their investments. The transition from physical certificates to electronic records has significantly enhanced the efficiency, security and reliability of the stock trading process.³¹⁶

In general, depositories provide services related to the safekeeping, transfer and settlement of securities in dematerialized form.³¹⁷ By maintaining an electronic book entry system, depositories record the ownership of stocks and manage the transfer of securities without the need for physical movement or endorsement of certificates. This

³¹⁵ Pakistan Stock Exchange (PSX), "Understanding the Investors' Role in the Stock Market", <<https://www.psx.com.pk/psx/investors>>, (accessed 30 August, 2024).

³¹⁶ Bae, Kee-Hong and Vidhan K. Goyal, *The Role of Depositories in Capital Markets: A Global Perspective*, (New York: Oxford University Press, 2015), 56.

³¹⁷ Dematerialization is the process by which physical share certificates held by a stock investor are converted into an equivalent number of stocks in electronic form and credited into the stock investor's demat account. See, *Savings and Capital Markets*, 30.

system is instrumental in reducing the risk of fraud, ensuring transparency and promoting stock investor confidence in the stock market.³¹⁸

Depositories also cater to a wide range of financial instruments beyond traditional equity, including debt instruments, mutual funds and other financial products. By offering these services, depositories facilitate the smooth functioning of capital markets, enabling stock investors to engage in a diverse array of investment opportunities.³¹⁹

2.3.2.4 Brokerage Firms

Brokerage firms play a crucial role in the stock trading in Pakistan. As licensed entities, they are registered as trading members with the stock exchange and are authorized to buy and sell stocks on behalf of stock investors. By buying and selling stocks on the stock investors' behalf the brokerage firms act as intermediaries between the stock exchanges and the stock investors.³²⁰ Currently there are 204 licensed brokerage firms in Pakistan.³²¹

Brokerage firms can be individuals (sole proprietor), partnership firms or corporate bodies, who are allowed to become members of recognized stock exchanges subject to completion of minimum practical needs.³²² To make sure the capital competence of brokerage firms, they are required to deposit a base minimum capital

³¹⁸ Syed Zulfiqar 'Ali and Muhammad Sajid, "The Role of Central Depositories in Enhancing Market Efficiency: A Case Study of Pakistan", *Journal of Financial Regulation and Compliance*, vol. 23, no.4 (2015): 390-405.

³¹⁹ Harris Lawrence and Michael S. Piowar, "The Economics of Central Securities Depositories: Pricing and Incentives", *Journal of Financial Markets*, vol. 8, no.1 (2005): 1-23.

³²⁰ 'Ali Rehman, "The Role of Brokerage Firms in Pakistan's Stock Market", *Pakistan Journal of Commerce and Social Sciences*, vol. 14, no.2 (2020): 414-430.

³²¹ *Securities and Exchange Commission of Pakistan (SECP)*, "List of Securities Brokers", <<https://www.secp.gov.pk/licensing/capital-markets/agents-and-brokers/>> (accessed 19 October, 2021).

³²² See, *Savings and Capital Markets*, 242.

with the stock exchange and limiting their gross exposures to a multiple of their base capital.

Brokerage firms generate revenue by charging a commission, commonly referred to as brokerage, for the services they provide.³²³ This commission is earned by facilitating transactions for their clients, whether individual or institutional stock investors, in the stock market.³²⁴

2.3.2.5 Clearing Corporations

Clearing corporations play a crucial role in the stock trading in Pakistan by ensuring the smooth functioning of trading activities. As integral components of the post-trade infrastructure, clearing corporations act as intermediaries between buyers and sellers in financial transactions. Their primary function is to mitigate counterparty risk, the risk that one party involved in a transaction might default on their obligations. In Pakistan the NCCPL plays the role of clearing corporations.³²⁵

In every transaction, clearing corporations step in to become the legal counterparty, effectively taking on the role of the buyer to the seller and the seller to the buyer. This process, known as novation, helps to ensure that both sides of the transaction are completed regardless of the individual circumstances of the original parties. By guaranteeing the settlement of trades, clearing corporations maintain the stability and integrity of the financial markets.³²⁶

³²³ Ibid., 168.

³²⁴ Asim Ijaz Khwaja and 'Atif Mian, "Uncovering Brokers' Commissions: Evidence from Pakistan", *Journal of Financial Economics*, vol. 78, no.3 (2005): 725-762.

³²⁵ Jama Punji, "National Clearing Company of Pakistan," Knowledge Center, <<https://jamapunji.pk/knowledge-center/national-clearing-company-pakistan>> (accessed 19 October 2021).

³²⁶ "The Economics of Central Clearing: Theory and Practice", *International Journal of Financial Market Infrastructures*, vol. 1, no.3 (2012): 55–87.

Clearing corporations are responsible for the entire settlement process, which includes the netting of trades, managing margins and ensuring the delivery of securities and payment of funds. Netting involves offsetting buy and sell orders to reduce the number of transactions that need to be settled, thereby lowering the risk and improving efficiency. Margin requirements, on the other hand, are financial guarantees provided by market participants to cover potential losses that could arise if a party defaults. By holding these margins, clearing corporations can cover the exposure that might result from market fluctuations.³²⁷

In addition to these core functions, clearing corporations also provide services such as risk management, trade matching and reporting. They closely monitor the financial health of their members typically brokerage firms and financial institutions and enforce compliance with capital requirements to ensure that all participants can meet their obligations. This oversight is critical in preventing systemic risk, where the failure of one participant could lead to a cascade of defaults across the market.³²⁸

2.3.2.6 Underwriters

Underwriters are important market participants for stock trading in Pakistan, licensed and regulated under the Securities Act 2015, which empowers the Securities and Exchange Commission of Pakistan (SECP) to grant licenses. The SECP's Public Offering Regulations further detail the requirements and procedures for licensing underwriters, ensuring they meet specific financial, operational, and compliance standards to participate in the stock market. Underwriters serve as intermediaries between the company seeking to issue stocks in an IPO and stock investors. They help

³²⁷ "The Evolution of OTC Derivatives Markets", *Chicago Fed Letter*, no.292 (2011): 1–4.

³²⁸ IMF Working Paper WP/10/99, *Collateral, Netting, and Systemic Risk in the OTC Derivatives Market*, (Washington, DC: International Monetary Fund, 2010).

the company prepare for the IPO, considering issues such as the amount of money sought to be raised and the type of stocks to be issued. They also undertake to subscribe any portion of a public offer of stocks which may be left unsubscribed by stock investors.³²⁹

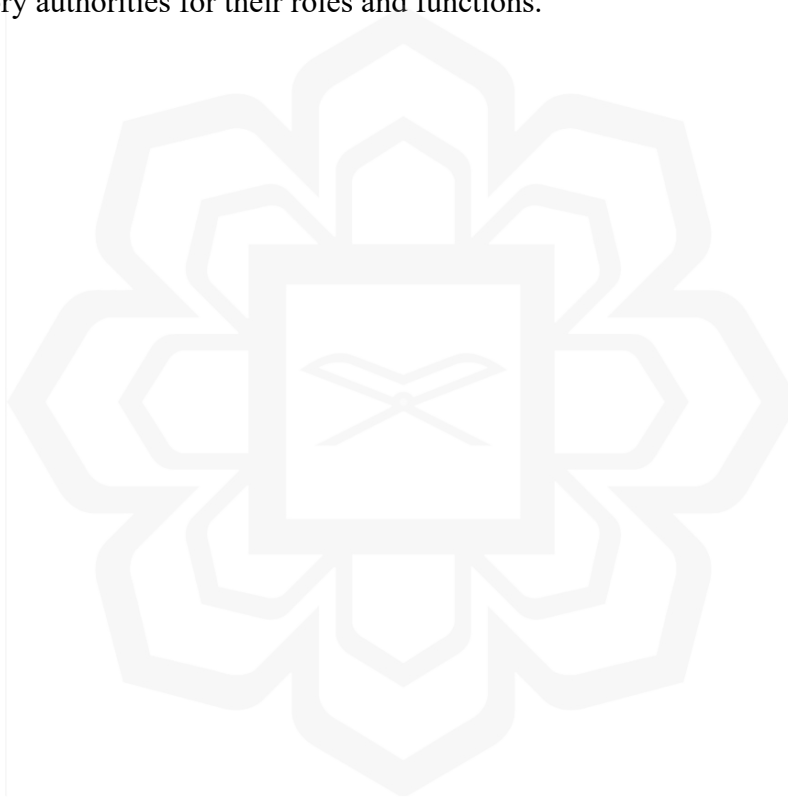
They play a vital role in the primary market, providing the issuer with the ease that if the stocks being offered to public do not attract the desired demand from stock investors, they will step in and buy the stocks which are not bought by the stock investors.

2.4 CONCLUSION

Stock trading holds significant importance in Pakistan, with clear objectives and benefits for the economy and takes place across three distinct markets which are ready market, leveraged market and futures market. It operates within a robust legal and operational framework. It is governed by a number of laws such as Securities Act 2015, Futures Market Act 2016, Central Depositories Act 1997, Depositories Act 1997, Contract Act 1872 and Companies Act 2017 and a number of regulations and rules such as Pakistan Stock Exchange Limited Regulations 2018, National Clearing Company Pakistan Limited Regulations 2018, Securities Brokers (Licensing and Operations) Regulations 2016, *Shari'ah* Governance Regulations 2018, Securities (Leveraged Markets and Pledging) Rules 2011 and Brokers and Agents Registration Rules 2001 which have been issued by different regulatory bodies such as the SECP, PSX, NCCPL and CDC. The legal framework governing stock trading in Pakistan provides an effective mechanism for the establishment, continuation and smooth functioning of stock trading. The operational framework of stock trading in Pakistan depends on the

³²⁹ Jaipur National University, *Capital Markets*, (Jaipur: Jaipur National University, 1st edn., 2013), 21.

involvement and participation of infrastructure institutions such as SECP, PSX, NCCPL and CDC which regulate and facilitate stock trading in the PSX. They perform different functions and responsibilities prescribed by the law for the smooth functioning of stock market, ensuring the safeguard of the interest of stock investors and market participants. Beside infrastructure institutions there are market participants such as stock exchange, stock investors, depositories, brokerage firms, clearing corporations and underwriters which also participate in stock trading operations in Pakistan. They are licensed by the regulatory authorities for their roles and functions.



CHAPTER THREE

***SHARĪ'AH* AND LEGAL ISSUES ON PRE-STOCK TRADING PRACTICE IN PAKISTAN**

3.0 INTRODUCTION

Stock trading in Pakistan is preceded by a number of activities and a number of measures which are considered pre-requisites for stock trading. The fulfilment of these pre-requisites is necessary before the trading starts at stock market since stock trading is a special kind of trading different from the ordinary trading as the stock investor cannot directly start trading before fulfilling these pre-requisites.

Hence, this chapter is designed to deal with pre-stock trading practice and analyse the *Sharī'ah* and legal issues pertaining to such practice.

3.1 PRE-STOCK TRADING PRACTICE

The pre stock trading involves various significant steps namely i- selection of brokerage firm, ii- account opening with the brokerage firm, iii- signing agreement between the stock investor and brokerage firm, iv- opening bank account for financial transactions related to stock trading, v- opening trading account with the brokerage firm, vi- assigning of a stockbroker to the stock investor by the brokerage firm, vii- funding the trading account by the stock investor, viii- accessing trading platform and ix- placing orders. These steps are discussed as follows.

Step 1: Selection of Brokerage Firm

A stock investor initially needs to find out a brokerage firm that can engage in stock trading on his behalf in stock exchange that operates through a complex infrastructure

that requires specialized access and technology. Brokerage firm serves as an intermediary between individual stock investor and the stock exchange, facilitating the execution of trades and providing various services to stock investor.¹

A stock investor needs to select a licensed brokerage firm to buy and sell stocks in the stock exchange.² The brokerage firm operating in the Pakistan Stock Exchange (PSX) needs to be licensed. This licensing is essential to maintain market integrity, protect stock investor and uphold transparency in the stock exchange. The license is granted by the Securities and Exchange Commission of Pakistan (SECP) which is an apex regulator regulating and overseeing the brokerage firms to ensure they comply with legal and regulatory requirements.³

Not only that, the stocks investor is also required to select registered brokerage firm in the PSX because it ensures regulatory compliance, stock investor protection, accountability and access to legal and transparent market operations. Registered firms adhere to regulatory standards, reducing the risk of financial misconduct and fraud, while also providing mechanisms for dispute resolution. This choice enhances stock investor confidence and safeguards their interests.⁴

He also needs to select a brokerage firm that has good repute. Choosing a reputable brokerage firm is essential to ensure that stock investor receives reliable services, timely execution of trades, access to accurate market data and expert guidance. A well-reputed brokerage firm enhances the stock investor's trading experience and offers trustworthiness and quality services. This choice is also important because it

¹ *Online Brokers & Trading Platforms in Pakistan*, "How to invest in stocks from Pakistan", <www.brokerchooser.com/Pakistan> (accessed 10 April 2023).

² *Pakistan Stock Exchange Limited*, "Select Your Stockbroker", <www.psx.com.pk> (accessed 10 April 2023).

³ *Securities and Exchange Commission of Pakistan (SECP)*, "Investor Protection", <<https://www.secp.gov.pk>> (accessed 7 September 2024).

⁴ *Pakistan Stock Exchange (SPX)*, "Regulations and Licensing", <<https://www.psx.com.pk>> (accessed 7 September 2024).

helps ensure the security of the stock investor's investments and a better overall experience in the stock exchanges.⁵

Moreover, he is required to select a well-established brokerage firm that has a track record of stability, experience and a larger stock investor base. This can provide stock investor with confidence in the firm's ability to manage his investments and navigate various market conditions effectively. However, it's also essential for the stock investor to consider other factors, such as services, fees and suitability for his specific investment goals, alongside the credibility of brokerage firm.

Step 2: Account Opening

After selecting the brokerage firm, the stock investor needs to open an account with the firm by filling in the account opening form.⁶ He has to provide essential personal details, including the stock investor's full name, date of birth and nationality to establish stock investor's identity. He is also required to provide contact information, such as residential address, email address and phone number as means of contact. These particulars establish the stock investor's identity and provide means for communication. In order to fulfil regulatory requirements, he has to submit a copy of identification documents such as copies of a government issued Computerized National Identity Card (CNIC) or passport. This is to ensure the verification of the stock investor's identity.⁷

Moreover, the stock investor needs to furnish details regarding his current employment, employer's name and financial information especially his annual income.

⁵ Securities and Exchange Commission of Pakistan, *Guidelines for Brokerage Houses*, (Islamabad: SECP, 2020).

⁶ Open Your Brokerage Account, <www.psx.com.pak> (accessed 10 April 2023).

⁷ 'Imran Ahmad, *Stock Market Regulations in Pakistan: A Legal and Regulatory Analysis*, (Lahore: Pakistan Law House, 2018), 45.

Additionally, information about the stock investor's net worth assists in determining financial capacity and suitability for various investment opportunities.⁸

The stock investor is also required to provide details about his bank account, including the bank's name, branch, account number and International Bank Account Number (IBAN). These details are essential for smooth fund transfers between the stock investor's bank and brokerage accounts.

After providing all the abovementioned details, the stock investor needs to sign the form and mention the submission date. By signing the form, stock investor verifies the accuracy of the information provided and acknowledge his understanding of the brokerage firm's terms and conditions.

The terms and conditions are as follows:

- (i) Fee structure that outlines the brokerage firm's charges for various services, ensuring transparency in financial transactions.⁹
- (ii) Trading policies that explain the brokerage firm's policies regarding trading execution, settlement procedures and communication protocols.
- (iii) The stock investor is informed of their responsibilities, including the need to ensure their account is adequately funded and to comply with all relevant trading regulations.¹⁰
- (iv) Risk disclosures that highlight the inherent risks associated with investments, informing stock investor about the chances for financial losses.¹¹

⁸ Nadeem Khan, *Securities Law and Practice in Pakistan*, (Karachi: Oxford University Press, 2019), 87.

⁹ *Rules Book of Pakistan Stock Exchange 2021*, "Standard Range of Brokerage Commission on Different Types of Transactions", Annexure III.

¹⁰ The Securities Brokers (Licensing and Operations) Regulations 2016, Chapter 3, s 16.

¹¹ *Ibid.*, s 13.

- (v) Privacy and data usage that highlights the brokerage firm's commitment to safeguarding the stock investor's personal and financial information.
- (vi) Termination and amendments that clarify the conditions under which the agreement may be terminated and the firm's right to amend its policies with appropriate notice.¹²

Step 3: Signing Agreement

After the completion of filling account opening form, the stock investor and the brokerage firm move towards signing an agreement that is referred to a "brokerage agreement". It is a legally binding contract between a stock investor and a brokerage firm.¹³ It spells out the rights of stock investor and brokerage firm. The rights of the stock investor are as follows:

- (i) Stock investor has the right to access the services specified in the agreement, such as trading, investment advice and account management.¹⁴
- (ii) Stock investor has the right to receive accurate and timely information about his investments, account activity and any changes in the terms of the agreement.¹⁵
- (iii) Stock investor' personal and financial information must be kept confidential and secure by the brokerage firm.¹⁶

¹² *Rules Book of Pakistan Stock Exchange 2021*, "Terms and Conditions of Brokerage Agreement", Annexure B.

¹³ The rights and duties of the stock investor and brokerage firm outlined in the brokerage agreement are governed by relevant regulations such as the Securities Act 2015, the Pakistan Stock Exchange Rulebook and the Broker and Agent Regulations 2001 issued by the Securities and Exchange Commission of Pakistan (SECP). If the brokerage agreement is standardized, it adheres to these regulatory frameworks. Each right and duty mentioned corresponds to obligations prescribed within these regulations. For instance, confidentiality obligations align with Section X of the Securities Act, while responsibilities related to order execution and fund handling are governed by the Rules Book of Pakistan Stock Exchange 2021.

¹⁴ Securities Act 2015, s 66(1).

¹⁵ *Ibid.*, s 66(2).

¹⁶ *Ibid.*, s 67; The Securities Brokers (Licensing and Operations) Regulations 2016, s 16.

On the other hand, rights of the brokerage firm include the following rights:

- (i) Brokerage firm has the right to receive fee for its services as outlined in the agreement.¹⁷
- (ii) Brokerage firm has the right to execute trades as per the stock investor's instructions and market conditions.¹⁸
- (iii) Brokerage firm has the right to disclose its fee, conflicts of interest and other relevant information to the stock investor.¹⁹

The agreement also lays down the responsibilities of stockbroker and brokerage firm. The responsibilities of the stock investor include the following responsibilities:

- (i) Stock investor is responsible for making informed decisions about his investments. He should conduct due diligence and research before making trades or investment choices.²⁰
- (ii) Stock investor must fund his account as agreed upon and ensure there are sufficient funds for trading activities.²¹
- (iii) Stock investor is responsible for communicating his trade instructions clearly and promptly to the broker.²²

The responsibilities of the brokerage firm are as follows:

- (i) Brokerage firm must provide accurate and timely information to stock investor, especially regarding investment opportunities, risks and costs.²³
- (ii) Brokerage firm must execute orders promptly and accurately according to the stock investor's instructions.²⁴

¹⁷ Rules Book of Pakistan Stock Exchange 2021, s 12.5.

¹⁸ Ibid., Chapter 12, s 12.7.

¹⁹ Securities Act 2015, s 68.

²⁰ Ibid., s 69(1).

²¹ Rules Book of Pakistan Stock Exchange 2021, s 12.10.

²² Ibid., s 12.12.

²³ Securities Act 2015, s 70(1).

²⁴ Rules Book of Pakistan Stock Exchange 2021, s 12.15.

(iii) Brokerage firm should be transparent about any conflicts of interest that might impact the interest of its stock investor.²⁵

(iv) Brokerage firm has the obligation to ensure proper handling and segregation of stock investor funds.²⁶ Handling stock investor funds with care and transparency is crucial for maintaining the brokerage firm's reputation and credibility. Properly managed funds in order to enhance stock investor's trust and contribute to the overall integrity of the brokerage.

Moreover, the agreement specifies the services the brokerage firm has to offer which may include executing trades, providing investment advice, managing portfolios and similar other services. The services depend on the nature of brokerage firm whether it is offering service for trading only, or trading and clearance or trading and self-clearing as well.²⁷

It is pertinent to mention that a stock brokerage firm is licenced to offer three types of services which are trading, trading and self-clearing and trading, clearing and custody. A firm licensed only for trading can execute trades on its own behalf or on behalf of its stock investors, but it cannot handle the settlement of trades or offer clearing services.²⁸

A firm licensed for both trading and self-clearing can execute trades and handle the settlement of those trades (both proprietary and those executed on behalf of its stock investors). Additionally, it can hold the custody of the securities involved in these transactions, but only for its own trades and those of its stock investors.²⁹

²⁵ The Securities Brokers (Licensing and Operations) Regulations 2016 define scope and contours of broker's fiduciary obligations and conflict of interest. See, Chapter 13: Conduct of Brokers, Chapter 15: Conflict of Interest and Chapter 16: Duties and Obligations of Brokers.

²⁶ Ibid., s 23 (2), (3), (4).

²⁷ There are three types of services provided by the broker, trading only: trading and self-clearance and trading and clearing. See, The Securities (Licensing and Operations) Regulations 2016, s 6.

²⁸ The Securities Brokers (Licensing and Operations) Regulations 2016, s 5: Eligibility Criteria.

²⁹ Ibid.

A firm licensed for trading, clearing and custody can not only execute and settle its own trades and those of its stock investors, but it also has the authority to settle trades for other brokerage firms and their stock investors. Additionally, it can hold the custody of securities for itself, its stock investors and other brokerage firms and their stock investors.³⁰

Furthermore, the agreement requires the brokerage firm to disclose to the stock investor cases of conflict of interest. If the firm has any conflicts of interest, such as receiving fee from third parties for promoting certain investments, these must be disclosed in the agreement. Similarly, if the brokerage firm is engaged in trading on its own account, known also as proprietary trading, he has to disclose it to the stock investor. The legal regime on conduct and responsibilities in Pakistan requires from a brokerage firm to ensure that it does not give or accept any inducement that is likely to conflict with any duties owed to the stock investor.³¹

The agreement also outlines the conditions under which either party can terminate the relationship. This could include breach of contract, non-payment of fees or other relevant factors.³²

³⁰ Ibid.

³¹ The Securities Brokers (Licensing and Operations) Regulations 2016, s. 14(4).

³² Some common factors outlined in such agreements are, Breach of Contract: If either party fails to fulfil its obligations as outlined in the agreement, it may be considered a breach of contract. For example, if the brokerage firm fails to provide agreed-upon services or if the stock investor fails to meet financial commitments, it could trigger the termination clause.

Non-Payment of Fees: If the stock investor fails to make agreed-upon payments or fees as outlined in the contract, the brokerage firm may have the right to terminate the agreement. This could include management fees, performance fees, or any other fees specified in the agreement.

Failure to Meet Performance Benchmarks: The agreement may include specific performance benchmarks or targets that the brokerage firm is expected to achieve. If these benchmarks are not met, it could give either party the right to terminate the relationship.

Regulatory or Legal Issues: Changes in regulations or legal requirements may also be specified as grounds for termination. If either party faces legal issues that could impact the ability to continue the relationship, termination may be allowed under these circumstances.

Mutual Agreement: In some cases, the agreement may allow for termination by mutual agreement. If both parties agree that it is in their best interest to end the relationship, they can do so without invoking specific breach conditions. See,

<https://psx.com.pk/psx/themes/psx/uploads/Schedule_of_Charges_%28As_of_October_7,_2022%29.pdf> (accessed 2 March 2024).

It also outlines the fees, commissions and other charges the stock investor incurs for using the brokerage services. This could include transaction fees,³³ management fees³⁴ and performance-based fees.³⁵ Understanding the fees and charges associated with brokerage services is crucial for the stock investor. Therefore, the PSX has implemented a fee schedule for brokerage firm, which outlines the charges they can apply to their stock investor for various services. This fee schedule acts like a rulebook and roadmap that helps both stock investor and brokerage firm understand as to how much they need to pay or charge for different types of trades and transactions. The different fees for different types of trades are as follows:

For trades in the ready market or odd lots market, a brokerage firm can charge Rs. 3.50 for every Rs. 100,000 of the trade's value. If it's a futures contract trade, whether it's deliverable, cash-settled, or related to stock index futures, the fee is Rs. 3.90 for every Rs. 100,000 of the trade's value. In Squaring-Up Market trades or Negotiated

³³ Transaction fees are incurred each time a stock investor buys or sells a financial instrument through the brokerage firm. Whether purchasing stocks, bonds, or other securities, typically this fee will be charged for the execution of trade. Transaction fees can vary widely among brokerage firms and can be assessed as a fixed fee or as a percentage of the transaction value. Stock investors should carefully consider these fees, as they can accumulate, especially for frequent traders, impacting the overall profitability of their investments. See, https://psx.com.pk/psx/themes/psx/uploads/Schedule_of_Charges_%28As_of_October_7,_2022%29.pdf (accessed 2 March 2024).

³⁴ Management fees are relevant to stock investors who opt for portfolio management or seek investment advice from their brokerage firm. Management fees are typically charged periodically, often on an annual or quarterly basis and are based on the total assets under management (AUM). They compensate the brokerage firm for the ongoing management of the stock investor's investment portfolio, including research, analysis and decision-making. It's crucial for stock investors to assess the impact of management fees on their returns, as high fees can eat into profits over time. It's also essential to consider the value provided by the management services in relation to the fees charged. See, https://psx.com.pk/psx/themes/psx/uploads/Schedule_of_Charges_%28As_of_October_7,_2022%29.pdf (accessed 2 March 2024).

³⁵ Performance-based fees are structured such that the brokerage firm earns a percentage of the profits generated from the stock investor's investments. This fee structure aligns the interests of the stock investor and the broker, as the broker only benefits when the investments perform well. However, it's essential to critically evaluate the terms of performance-based fees, as they can sometimes lead to high charges during strong market upswings, potentially offsetting the gains. See, https://psx.com.pk/psx/themes/psx/uploads/Schedule_of_Charges_%28As_of_October_7,_2022%29.pdf (accessed 2 March 2024).

Deals Market transactions, the fee is also Rs. 3.50 for every Rs. 100,000 of the trade's value. In the Debt Market, the fee is Rs. 2.80 for every Rs. 100,000 of the trade's value.³⁶

FEE SCHEDULE			
SERIAL NO.	MARKET NAME	RATE IN RUPEES	BASIS
1	Ready Market Trade	3.50	Rs. 100,000/- value trade
2	Odd Lots Market Trade	3.50	Rs. 100,000/- value trade
3	Deliverable Futures Contract Market- contract	3.90	Rs. 100,000/- value trade
4	Cash-Settled Futures Contract Market-contract	3.90	Rs. 100,000/- value trade
5	Stock Index Futures Contract Market-contract	3.90	Rs. 100,000/- value trade
6	Squaring-Up Market-trade	3.50	Rs. 100,000/- value trade
7	Negotiated Deals Market- transaction	3.50	Rs. 100,000/- value trade
8	Debt Market	2.80	Rs. 100,000/- value trade

Figure 3.1: Fee Schedule in Various Markets

This fee schedule is designed to bring clarity and transparency to the trading process, ensuring that stock investor know what to expect and the brokerage firm operate within defined boundaries.

It is pertinent to note that the schedule of fee is a part of brokerage agreement signed between the brokerage firm and the stock investor. This schedule is fixed by the brokerage industry with the approval of SECP and PSX. When the stock investor signs the agreement, he is deemed to have agreed to the schedule of fee. To disclose schedule of fee is the regulatory duty and mandatory on every brokerage firm so that it is known to the stock investor.

By signing this agreement, stock investor is protected and he gets legal basis for seeking remedies in case of any disputes. This agreement provides clarity on services offered, fee structures and terms of engagement. It prevents misunderstandings and

³⁶ See, https://psx.com.pk/psx/themes/psx/uploads/Schedule_of_Charges_%28As_of_October_7,_2022%29.pdf (accessed 2 March 2024).

conflicts by establishing a common understanding between the stock investor and the brokerage firm.

Step 4: Opening of Bank Account

After signing the agreement, the stock investor has to open a bank account for financial transactions related to stock trading. Opening a bank account is necessary for fund transfers from the bank account to the trading account.³⁷ It provides a clear source of funds and enables seamless transactions. The brokerage firm is required to maintain a separate stock investor trust account for handling stock investor funds. Maintaining a separate stock investor trust account ensures the segregation of stock investor funds from the broker firm's operational funds. This safeguards stock investor' investments and prevents misuse of funds. This practice enhances financial security in the stock exchange.

Step 5: Opening Trading Account

After opening the bank account, the stock investor needs to open a trading account with a registered brokerage firm to participate in the stock exchange. A trading account is a specialized account opened with a brokerage firm. It serves as a gateway for a stock investor to access the stock exchange and execute transactions. This account is distinct from a regular savings or checking account and is specifically designed for buying and selling securities.

The process of opening a trading account with a registered brokerage firm typically involves various steps and submission of various documents. Stock investor

³⁷ Securities and Exchange Commission of Pakistan (SECP), Securities Brokers (Licensing and Operations) Regulations 2016, s 11.

needs to submit these documents to the brokerage firm he choose to open his trading account with. Here's how the submission process typically works:

i Application Form

The brokerage firm provides application form that the stock investor needs to fill out. This form collects important information and supporting documents about the stock investor's personal details, financial background, investment experience and risk tolerance. Along with the completed application form, the stock investor needs to provide photocopies of the required documents. These documents can be submitted physically or electronically, depending on the brokerage's procedures. These documents include CNIC. Stock investor needs to provide a valid CNIC. Obtaining a valid CNIC from National Database and Registration Authority (NADRA) is mandatory identification document required for various financial transactions, including opening a trading account.³⁸

One of the requisites for stock investor is to provide the National Tax Number (NTN). Obtaining an NTN from the Federal Board of Revenue (FBR) is essential because it ensures that stock investor is tax-compliant and his financial activities are tracked by the government.³⁹

The stock investor also needs to attach recent passport-sized photographs for account verification and identification purposes. He also needs to provide proof of address to verify his residential address. This can be a utility bill, bank statement, or

³⁸ National Database and Registration Authority (NADRA), NADRA Ordinance 2000, s 9.

³⁹ Federal Board of Revenue (FBR), Income Tax Ordinance 2001, s 181.

any other official document displaying his name and address. The document should be recent and issued within the last three to six months.⁴⁰

Furthermore, he needs to provide details of his bank account, such as the account number and branch, for the purpose of funding his trading account and facilitating money transfers. Additionally, he needs to provide the Central Depository Company (CDC) stock investor account opening form. This form is required to open an account with the CDC to hold securities electronically. He also needs to submit the risk disclosure form. A document that informs about the risks associated with stock trading and helps in understanding potential losses.⁴¹

ii Verification

Once the application form is submitted the brokerage firm's compliance team thoroughly reviews the documents submitted by the stock investor. This verification process is critical as it confirms the authenticity of the provided information. The compliance team examines the submitted documents, such as identification, financial records and relevant signatures, to ensure they are genuine and accurate. Moreover, they verify that the information complies with the regulatory requirements imposed by financial authorities. This verification step is essential to prevent fraud, money laundering and other illicit activities within the stock exchange.⁴²

⁴⁰ Securities and Exchange Commission of Pakistan (SECP), Securities Brokers (Licensing and Operations) Regulations 2016, s 13.

⁴¹ Central Depository Company of Pakistan (CDC), "CDC Account Opening Procedures, 2020," Central Depository Company of Pakistan Limited, <<https://www.cdcpakistan.com/downloads/account-opening-forms-procedures/>> (accessed 2 March 2024).

⁴² Securities and Exchange Commission of Pakistan (SECP), "Anti-Money Laundering and Combating Financing of Terrorism Guidelines 2020", <<https://www.secp.gov.pk/laws/guidelines/>> (accessed 2 March 2024).

iii Approval

Once the verification process is successfully completed, the application moves on to the approval stage. Here, the brokerage's account-opening team assesses the application against the firm's internal policies and procedures. They ensure that the applicant meets the eligibility criteria set by the brokerage, including financial stability and compliance with the firm's specific terms. The approval process protects and safeguards the brokerage and its stock investor from potential risks. By carefully scrutinizing each application, the brokerage can maintain a secure and compliant trading environment.

The approval step is important because it protects the interests of both the brokerage firm and the stock investor. It ensures that only qualified and legitimate individuals or entities gain access to the stock exchange. Additionally, approval signifies that the brokerage firm has thoroughly assessed the applicant's suitability, reducing the risk of financial misconduct or fraud within the trading account. Ultimately, a strict approval process contributes to a safer and more trustworthy trading environment for all participants.⁴³

Step 6: Assignment of Stockbroker

After the stock investor is done with opening a trading account with brokerage firm, a stockbroker is assigned the stock investor by the brokerage firm. A stockbroker is under obligation to fulfil PSX membership requirements and establish necessary infrastructure. Fulfilling PSX membership requirements demonstrates a stockbroker's commitment to adhering to industry standards, ethical practices and regulatory

⁴³ Securities and Exchange Commission of Pakistan (SECP), Securities Brokers (Licensing and Operations) Regulations 2016, s 14.

guidelines. It assures stock investor that the stockbroker operates within a structured and regulated framework.

The assignment of a stockbroker after opening a trading account is an important step for the stock trading. A stockbroker plays an important role in facilitating financial transactions in the stock exchange. His advantages are numerous and can greatly benefit the stock investor. Firstly, he possesses a deep understanding of the market, offering valuable insights and advice to his stock investor. He has access to a wide range of financial instruments and can execute trades swiftly, ensuring timely responses to market fluctuations. Additionally, he provides personalized investment strategies designed to individual risk tolerance and financial goals. He keeps stock investor informed about market trends, news and updates, helping them make informed decisions.

Step 7: Fund Deposit

After the trading account is approved, the stock investor needs to fund his trading account by transferring funds from his-linked bank account to the trading account.⁴⁴ This can often be done through online banking or other electronic methods. Many brokerage firms offer online banking as one of the convenient methods for stock investor to fund his trading accounts. This process is secure and efficient, allowing stock investor to transfer money from his bank account to his brokerage account electronically. It provides ease of access and helps stock investor quickly fund his trading activities. A pre-requisite for initiating trade, is depositing funds into the trading account maintained with the brokerage firm. Stock investor needs to deposit funds into his trading accounts for several crucial reasons. These funds provide necessary capital

⁴⁴ See, *Savings and Capital Markets*, 165.

for buying stocks and other financial securities. Without a sufficient balance in the trading account, stock investor cannot execute buy orders and take ownership in companies. This capital facilitates stock purchases, allowing stock investor to participate actively in the stock exchange. Moreover, depositing funds enables diversification, a fundamental principle of investment strategy. Stock investor can spread his capital across various stocks or asset classes, reducing portfolio risk and potentially enhancing returns. Additionally, having funds readily available in a trading account allows stock investor to capitalize on market opportunities promptly. Stock exchanges are dynamic and the ability to seize favourable investment chances can be critical. It also provides flexibility in trading, allowing stock investor to align his decisions with his investment goals, whether it's short-term trading or long-term investments. Furthermore, depositing funds ensures that stock investor can cover transaction costs, such as brokerage fees and commissions and implement risk management strategies effectively. In essence, funds in a trading account are essential for active participation in the stock exchange, enabling stock investor to pursue his financial objectives and manage risks effectively.

Step 8: Access to Trading Platform

Once the funds are deposited in the trading account, the stock investor receives login credentials for the brokerage's trading platform.⁴⁵ This platform provides access to market data,⁴⁶ order placement,⁴⁷ portfolio tracking⁴⁸ and research tools.⁴⁹

Trading platforms provide information on stock, bond and commodity prices. This helps track trends and find good investment opportunities. Without this data, the stock investor would be guessing.

Additionally, the platform helps stock investor to buy and sell. The stock investor can input their trading instructions. They can set the quantity, price and order type. It's like giving instructions to make deals. Moreover, trading platforms enable the placement of complex orders, such as stop-loss or trailing stop orders. These advanced order types are instrumental in managing risk and optimizing returns, granting stock investor a higher degree of control over his investment strategies.

⁴⁵ The trading platform is a software interface provided by the brokerage to enable users, in this case, stock investors, to interact with financial markets. It can be accessed through a web browser, a downloadable application, or a mobile app. See, *Investopedia*, "Trading Platform", <<https://www.investopedia.com/terms/t/trading-platform.asp>> (accessed 29 September 2024).

⁴⁶ Market data refers to information about financial instruments such as stocks, bonds, commodities and indices. The trading platform provides access to the market data, including stock prices where real-time and historical prices of individual stocks can be accessed, bid-ask spreads where the difference between the buying (bid) and selling (ask) prices can be accessed, volume information where data regarding the total number of shares traded during a specific time period can be accessed, market news where relevant news and updates affecting the financial markets can be accessed. See, *Investopedia*.

⁴⁷ The trading platform allows stock investors to place various types of orders such as market orders which is an order to buy or sell a security at the best available price in the market, limit orders which is an order to buy or sell a security at a specific price or better, stop orders is an order to buy or sell a security once it reaches a specific price, triggering a market order. See, *Investopedia*.

⁴⁸ Stock investors can monitor and manage their investment portfolios through this platform. It provides the current value of the stock investor's portfolio based on market prices. The stock investors can also track the performance of their holdings, including overall gains or losses. This platform also provides a record of all past trades and transactions. See, *Investopedia*.

⁴⁹ Trading platforms often offer a number of research tools to assist stock investors in making informed decisions such as charts and technical analysis providing visual representations of price movements, trends and technical indicators. The platform also provide access to financial statements, earnings reports and other fundamental data about companies. Furthermore, timely updates on market news and events that may impact investments are also provided. Moreover, the platform also provides tools to filter and search for stocks based on specific criteria. See, *Investopedia*.

The platform also helps the stock investor to see if his investments are on track. The stock investor gains insights into how his investments are advancing, can assess the overall asset allocation and make timely adjustments as needed. Real-time portfolio tracking ensures that stock investor maintain a firm grip on his financial assets, empowering them to respond swiftly to market changes and remain aligned with his chosen investment strategies.

The platform also offers tools to access company finances, analyst reports, news and charts. These help to identify trends and good investments.

Step 9: Placing Order

After getting access to trading platform, the stock investor places buy/sell orders based on his investment strategy. Placing an order is a critical step that requires careful consideration of the stock investor's goals, risk tolerance and market conditions. Placing buy or sell orders in the PSX is a crucial step for a stock investor and it demands careful consideration of his investment strategy, risk tolerance and the prevailing market conditions. For brokerage firm, executing orders accurately and efficiently is vital to maintain stock investor trust and adhere to regulatory standards. Both stock investor and brokerage firm should be aware of the different order types and their implications to make informed decisions.

The process of placing an order in the PSX involves several interconnected steps. Stock investor accesses his trading account using the credentials provided by his brokerage, granting him entry into the trading platform where he can initiate orders. He then makes critical decision of selecting the appropriate order type, such as market

orders,⁵⁰ limit orders⁵¹ or stop orders,⁵² depending on their specific trading strategy, risk tolerance and the current market conditions.

Once the order type is determined, stock investor proceeds to select the specific stock or security he wishes to buy or sell, typically identified by its symbol or name on the trading platform. Afterward, stock investor specifies the quantity of shares he wants to trade, keeping an eye on the available quantity displayed on the platform.

For limit orders, a stock investor must set the price at which he is willing to buy or sell the stock, a crucial detail that directly affects the execution conditions. The next step involves a thorough review of the order details, including the stock symbol, quantity, order type and price (for limit orders) to ensure accuracy.

Once satisfied with the order parameters, stock investor submits the order through the trading platform, sending it to the brokerage for execution. Upon submission, stock investor receives a confirmation, affirming that his order has been received and is in the process of being executed. Here, the brokerage firm takes the lead, by facilitating order execution. It processes stock investor orders, ensuring compliance with regulatory standards while striving to execute orders promptly to achieve the best possible outcome for the stock investor. After execution, stock investor receives a confirmation notice, providing details of the executed trade, including the price at which the trade occurred.

⁵⁰ Market Order is an order to purchase or to sell shares at the best available existing price. See, *Savings and Capital Markets*, 169.

⁵¹ Limit Order refers to an order placed with brokerage firm to purchase or sell certain quantity of shares at a stated price. See, *Savings and Capital Markets*, 169.

⁵² A stop order to buy or sell become active after a specified price level has been reached. See, *Savings and Capital Markets*, 170.

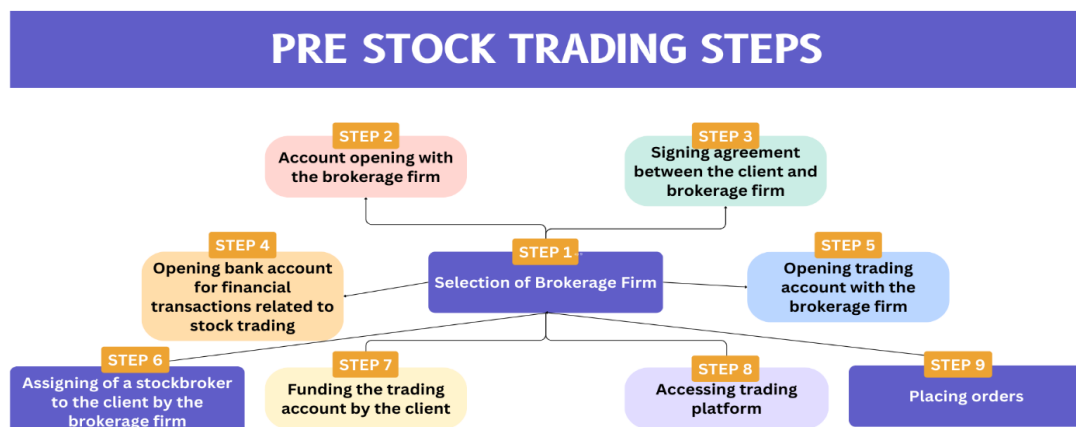


Figure 3.2: Steps of Pre-Stock Trading

The above diagram depicts clear picture of essential steps of pre-stock trading, covering aspects like choosing a brokerage firm, opening account with the brokerage firm, signing agreements between the client⁵³ and brokerage firm, setting up a bank account for financial transactions related to stock trading, opening trading account with the brokerage firm, assigning a stockbroker to the stock investor by the brokerage firm, funding the trading account by the stock investor, accessing the trading platform and placing orders. The diagram serves as a guide, providing a clear overview for stock investor entering the stock market.

3.2 *SHARĪ'AH* ISSUES IN PRE-STOCK TRADING PRACTICES

There are various *Sharī'ah* issues in pre stock trading practices such as: i) position of broker ii) conflict of interest iii) charging fee, commission, performance-based fee and

⁵³ In the diagram client refers to the stock investor.

incentive iv) stock investor's funds in the custody of brokerage firm. In the following, these issues are discussed.

3.2.1 Position of broker

An important *Sharī'ah* issue on pre stock trading practice is position of broker. As stated earlier, trading in stock market takes place through the authorized licensed brokerage firm. As such the stock investor is required to appoint a brokerage firm for this purpose. Now the *Sharī'ah* issue arises that what is position of brokerage firm: whether it is *simsār* (intermediary) or *wakīl* (agent) in *Sharī'ah*? *Simsār* is defined as a conduit or bridge and intermediary between the buyer and seller and matches them to affect sale and purchase transaction.⁵⁴ He is also called *dallāl*.⁵⁵

This definition indicates that a *simsār* matches the buyer and seller. He introduces one party to the other. But he himself does not execute the trade. He does not take any responsibility or liability with regard to executed trade.

On the other hand, a *wakīl* is a person who performs certain act, task or deposition on behalf of another person through a *wakālah* agreement. *Wakālah* is defined as to delegate certain act or deposition through another person provided the task or deposition is permissible in *Sharī'ah*.⁵⁶

The definition of *wakālah* indicates that this is the *wakīl* who performs the actual act or deposition delegated to him by the principal. Whereas the *simsār* does not perform or execute the task. He only serves as intermediary between the buyer and seller.

While examining the role of brokerage firm in the light of above definition, it becomes evident that the firm is not a *simsār*, because contrary to *simsār* the firm itself

⁵⁴ *Al-Mawsū'ah al-Fiqhiyyah*, (Kuwait: Ministry of Awqaf and Islamic Affairs, 1983), 10:151.

⁵⁵ Ibn 'Ābidīn, *Radd al-Mukhtār*, (Beirut: Dār al-Fikr, 1992), 5:39.

⁵⁶ *Al-Mawsū'ah al-Fiqhiyyah*, 45:5.

executes trade and takes the responsibility and liability with regard to execution of trade is also borne by the stock brokerage firm not by the buyer and seller. Thus, the status of brokerage firm is that of *wakīl* for the stock investor. Therefore, all the rules outlined for *wakīl* in classical and modern Islamic jurisprudence, are applicable to the brokerage firm.⁵⁷

In Islamic law, *wakālah* is allowed only in permissible acts. The *wakālah* agreement cannot be made for the performance of acts that are prohibited in *Sharī'ah*. For example, an individual is not allowed to hire services of a brokerage firm to buy securities such as bonds, debentures, options and derivatives because these securities and instruments are prohibited in *Sharī'ah* due to involvement of the elements of *ribā* (interest), *gharar* (uncertainty), *qimār* (gambling) and *maysir* (games of chance).⁵⁸

Furthermore, the act or the disposition of *wakālah* should be clearly known to the *wakīl* so that he is able to perform that act. For example, when a stock investor appoints a brokerage firm as its *wakīl* for brokerage services, he should clearly identify in the agreement that he is making it *wakīl* for trading only or for both trading and clearing. He should also specify which stocks he wants to purchase through his *wakīl*. For example, stocks of oil and gas company Pakistan.

Islamic law also requires that a *wakīl* should exercise due care and diligence while carrying out the task assigned to him. Thus, if any loss occurs to the stock investor as a result of negligence, misconduct and breach of conditions laid down in the agreement, he is liable for that loss. Islamic law requires if a *wakīl* is making any trading for himself, it should not be at the cost of the stock investor's interest. He should bring all the facts to the knowledge of his stock investor. Thus, from the perspective of

⁵⁷ Wahbah Zuhāyī, *Al-Fiqh al-Islāmī wa Adillatuhū*, (Damascus: Dār al-Fikr, 1989), 4:173.

⁵⁸ Subhī Mahmasānī, *Al-Mujibāt wa al-Uqūd fī al-Fiqh al-Islāmī*, (Beirut: Dār al-'Ilm li al-Malayin, 1983), 89.

Sharī'ah a *wakīl* is a fiduciary and trustee of his stock investor. From this it may be established that a brokerage firm is a *wakīl* for stock investor and owes fiduciary responsibility. This conclusion has been endorsed and validated by the respondents as well who hold the view that brokerage firm is a *wakīl* and thus it is under obligation to give priority to his stock investors' interest. They further maintained that brokerage firm is liable for loss in case of its misconduct and breach of instructions and conditions set by the stock investor in brokerage agreement.⁵⁹

This position was further confirmed in response to the following interview question, which was specifically posed to brokerage firms: Do you agree that brokerage firms, as agents under *Sharī'ah*, have a fiduciary duty to prioritize stock investors' interests and should be held liable for any loss resulting from negligence, misconduct, or breach of the brokerage agreement? The majority of respondents answered affirmatively. They acknowledged that being *wakīl* under *Sharī'ah*, the brokerage firm is under fiduciary duty to protect the interest of the stock investor and is liable for losses arising from misconduct or breach of contract. This confirms the *Sharī'ah* characterization of brokerage firms as agents who owe fiduciary responsibilities to their principals.

3.2.2 Conflict of Interest

An important *Sharī'ah* issue on pre stock trading practice is conflict of interest. As stated earlier that the brokerage firm hold the position of *wakīl* for its stock investor. This position implies that the firm should avoid the situations of conflict of interest and that he should always prioritize stock investors' interest over his own interest. The conflict of interest may arise when firms' own interest clashes with the interest of its

⁵⁹ Views expressed by respondent no. 102, 105, 111.

stock investor and the firm in such situation prefers its own interest. This happens when the firm, for the sake of generating its commission suggests unsuitable investments to its stock investor. Sometimes the brokerage firm, acting as underwriter for any company promotes its business and persuades the stock investor to buy its stocks. For this purpose, it may conceal the status of its being an underwriter for certain company. Here the interest of brokerage firm as underwriter conflicts with the interest of the stock investor because firms' duty as underwriter requires from him to promote the business of the company which has hired the firm for underwriting services. On the other hand, its duty as *wakīl* of the stock investor requires from him to recommend to the stock investor only the suitable and profitable business keeping in view stock investors' financial status and risk profile. Conflict of interest contradicts with the principles of *Sharī'ah*. Many *Sharī'ah* rulings on the duty of *wakīl* in classical and modern Islamic law emphasize the avoidance of conflict of interest. For example, the *Hanafis* maintain that if a person is a *wakīl* for sale of a certain property he should not sell it to himself nor should he sell it to his wife, father, grandfather, son, grandson and all those whose testimony is not accepted for him because in such case he will be accused of preferring his interest over the interest of the person who has appointed him as his *wakīl*.⁶⁰ If we apply this ruling to the sale of stocks by the brokerage firm, we may establish that according to *Hanafis* this would be a case of conflict of interest if the brokerage firm buys the stocks belonging to the stock investor for itself. The above ruling establishes the prohibition of conflict of interest. In the same way the *Hanafis* also hold the opinion that if a person is appointed *wakīl* for someone to buy a property, he is not allowed to sell his own property or the property of his wife, father, grandfather, son, grandson and all those whose testimony is not accepted for him, because it creates doubt in his

⁶⁰ Kasāni, *Badāi' al-Sanā'i*, (Beirut: Dār al-Kutub al-‘Ilmiyyah, 2003), 6:28.

integrity.⁶¹ The *Shaf'is* however allow a *wakīl* of sale to sell the property of his father, grandfather, adult son to the person who appointed him as his *wakīl* of sale provided it is at market value however, he cannot sell his own property or his minor sons' property to the person who has appointed him for sale.⁶² From the above discussion, we may conclude that although classical Islamic law does not clearly mention the conflict of interest, the above rulings indicate that the concept does exist in the Islamic law. The above rulings prove that the Islamic law prohibits conflict of interest.⁶³

3.2.3 Charging fee, commission, performance-based fee and incentive

An important *Shari'ah* issue on pre stock trading practice is *Shari'ah* position of charging fee, commission, performance-based fee and incentive from the stock investor for *wakālah* (brokerage services) by the brokerage firm. A brokerage firm charges fee, commission besides collecting performance-based fee and incentives. So now the *Shari'ah* issue arises that what is the position of charging fee, commission, performance-based fees and incentives for the *wakālah*. All the Muslim jurists are unanimous that *wakālah* can be made with fee and without fee. In case, *wakālah* is with fee, then it should be clearly specified in the agreement of *wakālah*. It is worth mentioning that in Islamic law fee (*ujrah*) and commission (*'umulāh*)⁶⁴ are used as interchangeable terms. In the same way Islamic law equates *wakālah* with *ijarah* and the rules of *wakālah* apply to it. Thus, according to AAOIFI the principles of *ijarah al-*

⁶¹ Ibn 'Ābidīn, 4:424.

⁶² Shirbīnī, *Mughnī al-Muhtāj*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 2:234.

⁶³ Additionally, *Shari'ah* principles emphasize *amānah* (trust) and *'adl* (justice), requiring a *wakīl* to act with honesty and fairness. The principle of *lā ḍarar wa lā ḍirār* (no harm and no reciprocating harm) further mandates that a *wakīl* must avoid actions that could harm the stock investor's interests. Moreover, the Prophet Muḥammad (S.A.W.) stated, "Whoever deceives is not one of us," underscoring the prohibition of deceptive practices, which includes concealing conflicts of interest.

⁶⁴ In Ḥadīth the word *'umālāh* has been used as which stands for fee and commission. In modern usage the word *'umālāh* is commonly used for fee and commission.

ashkhāṣ are applicable to *wakālah*. In this regard AAOIFI provides that a *wakālah* against commission or fee is *ijarah*.⁶⁵ This implies that the stock investor has hired services of brokerage firm for certain task in lieu of determined fee. With regard to *ujrah*, it is provided that the Holy Prophet (S.A.W.S.) used to send his workers to collect *ḥajj* and other revenues and he would fix their *ujrah* i.e. fee or commission, for their services.⁶⁶ It is also stated that if the fee is stipulated in *wakālah* agreement and the *wakīl* performs the assigned task, he becomes entitled to fee and if the fee is not stipulated in the contract, the *wakīl* will be considered as he has done this work voluntarily.⁶⁷ Therefore, he cannot demand fee on the completion of work.⁶⁸

If we apply the above rules regarding fee to stock brokerage service, it may be established that charging commission by the brokerage firm for the services rendered to its stock investor, is consistent with the principles of *Sharī'ah*. It is pertinent to note that the schedule of fee or commission to be charged by the brokerage firm is always a part of brokerage agreement signed between the firm and the stock investor. This fee and commission are fixed by the brokerage industry with the approval of SECP and PSX. When the stock investor signs the agreement, he is deemed to have agreed to the schedule of fee, commissions and other charges. To disclose schedule of fee is the regulatory duty and mandatory on every brokerage firm so that it is known to the stock investor. However, in certain cases the brokerage firm and stock investor may agree on performance-based fee and certain incentives as well. The example of performance-based fee or incentive is where the stock investor agrees that if the profit earned and the profit realized is above a certain ceiling or benchmark say 10 percent of the investment,

⁶⁵ AAOIFI, *Sharī'ah Standard No. 23 Agency and the Act of Uncommissioned Agent (Fudulī)*, Art 4.2.2.

⁶⁶ *Al-Mawsū'ah al-Fiqhiyyah*, 45:91.

⁶⁷ *Durar al-Hukkām Sharḥ Majallah al-Aḥkām 'Adliyyah*, (Istanbul: Maṭba'ah al-Dawlah, 1913), 3:593.

⁶⁸ *Ibid.*

the profit over and above this ceiling and benchmark will be given to the brokerage firm as an incentive. The AAOIFI holds such performance-based fee and incentive permissible.⁶⁹ It provides that if the agency is remunerated, the agent's fee should either a fixed amount or percentage of the amount invested. It is also permissible to link the fee to an established benchmark that is known to both parties. It should, however, be capped by assigning maximum and minimum limit.⁷⁰ This provision indicates that agency fee can be linked with certain benchmark for example KIBOR (Karachi Inter Bank Offer Rate). It further provides that it is permissible to stipulate that the agent, in addition to his fee, is entitled to all or part of any amount over and above the expected profit as performance incentive.⁷¹ This implies that AAOIFI, holds performance and incentive-based fee permissible in *Sharī'ah*. It also indicates that according to AAOIFI, there is no difference between performance-based fee and incentive. The justification for giving extra fee is that it is a type of reward (*ju'l*) which falls under Islamic contract of reward (*ju'ālah*). *Ju'ālah* is a contract in which one party offers certain fee (*ju'l*) to anyone who will achieve certain targets set by the *jā'il* (reward offeror). However, there are certain conditions for entitlement to above mentioned performance-based fee and incentive. The policy document issued by the Central Bank of Malaysia, sets some conditions for charging this fee. The important conditions include that the fee must be based on the actual performance of the investment and not on the mere promise of performance. The fee must also be reasonable and not excessive. The brokerage firm

⁶⁹ AAOIFI, *Sharī'ah Standard No. 12, Sharikah and Modern Corporations*, Art. No. 3.1.5.8.

⁷⁰ AAOIFI, *Sharī'ah Standard No. 46, Al-wakālah bil Iṣṭismār (Investment Agency)*, Art. No. 5.1.

⁷¹ *Ibid.*, Art. No. 5.4.

must bear the risk of loss along with the stock investor and not be guaranteed a profit. The fee must be disclosed to the stock investor in a clear and transparent manner.⁷²

3.2.4 Stock Investor's Funds in the Custody of Brokers

Another important *Shari'ah* issue on pre stock trading practice is the determination of the *Shari'ah* status of stock investor's funds with the brokerage firm. As mentioned earlier that when the stock investor appoints his brokerage firm, he is required to open an account with the brokerage firm and deposit sufficient funds in it. Now the issue arises what is the status of stock investor funds in the custody of brokerage firm. Whether the firm can benefit from that fund or not?

By virtue of agreement between the stock investor and the firm, the stock investor is under an obligation to transfer sufficient funds from his bank to the firm for trading purposes. He is also required to keep certain margin as collateral with the firm. For instance, when he borrows some stocks from his brokerage firm which he wants to use for short selling, in such case the brokerage firm requires from him some cash collateral equivalent to the value of borrowed stocks. In some other cases, he is required to deposit additional margin amounts on mark to market basis.⁷³

⁷² See,

<<https://www.bnm.gov.my/documents/20124/761679/Shari'ah+Governance+Policy+Document+2019.pdf>> (accessed 27 January 2024).

⁷³ Mark to-Market means valuing the stock at the current trading price. Therefore, the stock investor or trader is required to pay additional amount if the price of stock he has purchased in futures market, decreases on a particular day. For example, a person has purchased one thousand shares of Oil and Gas Company. Pakistan at the rate of Rs. 50 per share to be delivered by the seller after one month from the execution of trade. Now mark to profit and losses will be calculated on daily basis. If the price has gone to Rs. 55, the broker of stocks will collect five rupees per share from the stock investor. If price decreases to 45 rupees, five rupees will be collected from the seller. Thus, the stock investor of futures stock, is required to pay additional collateral. See, Securities and Exchange Commission of Pakistan (SECP), "Mark-to-Market Practices in Futures Trading," in *Futures Market Regulations*. <https://www.secp.gov.pk/document/futures-brokers-licensing-and-operations-regulations-2018/> (accessed on 23 March, 2023)

The stock investor's ordinary funds needed for trading may be categorised as *amānah* or trust in the hands of brokerage firm. The firm acts as *wakīl* and the money given to it is trust. Any use beyond the designated purpose amounts to breach of trust. A brokerage firm is a trustee and custodian of the assets of its stock investor. Such practices violate the trust between brokerage firm and stock investor. Moreover, it is also against the fiduciary relationship created by the brokerage agreement.

On the other hand, the margins and cash collateral may be categorized as *rahn*. According to *Majallah*, *rahn* is the security that can be lawfully employed for satisfaction of a claim in respect of a debt.⁷⁴ *Rahn* in Islam is instituted to safeguard the right of creditor and is meant for the security of debt, not for investment and profitable use. Any profitable use from the pledged property is regarded as usury in Islamic Law. Thus, if he earns any profit out of it, he is bound to return it to its owner. According to *Hanafis*, a pledgee can benefit from pledged property with the permission of pledgor. The other jurists do not allow it even with the permission of pledgor. The AAOIFI has endorsed this view. Mawdūdī in this regard writes that if the pledge is productive, the creditor should keep a regular account of the produce and deduct it from the debt; otherwise, any profit drawn from the pledged property would be interest. The only object in view of holding a pledge is the security of the repayment of the debt and it does not entitle the creditor in any way to make profit out of it. For instance, if a creditor lives in the houses which he holds as pledge for his debt or if he lets it to someone else, he is in fact guilty of taking interest, if he does not credit the rent of the house to the debtor, for there is no difference between taking direct interest on a debt or earning money from it or making use for the property delivered as a pledge.⁷⁵

⁷⁴ *Majallah*, Art. 701.

⁷⁵ Abū A'lā Al-Mawdūdī, *Tafhīm al-Qur'ān*, (Lahore: Maktabah Ta'mīr Insāniyyat, 1983), vol. 1, note 331.

Since the margins and cash collateral with the stock brokerage firm assumes the status of *rahn*, the firm has the right to recover any claim or debt in case of default from this amount. According to AAOIFI the pledgee has the right to claim the sale of pledged asset in case of default.⁷⁶

On the issue of stock investor's funds in custody of brokerage firm, all the respondents endorsed the above view that ordinary funds of the stock investor are *amānah* in the hands of brokerage firm while margins and cash collaterals have the stratus of *rahn*. The brokerage firm can use it only for the settlement of trade and in case of default recovery can be made from the margins and cash collaterals.⁷⁷

3.3 LEGAL ISSUES IN PRE-STOCK TRADING PRACTICES

There are various legal issues in pre-stock trading practices such as: i) conflict of interest ii) misuse of stock investor' funds and iii) non-segregation of accounts. In the following, these issues are discussed.

3.3.1 Conflict of interest

A significant legal issue pertaining to agreement signed between the brokerage firm and the stock investor is the conflict of interest. According to this agreement, the responsibility of the brokerage firm is that it should be transparent about any conflicts of interest that might impact the interest of its stock investor.⁷⁸ This means that if any

⁷⁶ AAOIFI, *Shari'ah Standard No. 39: Investment Funds, Accounting and Auditing Organization for Islamic Financial Institutions*, 2015.

⁷⁷ Views expressed by respondent no. 101, 103, 107, 109.

⁷⁸ The Securities Brokers (Licensing and Operations) Regulations 2016 define scope and contours of broker's fiduciary obligations and conflict of interest. See, Chapter 13: Conduct of Brokers, Chapter 15: Conflict of Interest and Chapter 16: Duties and Obligations of Brokers.

situation of conflict of interest arises, the brokerage firm should bring all facts to the knowledge of its stock investor.

The conflict of interest may be defined as a conflict between the private interests and the official responsibilities of a person in a position of trust.⁷⁹ Typically, this relates to situations in which the personal interest of an individual or organization might adversely affect a duty owed to make decision for the benefit of a third party. In the brokerage services industry, the firms are generally exposed to significant conflicts of interest. Conflict of interest may assume a number of forms. Some of these forms are as under.

- (i) Order routing practices
- (ii) Internalization of orders
- (iii) Recommendation of securities
- (iv) Underwriting activities
- (v) Undisclosed fees

i- Order Routing Practices:

Order routing refers to the process by which brokerage firm decide where to execute stock investor orders. The brokerage firm receives payment for order flow from market makers or exchanges in exchange for directing stock investor orders to these venues.⁸⁰

While this practice can result in cost savings for the brokerage firm, it may not always lead to the best execution for stock investor. The brokerage firm may prioritize routing orders to venues that provide payment, even if those venues do not offer the most

⁷⁹ See, CFA Institute, Conflict of Interest. <www.cfainstitute.org> (accessed January 27, 2024).

⁸⁰ Market makers and exchanges often pay brokerage firm for the privilege of executing their stock investors' orders. This payment can come in various forms, such as rebates or other incentives. By receiving payment for order flow, brokerage firm can offset some of their operational costs. See, SEC. "Payment for Order Flow." *U.S. Securities and Exchange Commission*, 2020.

favourable prices or liquidity. As a result, stock investor may not always receive optimal execution for their trades and may experience delays, price discrepancies, or reduced liquidity when their orders are executed.⁸¹

In case of *SEC v. Knight Securities, L.P.*,⁸² a brokerage firm Knight Securities, was alleged by the Securities and Exchange Commission (SEC) that it has failed to provide best execution to its stock investor by directing orders to trading venues that did not offer the most favourable prices. The SEC determined that Knight Securities breached its duty to ensure optimal execution for its stock investors' orders. The SEC's investigation uncovered that Knight Securities had routed stock investor orders to trading venues that did not provide the best available prices, thus violating its obligation to seek the most advantageous prices on behalf of its stock investor. Consequently, Knight Securities opted to settle the charges levelled by the SEC. The firm agreed to pay fines and enact changes to its order routing practices to ensure compliance with securities regulations.

ii- Internalization of Orders:

Internalization occurs when a brokerage firm matches buy and sell orders within its own system, rather than routing them to external markets.⁸³ By internalizing orders,

⁸¹ Schwab C., "U.S. Equity Market Structure: Order Routing Practices, Considerations and Opportunities,"

<<https://content.schwab.com/web/retail/public/about-schwab/Schwab-2022-order-routing-whitepaper.pdf>> (accessed 27 January 2024).

⁸² *SEC v Knight Securities, L.P.* 756086 (D.N.J. Mar. 31, 2005).

⁸³ Kacperczyk M., and Pagnotta E., "Institutional Order Handling and Broker-Affiliated Trading Venues,"

<<https://link.springer.com/content/pdf/10.1007/BF03396891.pdf>> (accessed 27 January 2024).

brokerage firm can save⁸⁴ on transaction costs and potentially profit⁸⁵ from the bid-ask spread.⁸⁶ The conflict arises when brokerage firm prioritize internalizing orders to maximize its own profitability rather than seeking the best execution outcomes for its stock investor.⁸⁷ By matching orders internally, the focus of the brokerage firm is on its own financial interests over obtaining the most favourable prices for stock investor trades. This conflict of interest can undermine the principle of best execution, where the brokerage firm is expected to execute stock investor orders promptly and at the most advantageous terms available in the market. Additionally, stock investor may not have visibility into how his orders are being executed internally, raising concerns about transparency and fairness.⁸⁸

iii- Recommendation of Securities:

Brokerage firm often provides research reports and investment recommendations to stock investor. However, these recommendations may be influenced by conflicts of interest.⁸⁹ For example, brokerage firm often have relationships with issuers or investment banking stock investor that influence its recommendations and create

⁸⁴ Internalization allows brokerage firm to save on transaction costs associated with executing orders on external markets. By matching orders internally, the brokerage firm can avoid paying exchange fees or other costs related to executing trades on public markets. See, Securities and Exchange Commission (SEC), "Report on Order Execution and Routing Practices", *SEC*, (2019).

⁸⁵ The brokerage firm can potentially profit from the bid-ask spread—the difference between the highest price a buyer is willing to pay and the lowest price a seller is willing to accept—when facilitating trades within its own system. See, *Ibid*.

⁸⁶ The bid-ask spread is the difference between the highest price a buyer is willing to pay (bid price) and the lowest price a seller is willing to accept (ask price) for a security. It reflects market liquidity and transaction costs, with a narrower spread indicating higher liquidity and potentially lower costs for traders. See, *Ibid*.

⁸⁷ 'Asim Ijaz Khwaja and Mian Atif, "Unchecked Intermediaries: Price Manipulation in an Emerging Stock Market", *Journal of Financial Economics, Forthcoming*, (2004): 23.

⁸⁸ This lack of transparency can raise concerns about fairness and whether stock investors are receiving optimal execution for their trades. Without transparency into the internalization process, stock investors may be unable to assess whether their orders are being executed in a manner that aligns with their best interests. Financial Industry Regulatory Authority (FINRA), "Report on Best Execution: A Review of the Factors Affecting Execution Quality", *FINRA*, (2019).

⁸⁹ *SEC*, "Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest", <<https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest>> (accessed 27 January 2024).

conflicts of interest in result because brokerage firms may feel pressured to provide favourable recommendations for securities issued by these entities, even if they may not be the most suitable investments for stock investor. The brokerage firm may receive incentives or fee based on the sale of certain securities. These incentives can influence the recommendations provided to stock investor, as brokerage firm may be motivated to promote securities that offer higher commissions or bonuses, rather than those that best align with the stock investor's investment objectives and risk tolerance.⁹⁰

iv- Underwriting Activities:

Brokerage firm involved in underwriting securities offerings may face conflicts of interest when recommending these securities to stock investor.⁹¹ Underwriting involves the process of arranging and facilitating the sale of securities issued by companies or other entities. Brokerage firm that underwrites securities offerings may have a financial interest in promoting these securities to stock investor, even if they are not the most suitable investments.⁹² Stock investor should be cautious when considering investment opportunities recommended by brokerage firm involved in underwriting activities and

⁹⁰ Syed Irtaza 'Ali, *Moral Neutralization in Pakistan's Capital Markets: A Study of Market Abuse*, (University of Pennsylvania, 2017).
<https://repository.upenn.edu/cgi/viewcontent.cgi?article=1157&context=wharton_research_scholars>
(accessed 20 March 2024).

⁹¹ Brokerage firm that underwrites securities offerings often have a financial interest in promoting these securities to stock investors. Since the brokerage firm is involved in the underwriting process, it may receive fees or other forms of compensation based on the success of the offering. This financial incentive can create a conflict of interest if the brokerage firm prioritizes promoting the securities it underwrites, even if they may not be the most suitable investments for stock investors. See, Securities and Exchange Commission (SEC), "Report on the Study of Conflicts of Interest in the Financial Services Industry", *SEC*, (2011).

⁹² The brokerage firm's involvement in underwriting can compromise the objectivity of its recommendations to stock investors. There may be pressure to support the success of the offering by encouraging stock investors to invest in the securities being underwritten, potentially leading to biased or less-than-objective advice. See, *Ibid*.

should conduct his own due diligence to assess the risks and suitability of these investments.⁹³

In *SEC v. Citigroup Global Markets Inc.*,⁹⁴ the Citigroup Global Markets Inc. a brokerage firm faced allegations brought by the SEC concerning improper disclosures regarding its underwriting activities. The SEC accused Citigroup Global Markets Inc. of neglecting to disclose crucial information to its stock investors regarding its underwriting activities. The SEC contended that Citigroup misled its stock investors regarding the extent of its involvement and exposure to the market, alleging that the firm made misleading statements and omissions in its disclosures, resulting in a conflict of interest. As a result of the SEC's accusations, Citigroup settled the charges by agreeing to pay fines and undertaking remedial actions to address the deficiencies identified by the SEC.

v- Undisclosed fees:

Undisclosed fees refer to charges associated with investment products or brokerage services that are not fully revealed to the stock investor by brokerage firm. These fees may include commissions, portfolio management fees, or other costs incurred when buying, selling, or holding investments.⁹⁵

⁹³ Given the potential conflicts of interest associated with underwriting activities, stock investors should exercise caution when considering investment opportunities recommended by brokerage firm involved in underwriting. It's essential for stock investors to conduct their own due diligence to assess the risks and suitability of these investments. This may involve reviewing the prospectus or offering documents, analyzing the financial health and prospects of the issuing company and considering how the investment aligns with their investment objectives and risk tolerance. See, Loughran Tim and Jay Ritter, "Why Has IPO Underpricing Increased Over Time?", *Financial Management*, vol. 28, no.3, (1999): 5-37.

⁹⁴ *SEC v Citigroup Global Markets Inc.* WL 111968 (S.D.N.Y. Jan. 9, 2008).

⁹⁵ Justia, "Undisclosed Fees," <<https://www.justia.com/consumer/deceptive-practices-and-fraud/undisclosed-fees/>> (accessed 27 January 2024).

Conflicts of interest can arise when the brokerage firm charge higher fees for certain investment products or services that generate greater revenue for the firm, even if they are not the most cost-effective or suitable options for stock investor.⁹⁶

The brokerage firm recommend certain investment products or services to its stock investor that carry additional fees or commissions for them. However, they may not fully disclose these fees or commissions to the stock investor upfront, leading to a lack of transparency in the stock investor and the brokerage firm relationship. This lack of transparency creates a conflict of interest because the brokerage firm may prioritize recommending products or services that generate higher fees or commissions for themselves, rather than focusing solely on the stock investor's best interests. For example, the brokerage firm may recommend a mutual fund with a high expense ratio or a load fee without adequately explaining these costs to the stock investor. As a result, the stock investor may unknowingly incur higher fees that could erode their investment returns over time.

In *SEC v. TD Ameritrade*,⁹⁷ the SEC brought allegations against TD Ameritrade a brokerage firm, asserting its involvement in undisclosed fees and payment for order flow practices, which were deemed violations of securities laws. Specifically, the SEC contended that TD Ameritrade, a brokerage firm, failed to disclose certain fees and arrangements to its stock investor, including payment for order flow practices. Payment for order flow entails broker-dealers receiving fees from market makers in exchange for directing stock investor orders to them. The SEC argued that TD Ameritrade's omission

⁹⁶ The brokerage firm may charge higher fees for specific investment products or services, even if more cost-effective or suitable options are available. This can create a conflict of interest because the firm may prioritize promoting products or services that result in higher revenue, rather than those that offer the best value or performance for the stock investor. See, Friedman David, "Understanding Conflicts of Interest in the Financial Services Industry", *Journal of Financial Planning*, vol. 32, no.5, (2019), 38-46.

⁹⁷ *SEC v TD Ameritrade* WL 3849509 (S.D.N.Y. Aug. 31, 2011).

of these arrangements constituted a conflict of interest and breached securities laws. Ultimately, TD Ameritrade settled the charges with the SEC. As part of the settlement, the firm agreed to pay fines and to undertake remedial actions to improve its disclosure practices and ensure compliance with securities regulations.

Such conflicts of interest can lead to serious repercussions for both stock investors and brokerage firms. For instance, when a stock investor relies on advice from the firm, expecting guidance that aligns with their best interests, the firm's preoccupation with maximizing its own profits can significantly compromise the trust placed in the principal-agent relationship. The brokerage firm's focus on self-gain, disregarding the stock investor's interests, not only constitutes misconduct but also breaches its fiduciary obligations.

This breach of duty violates the legal framework governing brokerage conduct. Under the Contract Act 1872, which outlines the principal-agent relationship, brokerage firms are obligated to act in the best interests of stock investors. The Act mandates that brokerage firms compensate any losses resulting from neglect or misconduct and allows stock investors to repudiate transactions undertaken without their informed consent. If any material facts are dishonestly concealed or if the firm's actions disadvantage the stock investor, the principal has the right to cancel such contracts.⁹⁸

Moreover, these practices violate the Securities Brokers (Licensing and Operations) Regulations 2016, which explicitly requires brokerage firms to disclose conflicts of interest to their stock investors and ensure that no direct or indirect benefit is derived from such situations. The Regulations also prohibits brokerage firms from

⁹⁸ The Contract Act 1872, <http://www.na.gov.pk/uploads/documents/1333523681_951.pdf> (accessed 20 January 2024).

accepting inducements that may conflict with their duty to stock investors, reinforcing that the firm must act in the stock investor's best interest at all times.⁹⁹

In alignment with international standards, such as those set by the International Organization of Securities Commissions (IOSCO), brokerage firms are expected to avoid conflicts of interest and ensure fair treatment of all stock investors through proper disclosure and confidentiality. These guidelines emphasize that firms should never prioritize their own interests over those of their stock investors, and any potential conflicts must be managed with transparency and integrity.¹⁰⁰

From the above discussion, it may be established that the practice of conflict of interest in PSX, violates the prevailing legal regime on the code of conduct prescribed for brokerage firm.

Predominantly the respondents endorsed the view that the brokerage firm in Pakistan is generally involved in the practices of conflict of interest and giving its interest priority over the interest of stock investor. They suggested that regulator should closely monitor it and take strict enforcement actions against such practices.¹⁰¹ However, a few respondents did not agree with this analysis. Their view was that it is not correct to generalize this position. In their view there is an efficient regulatory regime that discourages such practices.¹⁰²

This concern was also acknowledged by multiple representatives of brokerage firms themselves, who, when asked whether such firms prioritize their own interests over those of stock investors or whether the regulatory framework is effective in

⁹⁹ The Securities Brokers (Licensing and Operations) Regulations 2016, See, <https://www.icm.org.pk/downloads/laws_and_definitions/secp/Securities%20Brokers%20%28Licensing%20and%20Operations%29%20Regulations%202016.pdf> (accessed 27 January 2024).

¹⁰⁰ See, <https://www.iosco.org/about/?subsection=key_regulatory_standards> (accessed 27 January 2024).

¹⁰¹ Views expressed by respondent no. 108, 110 and 118.

¹⁰² Views expressed by respondent no. 113, 115 and 116.

preventing such conflicts, affirmed the existence of this issue. Their responses strengthen the argument that conflicts of interest remain a prevalent challenge in Pakistan's brokerage industry despite the existing legal and regulatory safeguards.

3.3.2 Use of Stock Investor's Funds

A significant legal issue is use of stock investors' funds by the brokerage firm which have been found involved in pledging their stock investors' funds with the banks for seeking loans from the banks for brokerage firm's business or paying back their loans. According to a report on misconduct of brokerage firm, during the last two decades stock market experienced three major crises. The crises have been marked by allegations of market abuse by the brokerage firm, misuse of stock investors' funds and assets and the fraudulent practices.¹⁰³

As stated earlier, after signing the agreement, the stock investor is required to deposit certain funds with the brokerage firm to be used for purchase of stocks ordered by the stock investor. A sufficient amount should always be available in the account so that the firm could cater default cases. Now the question is, can a brokerage firm legally use stock investor's funds? What is the position of law on it?

Under the prevailing legal regime, protection of stock investor's assets, is the obligation of brokerage firm. The Karachi Stock Exchange Rules Book¹⁰⁴ provides that except as permitted above, the stock investor funds and securities shall not be used by the brokerage firm for any purpose other than as authorized by the stock investor in writing in the manner and procedure prescribed by the stock exchange and/or CDC.¹⁰⁵

¹⁰³ Syed Irtiza 'Ali, 3.

¹⁰⁴ This book is collection of rules and regulations issued by the stock exchange with the approval of SECP. This has been compiled by Karachi Stock Exchange.

¹⁰⁵ **KSE Rule Book, Chapter 4.19.2, Annexure-I.**

The standardized account opening form also emphasizes this condition, it provides that the credit amount of the account holder(s) shall be kept by the brokerage firm in a separate bank account titled “account holder/stock investor account” and shall not be used by the brokerage firm for his own business.¹⁰⁶

From this, it may be concluded that the brokerage firm is not allowed to use stock investor’s funds beyond the purpose other than trading on account of stock investor and fulfilling default obligations from the collateral amount. The practice of using stock investors’ funds for pledging with banks to obtain loans, is a breach of fiduciary relationship. The brokerage firm is not allowed to engage in such practices.

On the issue of use of stock investor’s funds, the respondents acknowledged that it is a serious legal issue which amounts to act of misconduct by the brokerage firm. It badly shatters the confidence of stock investor in the brokerage firm. Thus, they suggested that meager financial penalties may not be sufficient to curb these malpractices. The regulator should take strict action proportionate to magnitude of this practice.¹⁰⁷

This concern was also acknowledged by several representatives of brokerage firms themselves. When asked whether brokerage firms use stock investors’ funds for their own benefit, the majority confirmed that such practices do occur, further emphasizing that stricter monitoring and penalties are necessary to prevent these actions. Their responses strengthen the argument that the misuse of stock investors’ funds remains a significant issue in the brokerage industry, despite the legal and regulatory safeguards that are supposed to protect investors.

¹⁰⁶ Ibid.

¹⁰⁷ Views expressed by respondent no. 108, 110, 117.

The case law also endorses this legal position. The SECP has adjudicated many disputes and complaints from the stock investor against brokerage firm involved in use of its funds for the firm's benefit.¹⁰⁸

In *SECP vs. Fortune Securities Limited*,¹⁰⁹ the SECP alleged Fortune Securities Limited a brokerage firm for misuse of its stock investors' funds. The SECP initiated proceedings via a show cause notice dated September 22, 2015, under section 22 of the Securities and Exchange Ordinance 1969 and Rule 8 of the Brokers and Agents Registration Rules 2001 ("Broker Rules") against Fortune Securities Limited. During an inspection of the firm's books and records, the SECP's inspection team noted that the respondent had obtained loans against liens on stock investors' bank accounts. Additionally, they observed that a credit balance of Rs 14.9 million in one stock investor's account was used to offset debit balances in accounts of two other stock investors. In response, the respondent argued that it had obtained written authorizations from its stock investors to utilize surplus funds in their accounts for meeting its working capital requirements. The respondent provided documentary evidence to support this claim. Following discussions and the respondent's assurance of future compliance with regulations, the matter was disposed of, with a warning to adhere to regulations both in letter and spirit. This shows that the court believed that the spirit of the law has been frustrated in this case which should be upheld at all costs.

3.3.3 Non-segregation of Accounts

Another important legal issue is non-segregation of accounts by the brokerage firm or failure to maintain separate bank accounts for stock investor' funds. This practice

¹⁰⁸ Securities and Exchange Commission of Pakistan Ordinance 1969, s 20.

¹⁰⁹ See, <<https://www.secp.gov.pk/document/fortune-securities-limited/>> (accessed 27 January 2024).

shatters stock investor' confidence and exposes him to potential misuse of his assets by the brokerage firm.

The regulatory requirements, as highlighted in the KSE Rule Book,¹¹⁰ emphasize the segregation of stock investor' assets and the maintenance of separate bank accounts for stock investor funds.¹¹¹ The standardized account opening form of KSE Rule Book provides that the credit amount of the account holder(s) shall be kept by the brokerage firm in a separate bank account titled "account holder/stock investor account" and shall not be used by the brokerage firm for his own business.¹¹² Breaches of these requirements have led to legal proceedings against firms.

In *SECP vs. Alfa Adhi Securities (Private) Limited*,¹¹³ a brokerage firm Alfa Adhi Securities (Private) Limited was alleged by the SECP that it has failed to maintain separate bank account for its stock investor. The SECP initiated the proceedings via a show cause notice dated September 5, 2014, served to Alfa Adhi Securities (Private) Limited, a trading right entitlement certificate holder/broker of the Karachi Stock Exchange Limited. The SECP, exercising its powers under sub-section (1) of Section 6 of the Ordinance in conjunction with rule 3 and rule 4 of the Stock Exchange Members (Inspection of Books and Record) Rules 2001 (Inspection Rules), ordered an inspection of the books and records mandated to be maintained by the respondent. During the inspection, the team noted the firm's non-compliance with the regulatory requirement of maintaining a separate bank account for its stock investor. In response, the representatives of the respondent assured compliance during the hearing and the

¹¹⁰ This book is collection of rules and regulations issued by the stock exchange with the approval of SECP. This has been compiled by Karachi Stock Exchange.

¹¹¹ KSE Rule Book, Annexure-I.

¹¹² Ibid.

¹¹³ See, <<https://www.secp.gov.pk/document/order-alfa-adhi-securities-pvt-limited/>> (accessed 12 January 2024).

respondent reiterated this commitment in its written response. The court disposed of the matter, by imposing a penalty of Rs. 25,000/- on the respondent. It directed the respondent to comply with the Rules 1971 and the guidelines issued in letter and spirit; and ensure segregation of stock investor' assets and maintain separate bank account for the stock investor' funds. The court remarked in this case that the segregation of stock investor' assets is of prime importance to strengthen stock investor' confidence in the stock market and to avoid misuse of stock investor' assets by the brokerage firm and probable default of the brokerage house. The respondent being custodian of stock investor' assets is expected to perform its business with due care and conscientiousness. In order to protect the interest of stock investor, the commission has promulgated a set of rules and regulations which the respondent is required to comply with the relevant rules.

Another case of non-segregation of stock investor's account is *SECP vs. Invest and Finance Securities Limited*,¹¹⁴ where the SECP alleged Invest and Finance Securities Limited a brokerage firm that it has failed to maintain proper segregation of stock investors' assets and standardized account opening forms. The SECP initiated proceedings against the respondent for certain alleged irregularities. The commission, utilizing its authority under sub-section (1) of section 6 of the Ordinance in conjunction with rule 3 and rule 4 of the Stock Exchange Members (Inspection of Books and Record) Rules 2001 (Inspection Rules), ordered an inspection of the books and records required to be maintained by the respondent. The inspection team submitted the report (Inspection Report) on December 15, 2014, which was shared with the respondent as per rule 7 of the Inspection Rules. The inspection report revealed that the respondent failed to maintain proper segregation of stock investor assets and standardized account

¹¹⁴ *SECP v Invest and Finance Securities Limited* [2014] CLD 1670.

opening forms. In response, the representative of the respondent argued that they only use an Askari Bank account for their official expenditure, while other bank accounts are used to maintain stock investor funds. They stated that they have requested the banks to convert these accounts into stock investor accounts.

After a thorough review of the facts and arguments presented during the hearing, the court found that the respondent failed to fulfil its regulatory obligations during the inspection period. Consequently, under Section 22 of the Ordinance, a penalty of Rs. 500,000/- was imposed on the respondent. Additionally, the respondent was directed to comply with the Rules 1971 and guidelines issued by the commission, maintain separate bank accounts for stock investor funds, ensure segregation of stock investor assets and provide bank statements and trial balances by specified dates. The court remarked in this case that the segregation of stock investor' assets strengthen stock investor' confidence in the stock market and to avoid misuse of stock investor' assets by the brokerage firm and probable default of the brokerage firm. The respondent being custodian of stock investors' assets is required to perform its business with due care and conscientiousness. In order to protect the interest of stock investor, specific requirements pertaining to the segregation of stock investor' assets are detailed in the KSE Rule Book and the respondent is bound to follow the regulatory provisions in letter and spirit and strictly keep stock investor' funds segregated.

Another case of non-segregation of stock investor's account is *SECP vs. BMA Capital Management (Private) Limited*,¹¹⁵ where the SECP alleged BMA Capital Management (Private) Limited a brokerage firm for misuse of stock investor funds and non-maintenance of separate stock investor accounts. The SECP initiated the

¹¹⁵ See, <<https://www.secp.gov.pk/document/order-dated-08-01-2021-bma-capital-management-limited-2/>> (accessed 12 January 2024).

proceedings through a show cause notice against the brokerage firm. In exercising its powers under the Ordinance, the SECP ordered an inspection of the respondent's books and records. Based on the inspection team's report and the respondent's response, proceedings were initiated. The SECP argued that the respondent violated regulatory requirements by using stock investor accounts for its business and not maintaining separate accounts for stock investors. The respondent refuted these allegations, asserting that stock investor funds were used for proprietary investments but the proceeds were credited to stock investor accounts. The court deemed the respondent's stance unjustifiable, as it cannot use stock investor funds for generating income. Moreover, the respondent's claim of maintaining separate ledger accounts for each stock investor was not accepted. The regulatory requirement mandates maintaining separate bank accounts tagged as "stock investor bank accounts". It was concluded that the respondent breached regulatory requirements, resulting in a penalty of Rs. 30,000/-. The respondent was directed to comply with regulatory requirements regarding the use of stock investor funds and maintaining separate stock investor accounts.

From the above discussion it may be concluded that the non-segregation of accounts constitutes a serious legal issue, reflecting misconduct by brokerage firm and shattering stock investor confidence. Merely imposing financial penalties may not suffice to address these malpractices; regulators must take strict regulatory actions proportional to the magnitude of such practices to curb such misconduct and restore stock investor's trust in the market.

3.4 CONCLUSION

Pre stock trading practices involve various *Sharī'ah* and legal issues. The *Sharī'ah* issues include position of a brokerage firm, conflict of interest, charging fee,

commission, performance-based fee and incentive and stock investor's funds in the custody of brokerage firm. It is found that position of brokerage firm is a *wakīl* of stock investor resulting the rules of *wakālah* and agency apply to him. It has been concluded that *Sharī'ah* emphasizes on avoidance of conflict of interest. It has been established that charging normal fee, commission, performance-based fee and incentives by the brokerage firm is consistent with *Sharī'ah*. Charging fee and commission falls under *wakālah* contract, whereas the performance-based fee and incentive conforms to the principles of *ju'ālah*. It has been concluded that the stock investor's funds in the custody of brokerage firm are *amānah* and trust. If any loss occurs in stock investor's funds without his negligence, the brokerage firm will not be liable.

The legal issues include practices of conflict of interest, use of stock investor's funds for brokerage firm and non-maintenance of separate bank account for stock investor. It has been concluded that these practices violate the prevailing legal regime prescribed for the brokerage firm. The broker cannot use stock investor's money for his own business, nor can he use it for pledging and obtaining financing facility from the banks. The respondents also recognize above issues as significant *Sharī'ah* and legal issues. They endorsed the view that brokerage firm is generally involved in these practices.

CHAPTER FOUR

***SHARĪ'AH* AND LEGAL ISSUES ON STOCK TRADING PRACTICE IN PAKISTAN**

4.0 INTRODUCTION

Stock trading is an important business and economic activity for the stock investor, which includes buying and selling of stocks that plays an important role to facilitate capital formation, providing investment opportunities, promoting market efficiency and contributing to economic growth and development. Stock trading allows stock investor to participate in the ownership of companies, potentially generating profits through dividends and capital gains. The buying and selling of stocks is carried out at Pakistan Stock Exchange (PSX) which undertakes initiatives to develop the capital market in Pakistan by introducing new products, enhancing market infrastructure and promoting stock investor participation. It also ensures transparency and fairness in trading activities, providing stock investor with confidence in the integrity of the market.¹

Therefore, this chapter discusses into detail the stock trading practices carried out at PSX together with *Sharī'ah* and legal issues pertaining to these practices.

4.1 STOCK TRADING PRACTICES IN PAKISTAN

The stock trading activity in Pakistan takes place at PSX in three designated markets namely, regular market, leveraged market and futures market. In these markets a variety of products are offered and trading modes are practiced. In the following, trading practices of these markets are discussed.

¹ Securities and Exchange Commission of Pakistan (SECP), *Annual Report 2023*, (Islamabad: SECP, 2023), 30-35.

4.1.1 Regular Market Trading Practices

The regular market is a market in PSX where stock investor buys and sells stocks. It is also called ready delivery market.² Regular market is defined as a market where stocks are traded for immediate delivery and payment, within two business days.³ It shows that regular market is essentially a spot market where stocks are traded for immediate delivery and payment. The transactions are settled immediately or within a short period, within two business days.

The trading in regular market allows stock investor to invest in companies he believes that will grow over time. It also facilitates capital formation for stock investor, allowing him to raise funds. It has generally lower risk due to absence of borrowing or complex contracts.

The trading in the regular market takes place through brokerage firm that is obliged to consider certain obligations while undertaking trading for its stock investor. The prominent obligation of the firm that it should undertake trading in fair and transparent manner and work in the best interest of its stock investor. It should not be engaged in market manipulation to artificially increase price that harms the stock investor.⁴

Moreover, the brokerage firm is prohibited from using secret or non-public information in its trading activities. This prohibition is essential to prevent insider trading, which occurs when stock investor trades stocks based on material, non-public information. Insider trading undermines market integrity and fairness by providing

² Securities and Exchange Commission of Pakistan (SECP), *Trading Regulations and Market Structure*, (Islamabad: SECP, 2021), 25-28.

³ See, <https://www.investopedia.com/terms/s/stockmarket.asp#:~:text=The%20stock%20market%20is%20a, and%20earn%20income%20through%20dividends> (accessed 6 March 2024).

⁴ Jones Sarah, "Market Manipulation: Impact on Stock investors and Regulatory Responses", *Journal of Financial Regulation*, vol. 25, no.4 (2018): 112-130.

unfair advantages to those with access to privileged information, while disadvantaging other market participants.⁵

The buying and selling of stocks in regular market follows certain sequential steps that start with placement of order by the stock investor where the stock investor places buy or sell orders through his brokerage firm specifying the quantity of stocks and the stock symbol.⁶ These orders can be market orders, where the stock investor agrees to buy or sell at the prevailing market price, or limit orders, where the stock investor specifies a price at which he is willing to buy or sell. Once the brokerage firm receives the stock investor's order, it routes the order to the PSX. The order is transmitted electronically to the PSX's trading system which operates a central order matching system where buy and sell orders are matched based on price and time priority. The stock exchange uses a specific matching system to match 'buy' and 'sell' orders from different stock investor as shown in the diagram below:

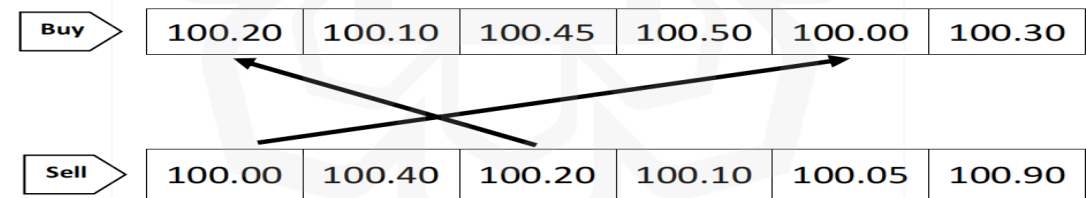


Figure 4.1: Matching Table of Trades

⁵ Smith John, *Insider Trading: Ethics and Regulation*, (New York: Academic Press, 2020), 45-60.

⁶ A stock symbol, also known as a ticker symbol, is a unique series of letters assigned to a particular publicly traded company's stock. It serves as an abbreviation or shorthand way to identify a stock on a stock exchange. Stock symbols are used by investors, traders and financial professionals to quickly locate and trade stocks.

For example, "AAPL" is the stock symbol for Apple Inc., "GOOGL" is the stock symbol for Alphabet Inc. (Google's parent company) and "MSFT" is the stock symbol for Microsoft Corporation.

Stock symbols are typically listed alongside stock prices in financial news, trading platforms and stock exchange websites. They provide a Standardized way to refer to specific stocks, helping to streamline communication and trading activities in the financial markets. See, *U.S. Securities and Exchange Commission (SEC), "Stock Symbols"*, <<https://www.sec.gov/stock-symbols>> (accessed 29 Sep 2024).

The diagram shows that the buy prices are matched against the cheapest available sell prices and when the buy price is less than or equal to the best available sell price, a match is done.⁷

An order entered as bid or offer may match immediately or at a later stage or remain unexecuted. Bids are displayed in an order from highest to lowest price whereas offers are displayed in an order from lowest to highest price. At PSX, buy and sell orders are matched up based on the price people are willing to pay and the time they placed their order. When a buy order matches with a sell order, the trade occurs and the transaction is executed at the agreed-upon price. Once a trade is executed, the PSX sends trade confirmation messages to the brokerage firm involved in the transaction. These messages confirm the details of the trade, including the stock symbol, quantity, price and trade execution time. The brokerage firm is obliged to intimate its stock investors through acceptable mode of communication, within twenty-four hours of execution of trade.⁸

Subsequent to the execution and confirmation of trades, the trades are forwarded to the National Clearing Company of Pakistan Limited (NCCPL) as locked-in contracts for post-trade risk management until the settlement date, with clearing and settlement occurring on the settlement date. NCCPL applies its netting rules on the executed trades to determine settlement obligations. In case of execution of trades by same stock investor, same security and same settlement period, the trades are netted against each other. Before the relevant settlement date, NCCPL prepares balance order determining the stock investor level stocks obligations and brokerage firm level money obligations

⁷ See, Clearing And Settlement Procedure In The Indian Stock Market, <<https://www.edelweiss.in/investology/introduction-to-stock-markets-51c006/what-is-stock-trade-settlement-process-2a34b3>> (accessed 18 May 2022).

⁸ See, <<https://www.nasdaqtrader.com/Trader.aspx?id=PSXBasic>> (accessed 30 March 2024).

for all the trades executed by a brokerage firm. For settlement of money obligations determined on brokerage firm level, NCCPL's auto pay and collect system issue instructions to the respective settling banks. Designated bank accounts of buying brokerage firm are automatically debited while crediting the designated bank accounts of selling brokerage firm. For settlement of stocks obligations netted at stock investor level, NCCPL issues instructions to CDC (Central Depository Company) to pick stocks from respective seller account and park the same into respective buyer account through automated stocks settlement system.⁹ Throughout this process, the PSX provides updates on market activity, helping stock investors stay informed. Overall, buying and selling stocks involves several steps that ensure trades are fair and transparent for everyone involved.

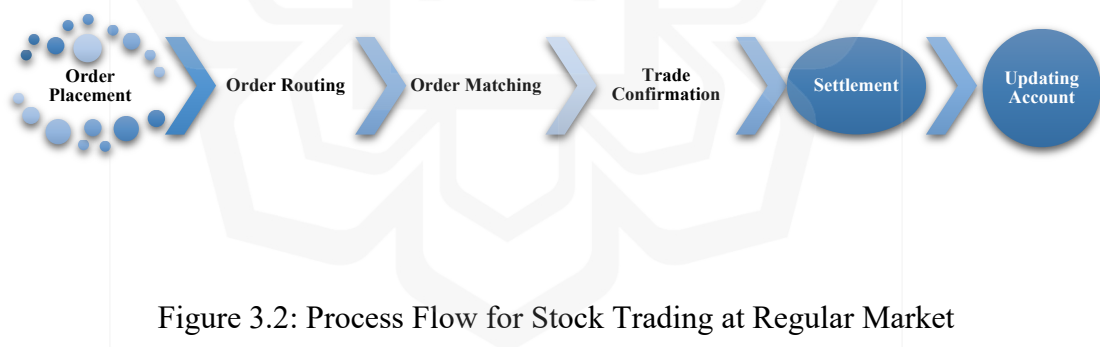


Figure 3.2: Process Flow for Stock Trading at Regular Market

The transaction flow in the stock trading market can be visualized through the above diagram illustrating the sequential steps from order placement to account updating, involving multiple stakeholders and processes. Each step plays an important role in ensuring the efficient and orderly functioning of the market, facilitating fair and

⁹ See, <<https://www.nccpl.com.pk/en/products-services/clearing-settlement-services>> (accessed 30 March 2024).

transparent transactions between buyers and sellers. Understanding this transaction flow is important for stock investor to navigate the complexities of stock trading effectively.

4.1.1.1. Classification of Trading in Regular Market

Trading in regular market may be broadly classified in two categories A) trading with regard to status of stocks and B) trading with regard to period of settlement.

A) Trading with Regard to Status of Stocks

Trading with regard to status of stocks is of two types: I) trading in *Sharī'ah* compliant stocks and II) trading in conventional stocks. These types are discussed in detail as follows.

I) Trading in *Sharī'ah* Compliant Stocks

Trading in *Sharī'ah* compliant stocks includes trading in those stocks that meet *Sharī'ah* screening criteria prescribed by the Securities and Exchange Commission of Pakistan (SECP).¹⁰ The companies that meet *Sharī'ah* screening criterion are called *Sharī'ah* compliant companies. The PSX conducts review about *Sharī'ah* status of companies bi-annually. Currently there are about 258 companies out of a total of 544 companies¹¹ listed in PSX, that have been declared as *Sharī'ah* compliant companies as a result of review conducted by PSX in the month of December, 2023 and a notification to this effect has been issued by the PSX by the PSX.¹² This shows that almost 50 per cent of

¹⁰ See, <<https://www.meezanbank.com/Sharī'ah-screening-criteria/>> (accessed 30 March 2024).

¹¹ See, 5 Years Progress Report - Pakistan Stock Exchange (PSX), <dps.psx.com.pk/progress-report> (accessed 01 March 2024).

¹² According to notification issued by PSX on Dec 18, 2023, 258 companies have been declared *Sharī'ah* compliant companies during the period 01-01-2023 to 30-06-2023. These companies compose KMI All Share Islamic Index of Pakistan, See, <www.psx.com.pk/psx/themes/psx/uploads/Notice-_KMI_All_Index_Re-composition> (accessed 01 March 2024).

total number of companies registered with PSX, are *Sharī'ah* compliant. The screening criteria are discussed as follows:

i Business of the Investee Company

The criterion provides that the core business of investee company should be permissible. It should not be inconsistent with the *Sharī'ah* principles for a valid business. As such the stocks of the company which are engaged in some unlawful and prohibited activity such as gambling, conventional insurance, conventional banking, dealing in pork, wine or tobacco etc. are unlawful and their trading is prohibited. In the same way the companies which carry out unethical business such as the industry which promotes obscenity and pornography are also treated unlawful and the trading of their stocks is prohibited.

ii Interest Bearing Debt to Total Assets, <37%

The criterion provides that the interest-based debt ratio to total assets should not exceed 37%. This means that if total assets of the company are of the value of one hundred thousand rupees and the interest borrowing of the company is up to thirty-seven thousand rupees, such company and its stocks will be considered *Sharī'ah* compliant. The word debt in these criteria covers debentures, bonds, commercial papers, term finance certificates and financial lease. The rationale for tolerating interest-based debts up to 37% is that an ordinary and minority stockholder does not have any role in the decisions of the company for interest-based borrowing and lending. He does not have prior knowledge of this practice while subscribing the stock of a company which is

involved in interest bearing lending or borrowing. Now if he raises his voice against this practice in the annual general meeting he is absolved of his responsibility.¹³

iii Non-Compliant Investments to Total Assets, <33%

The criterion provides that if a company under certain circumstances makes investment of its surplus funds in conventional banks and mutual funds or buys T-bills, Commercial papers, or futures contracts, then such unlawful investments will be tolerated only up to an extent of 33%. As per this criterion, if the value of company's asset is one hundred thousand rupees, interest-based lending or placement of funds with conventional banks will be tolerated up to thirty-three thousand rupees if this investment exceeds 33% then such company will be considered as a *Sharī'ah* non-compliant company.¹⁴

iv Non-complaint Income to Total revenue, <5%

The criterion suggests that the income derived from unlawful investment and *Sharī'ah* non-compliant business should be less than 5%. For example, the company has invested its funds in conventional banks or conventional insurance companies and has received insurance claim or it has invested in derivatives or it has received some income from the sale of addictive drugs etc. then such company will be considered *Sharī'ah* compliant only when the illegitimate income from the above sources remains less than 5% of the total income of company.

¹³ Taqī 'Usmanī, *Islam aour Jadīd Ma'ishat wa Tijarat*, (Karachi: Maktabah Ma'arifah, 2002), 87.

¹⁴ This is pertinent to note that the ratios of 37% and 33% are mere result of *ijtihad* by *Sharī'ah* scholars keeping in view the needs of market. The ratios are not based on any solid *Sharī'ah* evidence. It is suggested that regulator should gradually lower these ratios till the borrowing and lending becomes totally *riba* free by the end of Dec 27, 2022, when the whole economic and financial system will be transformed to complete Islamic economic and financial system, as per judgment of Federal *Sharī'at* Court of Pakistan issued on April 27, 2022. See, Federal *Sharī'at* Court of Pakistan, Judgment on the Transformation of the Economic and Financial System to an Islamic Framework, April 27, 2022. <https://www.federalshariatcourt.gov.pk/en/leading-judgements/> (accessed on 7 March 2024)

The companies meeting this criterion, are included in Karachi Meezan All Shares *Islamic* Index (KMI).¹⁵ This index has been created by PSX to measure the performance of *Shari'ah* compliant companies. The index is composed bi-annually. The purpose of this index is to track performance of *Shari'ah* compliant companies.

II) Trading in Conventional Stocks

Another type of trading is trading in conventional stocks. These are the stocks which are issued by conventional banks, insurance companies conventional leasing companies and similar other banking and non-banking financial institutions, whose core business activity is impermissible in *Shari'ah*. If a stock investor buys the stocks of these companies, he actually becomes the partner in impermissible business. Another type of conventional stocks is the stocks issued by the companies whose core business is *halal* i.e. pharmaceutical companies, food companies, services companies, but the stocks do not qualify *Shari'ah* screening test. The stocks of this category are generally included on Karachi Stock Exchange 100 Index (KSE-100 index)¹⁶ and other conventional indices such as Karachi Stock Exchange 30 Index (KSE-30 Index), Karachi Stock Exchange All Share Index (KSE All Share Index), Karachi Stock Exchange Consumer Goods Index (KSE-Consumer Goods Index), Karachi Stock Exchange Oil & Gas Index (KSE-Oil & Gas Index) and Karachi Stock Exchange Transport Index (KSE-Transport Index). The stocks of companies whose core business is not *halal*, such as wine industry,¹⁷ are part of this second type of trading. The stocks of this category also

¹⁵ KMI stands for Karachi Meezan Index.

¹⁶ KSE launched KSE-100-Index on November 30, 1991, The Index has a Base Figure of 1000. KSE 100-Index includes the top 100 traded companies at PSX and captures 37% of the market capitalization and 76% of the total trading volume of PSX. See, *Pakistan Stock Exchange (PSX)*, "KSE-100 Index", <[Pakistan Stock Exchange](#)> (accessed 29 September 2024).

¹⁷ Wine industry is licensed by the government, however, its sale for Muslims is forbidden. Wine drinking is liable to Hadd punishment according to Pakistani penal law.

include preferred stocks, that are traded in the market. These are the stocks that have priority over ordinary stocks as to the payment of dividend and distribution of assets on winding up. Dividend payment is usually a fixed percentage of the nominal value of the stock. For example, if the value of stock is 100 rupees and company earns profit of 7 rupees per stock, the preferred stockholder is given a fixed profit, say Rs. 5, which is 5% of 100 rupees. After distributing this amount, remaining two rupees profit is distributed among ordinary stockholders. In other words, preferred stockholders are given priority in distribution of profit over ordinary stockholders. One of the types of preferred stocks is cumulative preferred stocks, which are also actively traded. These are the same as above, but if the specified dividends are not paid in a given year, they are paid in in a subsequent year before payment to an ordinary stockholder. This implies that the return in preferred stocks is always fixed.

B) Trading with Regard to Period of Settlement

Trading with regard to period of settlement is of three types (i) trading on T+2 basis, (ii) trading on T+0 basis and (iii) intraday trading. These types of trading are discussed in detail as follows.

i- Trading on T+2 Basis

Trading on T+2 basis is the most common form of stock trading in the regular market at PSX where the settlement cycle is on T+2 basis, which means the trade has to be settled on trading plus two-day cycle.¹⁸ This means that the actual delivery of stocks by the seller to the buyer and payment of price by the buyer to seller takes place two days

¹⁸ In many stocks markets of the world including Malaysia and India, settlement of executed trade takes place on T+2 basis i.e. two days after the execution of trade.

after the trade date when the parties enter into the contract. On settlement date every buying brokerage firm is required to settle his money obligation with a clearing house. Similarly, every selling brokerage firm is required to deliver stocks to the buying brokerage firm, as per instructions issued by the clearing house, through delivery orders. Both the parties keep certain margin with the stock exchange as a guarantee to fulfil their commitment. Each executed trade is allotted a unique trading ticket number for identification purposes. The brokerage firm is under obligation to intimate its stock investors through acceptable mode of communication, within twenty-four hours of execution of trade. Subsequent to execution and confirmation of trades, the trades are forwarded to NCCPL as locked-in contracts for post-trade risk management till the settlement date and clearing and settlement on the settlement date. For settlement of money obligations determined on brokerage firm level, 'NCCPL's auto pay and collect system' issues instructions to the respective settling banks. Designated bank accounts of buying brokerage firm are automatically debited while crediting the designated bank accounts of selling brokerage firm. For settlement of stocks obligations netted at stock investor level, NCCPL issue instructions to CDC to pick stocks from respective seller account and park the same into respective buyer account through automated stocks settlement system.

ii- Trading on T+0 Basis

Trading on T+0 basis is common for trading in *Sharī'ah* compliant stocks at PSX that has been approved by SECP since 2017. A separate counter known as *Sharī'ah* compliant counter has been designated for *Sharī'ah* compliant stocks where the

transaction is settled on the same day.¹⁹ A key feature of this newly introduced system is the existence of pre-funded account of buyer. In other words, he should have sufficient funds available so that these funds could be transferred to seller's account for payment of price for the purchased stocks. The facility of settlement on T+0 basis will be available only for *Sharī'ah* compliant stocks. The SECP while approving the establishment of *Sharī'ah* compliant trading counter at PSX, has also outlined *Sharī'ah* rules that should be observed and ensured in trading on *Sharī'ah* compliant trading counter. These rules include the following:

- a) The seller must have the ownership of the stocks to be sold at the time of sale.
- b) The seller must transfer all the rights and responsibilities related to the stocks to the buyer with complete authority to sell it or use it in any other transaction.
- c) The transfer of ownership and possession should be legally recognized and enforceable.
- d) The buyer should be allowed to sell the stocks that are owned and possessed by him on the same day.
- e) The *Sharī'ah* compliant eligible stocks should be traded on *Sharī'ah* trading counter only.²⁰

From the above discussion, it may be concluded that in regular market of PSX, both the *Islamic* and conventional stocks are traded. After the proper activation of

¹⁹ *International The News*, "SECP approves *Sharī'ah*-compliant trading counter at PSX", <<https://www.thenews.com.pk/print/247967-secp-approves-Sharī'ah-compliant-trading-counter-at-psx>> (accessed 20 October 2021).

²⁰ *Sharī'ah Compliant Trading Guidelines*, "Meezan Bank", <<https://www.meezanbank.com/wp-content/themes/mbi/downloads/overseas-pakistani-account/Sharī'ah-Compliant-Trading.pdf>> (accessed 22 Oct 2021).

Shari'ah compliant counter, all *Shari'ah* compliant stocks will be traded on this counter.

T+2 system will be available only for conventional companies and their stocks.

iii- Intraday Trading

Intraday trading is common where trading takes place in single day. It is characterized by rapid transactions and short holding periods, with stock investor aiming to profit from small price fluctuations in the market. Intraday trading plays an important role in the PSX, attracting stock investor seeking to capitalize on short-term market movements.

In intraday trading, the stock investor who has bought stocks, on a particular day, sell those stocks on the same day and thus without paying any amount earn profit with the difference in prices. Trader A, for example, buys a stock from trader B for Rs. 50, for which he has made no payment and whose possession he has not taken. He then sells it to Trader C for Rs. 55 at the end of day before the closure of trade on exchange. Thus, he earns profit of 5 rupees without this stock being first transferred to his ownership and possession.²¹

Intraday trading at the PSX offers several benefits. Firstly, it provides an opportunity for traders to generate profits in a relatively short timeframe, compared to longer-term investment strategies. Secondly, intraday trading offers the potential for high liquidity, particularly in actively traded stocks. This liquidity facilitates swift execution of trades, enabling traders to enter and exit positions with minimal slippage and without significantly impacting market prices.²² This aspect is particularly

²¹ "The Dynamics of Intraday Trading: Benefits and Risks", *Journal of Financial Markets*, vol. 20, no.2 (2023): 54-60.

²² "Managing Risks in Intraday Trading: Best Practices and Strategies", *International Journal of Financial Risk Management*, vol. 12, no.1 (2024): 22-30.

advantageous for traders who seek to actively manage their positions and capitalize on short-term price movements. Thirdly, intraday trading has reduced overnight risk unlike swing or position trading, where traders hold positions overnight and are exposed to overnight market risks such as unexpected news or events, intraday traders close their positions by the end of the trading day. This reduces exposure to overnight risks and helps traders avoid potential gaps in prices that may occur between consecutive trading sessions.²³

However, intraday trading at the PSX comes with inherent risks such as market volatility²⁴ caused by sudden price fluctuations due to economic news and liquidity constraints²⁵ or scarcity, which is difficulty in buying or selling stocks due to low trading volume and execution risks²⁶ which can be caused by delays or failures in executing trades as intended, leading to undesired outcomes i.e., orders not being filled at desired prices due to rapid market movements. These inherent risks impact trading outcomes.²⁷ As a result it is essential for intraday traders to manage risk prudently,

²³ Brown H. Lowell, *Legal Issues in Securities and Financial Markets*, (New York: Oxford University Press, 2019), 90-95.

²⁴ An intraday trader purchases stocks of a company at the beginning of the trading session with the expectation of profiting from a short-term price increase. However, during the trading day, unexpected news regarding the company's financial performance is released, causing a sharp decline in its stock price. This sudden and drastic movement in price reflects market volatility, which can lead to substantial losses for the trader if they are unable to react swiftly. See, *Securities and Exchange Commission of Pakistan (SECP)*, "Understanding Market Volatility", <[SECP](#)> (accessed 29 September 2024).

²⁵ An intraday trader identifies an opportunity to buy a significant number of stocks of a relatively small-cap stock at a specific price point. However, due to limited trading activity and low trading volumes in that particular stock, there might not be enough buyers or sellers in the market to execute the desired trade efficiently. This lack of liquidity can result in delays in executing trades or obtaining unfavorable prices, impacting the trader's ability to enter or exit positions effectively. See, *Ibid*.

²⁶ An intraday trader places a market order to buy stocks of a well-known company at the current market price. However, at the moment the order is placed, there is a sudden surge in trading activity, causing the market price to fluctuate rapidly. As a result, by the time the order is executed, the actual purchase price may differ significantly from the initially quoted price, leading to unexpected costs or missed profit opportunities. This discrepancy between the intended execution price and the actual execution price exemplifies execution risk, which can adversely affect trading outcomes. See, *Ibid*.

²⁷ Trading outcomes such as significant price fluctuations within a single trading day. For example, a trader may buy a stock expecting it to rise in value during the day, but if the market suddenly turns bearish, the stock price could plummet, resulting in substantial losses. See, *Ibid*.

employing risk mitigation strategies such as stop-loss orders and position sizing to protect capital.²⁸

Furthermore, intraday trading involves leveraging as a common tool used to amplify returns that can magnify losses in the event of adverse price movements.²⁹ To mitigate losses associated with leverage in intraday trading, stringent risk management practices can be employed such as determining maximum risk per trade and utilizing stop-loss orders effectively. The loss can also be mitigated by diversifying the portfolio to spread loss, considering using lower leverage ratios and staying informed about market conditions. Moreover, to mitigate losses the discipline and patience are essential, along with practicing in simulated environments and continuously educating. Furthermore, regularly monitoring and reviewing trades to identify areas for improvement and adjusting strategies accordingly are also essential factors to be considered for mitigating losses. By prioritizing capital preservation and implementing these strategies, intraday traders can reduce the impact of adverse price movements and enhance their long-term trading success.

4.1.2 Leveraged Market Trading Practices

A leveraged stock trading market is a market which involves trading stocks with borrowed funds or margin, allowing a stock investor to control a larger position than his initial investment. In this market, a stock investor can amplify potential gains, but can also face increased risks due to the magnified exposure. It provides flexibility and

²⁸ For instance, setting a stop-loss order at a predetermined price level can help limit losses by automatically selling a position if the price reaches that level. Additionally, careful position sizing ensures that traders do not overexpose themselves to excessive risk, thereby preserving capital and mitigating potential losses. See, *Securities and Exchange Commission of Pakistan (SECP)*, "Margin Trading Regulations", <[SECP](#)> (accessed 29 September 2024).

²⁹ For instance, if a trader uses leverage to increase their position size, a small decline in the stock price can lead to disproportionately large losses due to the amplified exposure. See, *Ibid*.

potential for higher returns to the stock investor but requires careful risk management due to increased exposure to losses. To avoid losses, the stock investor must conduct analysis and make decisions on which stocks to trade based on his market research, analysis and investment strategy.

The procedure for trading in the leveraged market involves various steps starting with opening a margin account where the stock investor has to open a margin account with his brokerage firm. This account allows him to borrow funds from the broker to amplify his trading position. After opening the margin account, the stock investor deposits an initial margin, which is a percentage of the total value of the stocks he intends to purchase. He must also maintain a minimum margin level in his account as per the brokerage firm's requirements.³⁰ This margin acts as a cushion against potential losses. The stock investor then places buy or sell orders through his margin account. These orders can be market orders³¹ or limit orders,³² specifying the price and quantity of the stocks he wants to trade.³³ When the market conditions meet the stock investor's specified price, the brokerage firm executes the trade. The brokerage firm also checks if the stock investor's margin account meets the required margin levels to support the trade. If the stock investor's margin account does not have sufficient funds to cover the

³⁰ These requirements dictate the minimum amount of equity that investors must maintain in their accounts relative to the total value of the positions held. Margin requirements help mitigate the risks associated with leveraged trading and protect both investors and brokerage firms from excessive losses.

³¹ A market order is an instruction to buy or sell a stock at the current market price. This means the transaction will be executed immediately at the prevailing market price, ensuring a quick fulfilment of the order. However, the exact price at which the trade is executed may vary slightly from the quoted price due to fluctuations in the market. See, *Securities and Exchange Commission of Pakistan (SECP)*, "Margin Trading Regulations", <[SECP](#)> (accessed 29 September 2024).

³² A limit order allows the stock investor to specify the price at which they are willing to buy or sell a stock. For example, a buy limit order specifies the maximum price the investor is willing to pay for a stock, while a sell limit order specifies the minimum price at which they are willing to sell. The trade will only be executed if the market price reaches the specified limit price. This gives investors more control over the price at which their trades are executed, but there is a possibility that the order may not be filled if the market price does not reach the specified limit. See, *Ibid*.

³³ Both market orders and limit orders allow stock investors to specify the quantity of stocks they want to trade, providing flexibility in managing their investment strategies and objectives. See, *Ibid*.

trade, the brokerage firm lends the necessary funds to complete the transaction. The stock investor pays interest on the borrowed funds. After the trade is executed, the settlement process begins where stocks and funds are exchanged between the stock investor's account and the counterparty's account, typically within a T+2 settlement cycle. Throughout the trading day and beyond, stock investor must monitor his margin levels closely. If the value of his stocks falls below a certain threshold (maintenance margin),³⁴ he may receive a margin call from the brokerage firm, requiring him to either deposit additional funds into the firm's account or sell stocks to restore the required margin level. Failure to meet a margin call may result in the brokerage firm liquidating the stock investor's positions to cover the outstanding debt. The stock investor has the flexibility to close his leveraged positions at any time by placing sell orders. The brokerage firm processes the sell orders and settles the trades accordingly.

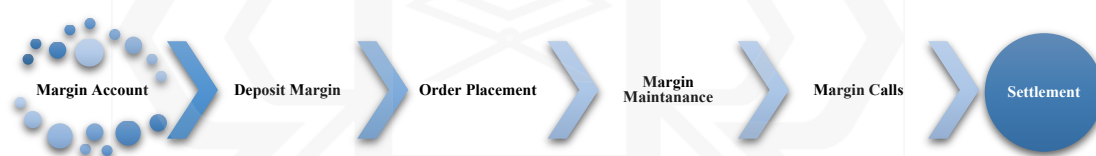


Figure 4.3: Process Flow for Stock Trading at Leveraged Market

³⁴ The maintenance margin is the minimum amount of equity that must be maintained in a margin account to continue holding leveraged positions. It is a predetermined percentage of the total value of the stocks held in the account.

In leveraged trading, stock investors borrow funds from their brokerage firm to amplify their trading positions. However, to mitigate the risks associated with borrowed funds, brokerage firms require stock investors to maintain a minimum level of equity in their margin accounts, known as the maintenance margin.

If the value of securities held in the margin account falls below the maintenance margin level due to market fluctuations, the stock investor may receive a margin call from the brokerage firm. A margin call requires the investor to deposit additional funds or securities into the account to bring the equity back up to the required maintenance margin level.

Failure to meet a margin call may result in the brokerage firm liquidating some or all of the stock investor's positions to cover the outstanding debt. This process is known as a margin call liquidation.

The maintenance margin acts as a safeguard to ensure that stock investors can cover potential losses and fulfil their financial obligations in leveraged trading. It helps protect both the investor and the brokerage firm from excessive risks. See, *Securities and Exchange Commission of Pakistan (SECP)*, "Margin Trading Regulations", <[SECP](#)> (accessed 29 September 2024).

The process flow in leveraged market transactions can be illustrated through above diagram outlining the important sequential steps from opening margin accounts to settling trades, with several intermediary steps such as depositing margin, maintaining margin requirements and managing margin calls. Understanding this process flow is essential for stock investors engaging in leveraged trading, as it ensures effective risk management and compliance with margin regulations set by brokerage firms and regulatory authorities.

4.1.2.1 Classification of Trading in Leveraged Market

As such, there are three types of leveraged market transactions which are: A) short selling, B) margin financing and C) *murabahah* shares financing (MSF).

A) Short Selling

Short selling is a trading strategy involving an arrangement to sell something in the form of stocks in the future which the seller thinks he can buy for less than the agreed selling price.³⁵ It is defined as a sale by a brokerage firm, on its proprietary account or on stock investor's account, when the brokerage firm or stock investor does not own stocks respectively at the time of sale or the sale does not constitute a sale with pre-existing interest, but the brokerage firm or the stock investor, as the case may be, has SLB

³⁵ Jane Russell, *Dictionary of Banking and Finance*, (London: A & C Black, 2003), 326.

contract³⁶ (securities lending and borrowing) executed through SLB Market³⁷ at NCCPL in accordance with NCCPL Regulations and procedures to meet delivery requirements on the settlement date.³⁸ This indicates that there are three main activities involved in the short selling. They are selling stocks without owning them by a brokerage firm on its own account or on account of its stock investor, executing securities lending and borrowing contracts through SLB market and delivering them on settlement date.

Short selling may be explained with the following example: A seller anticipates that value of the stocks of PSO (Pakistan State Oil), an oil marketing company will fall in near future by 20% to 30%. Suppose the current value of PSO stock is Rs. 50 per stock. He instructs his brokerage firm to sell on his behalf 10 stocks of PSO company. In compliance with his instructions, the brokerage firm sells 10 stocks to a party. He simultaneously makes a borrowing arrangement with some brokerage firm. It may itself lend these stocks to him if it possesses required stocks. After some time say, one month if the value of PSO stocks declines to Rs. 20 per stock, he asks his brokerage firm to purchase 10 stocks and deliver those stocks to the lending party. Here we observe that

³⁶ 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 stock 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 loan, the fee or interest rate paid to the lender and the collateral provided by the borrower to secure the loan. This contract provides legal clarity and protection for both parties involved in the securities lending process. See, *National Clearing Company of Pakistan Limited (NCCPL)*, "Securities Lending and Borrowing (SLB) Market Overview", <[NCCPL](#)> (accessed 29 September 2024).

³⁷ 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. See, *Ibid*.

³⁸ The Stock Exchange Regulations 2022, Chapter 2.4. on General Definitions.

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

The above discussion shows that the short selling is different from the ordinary sale³⁹ in a sense that the stock 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 sale⁴⁰ 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.

³⁹ 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 stock, he receives delivery and if he sells the stock, he has to deliver the stocks 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, *Securities and Exchange Commission of Pakistan (SECP)*, "Savings and Capital Markets", 19.

⁴⁰ Blank sale or naked shorting is defined as: A sale by a broker on its proprietary account or on stock investor's account when the broker or stock investor does not own stocks 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, 3.

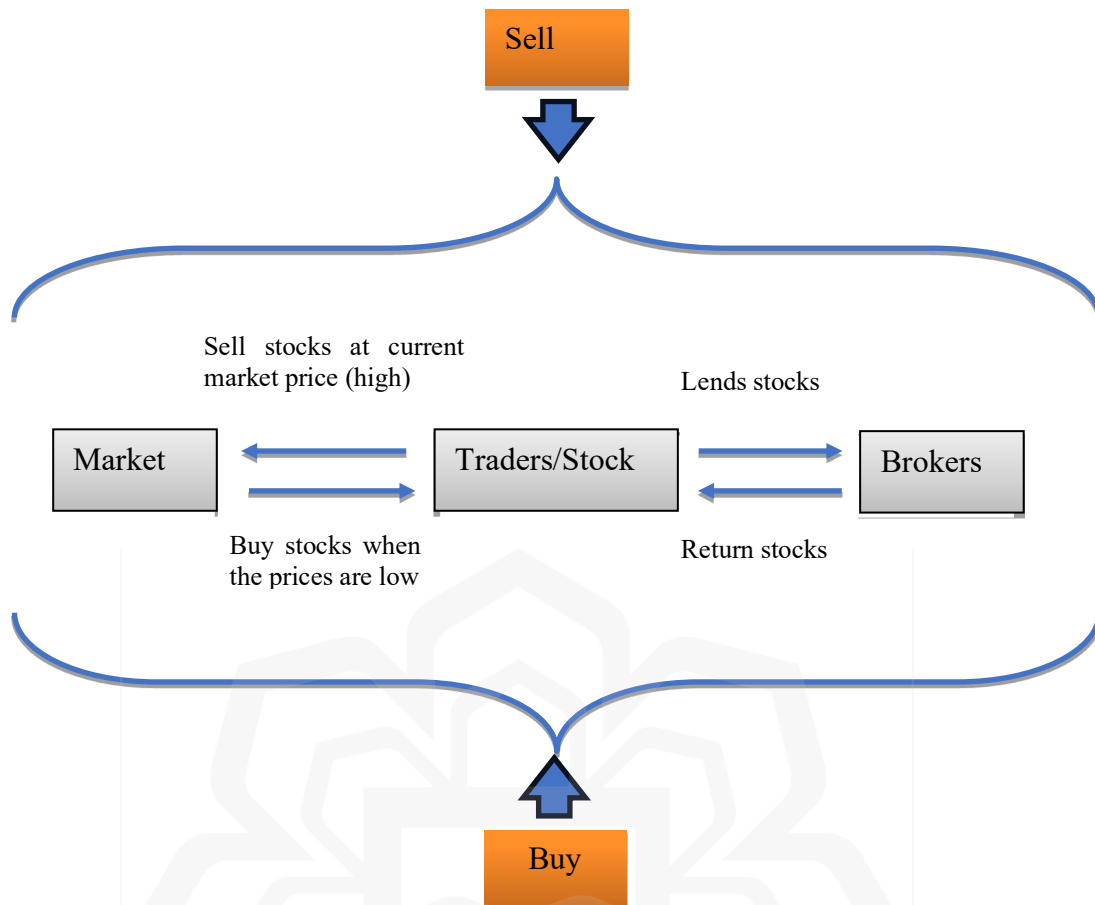


Figure 4.4: What is Short Selling?

The above diagram shows that the stock investor sells first at current market price (high) and buys later. He sells the stocks borrowed from brokerage firm. Then buys stocks when the prices are low and returns borrowed stocks to the lender brokerage firm. Thus, he earns from the price difference.

In short selling, a number of steps are required to be observed. The process of short selling begins with opening of trading account. The stock investor or short seller in order to engage in short selling, opens trading account with a registered brokerage firm in Pakistan.⁴¹ After opening the trading account, the stock investor opens a margin

⁴¹ Pakistan Stock Exchange, "Short Selling Regulations", <<https://www.psx.com.pk/short-selling-regulations>> (accessed 30 March 2024).

account with brokerage firm. In this account, he deposits a certain amount of cash or stocks that serve as collateral for short selling transactions. After opening the margin account to short sell, a specific stock, the stock investor, short seller enters borrowing agreement with brokerage firm or some other lender to borrow the stocks.⁴² 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. After borrowing arrangement, the stock investor places a sell order through his brokerage firm. 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 brokerage firm to sell, say, 100 stocks of certain company designating the transaction as 'Short selling'. The brokerage firm sells one hundred stocks as per the instruction of its stock investor in open market and credits sale proceeds into margin account of short seller. After placing the sale order the stock investor has to deliver the borrowed stocks within two trading days after the trade date (T+2). After delivery of borrowed stocks, to close out short position and realize a profit (or loss), the stock investor buys back the same number of stocks that he initially borrowed. This is called "covering" short position.⁴³ The stock investor buys stocks from the market and returns the borrowed stocks to lender on the day specified in the borrowing agreement. The stock investor may place a buy order through his own brokerage firm. After buying back the stocks, the stock investor, short seller returns borrowed stocks to the lender, usually his own brokerage firm. The profit

⁴² Zahid Akhtar and Shahid A. Zia, "Short Selling in Pakistan: Regulation, Challenges and Opportunities", *Pakistan Economic and Social Review*, vol. 58, no.2 (2021): 345-367.

⁴³ Saima Khan, "Understanding Short Selling Practices in the Pakistani Stock Market", *Journal of Financial Markets*, vol. 23, no.4 (2019): 78-92.

or loss is determined by the difference between the selling price and the buying price minus any transaction costs and borrowing fees.⁴⁴

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

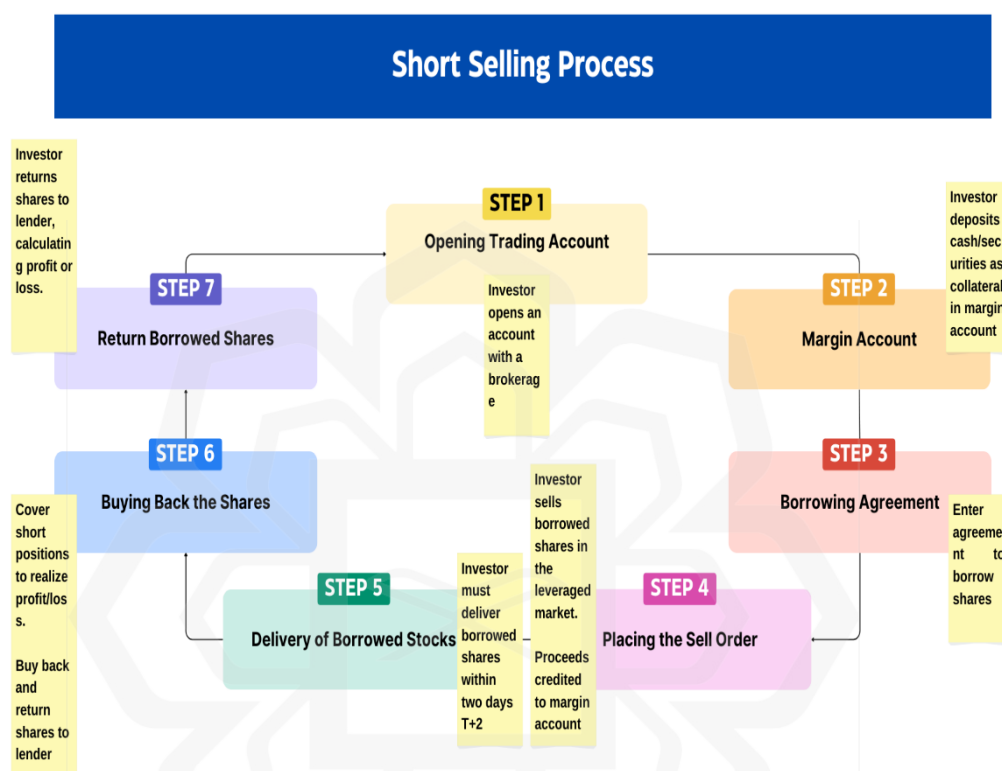


Figure 4.5: Short Selling Process Flow

The above diagram shows that short selling involves various steps. It starts with opening of trading account of short seller with the brokerage firm, followed by margin account and placing required margin amount in it. At third step, stock investor makes borrowing arrangement. He borrows stocks from the brokerage firm. At fourth stage he places order for sale of stocks and sells the borrowed stocks and delivers them to buyer.

⁴⁴ Ahmed Siddiqui, "Short Selling Dynamics: Evidence from Pakistan Stock Exchange", *Pakistan Journal of Finance and Economics*, vol. 35, no.1 (2020): 112-128.

In next step, he buys stocks from the market, He then returns those stocks to the lender, brokerage firm.

B) Margin Financing

Margin financing is to purchase stocks with borrowed money and using those stocks as collateral or security with the financier. Under this transaction, the stock investor buys certain quantity of stocks using his own money and the money borrowed from the financier⁴⁵ who is either a brokerage firm, bank or any financial institution admitted with stock exchange.⁴⁶ The stock investor who is desirous to buy stocks with the borrowed money, enters into an agreement known as margin financing agreement with financier. On the instruction of stock investor the brokerage firm, buys required stocks with the funds of the stock investor i.e. 15% and the borrowed money from the financier 85% of the total value of stock. He makes payment of this money on settlement day on T+2 basis, to NCCPL.⁴⁷ The stock investor pays interest or mark-up, on the borrowed amount and some commission prescribed by the stock exchange, the rate payable is KIBOR⁴⁸ +8% per annum. He is required to maintain minimum margin requirement at every stage till the debt is paid off. The minimum margin amount required to be paid by the stock investor is called Financing Participation Ratio (FPR) which is 15% of the

⁴⁵ See, NCCPL Regulations 2018, Chapter 7B, Definitions. According to NCCPL Regulations, banks, investment finance companies can also get themselves registered as margin financiers. See, NCCPL Regulations, Chapter 7B 2.1.

⁴⁶ In practice various financial institutions in Pakistan provide margin financing facility including Meezan Bank, Dubai Islamic Bank Pakistan, Bank Islami Pakistan Limited, Al Baraka Bank (Pakistan) Limited, Faysal Bank Limited, MCB Islamic Bank Limited, Bank Alfalah Islamic Banking, Askari Islamic Bank, Soneri Bank Islamic Banking, Habib and Metro Islamic Banking. See, *Securities and Exchange Commission of Pakistan*, "Islamic Financing Institutions in Pakistan", <[SECP](#)> (accessed 29 September 2024).

⁴⁷ See, <www.psx.com.pk/product> (accessed 05 Jan 2023).

⁴⁸ Kibor stands for Karachi interbank offer rate. This is a policy rate announced by the State Bank of Pakistan. It is currently 22%. This means if the financier has provided one hundred thousand rupees to the stock investor for the purchase of stocks for a period of three months it will charge thirty thousand rupees per annum from the financee. See, *State Bank of Pakistan*, "Karachi Interbank Offered Rate (KIBOR)", <[State Bank of Pakistan](#)> (accessed 29 September 2024).

borrowed amount. The remaining 85% is provided by the financier. After buying required stocks these stocks are transferred from seller to the buyer. However, they are kept by the CDC in the account of financier in blocked status as collateral. They are considered as pledge from the stock investor with the financier. The financier cannot on his own deal with these stocks.

The stock investor is also required to have margin maintenance by paying marked to market losses to NCCPL on daily basis in cash till the final settlement of financing which is generally 60 days from the date of payment of price to NCCPL and the delivery of stocks from the seller to the stock investor. Marked to market loss is a loss when the price of purchased stocks falls below the value of financed amount. The term mark-to-market loss is defined as an amount payable by brokerage firm at any point in time during a trade date on account of trades executed on behalf of its stock investors to NCCPL due to the difference between the trade price, on trade-to-trade basis, of the unsettled position in each security and the closing price of that security and the last executed price.⁴⁹ The interest or mark-up rate payable on borrowed fund is KIBOR +8% per annum.

Margin maintenance works in the following ways. For example, a stock investor has bought stocks worth one hundred thousand rupees with eighty-five thousand rupees borrowed from the financier and fifteen thousand rupees from his own sources. Now if the value of those stocks on particular day decreases from hundred thousand to eighty thousand rupees, the stock investor will be required to make additional payment of five thousand rupees to the financier to equalize value of his stocks with the value of borrowed amount. With this amount of five thousand rupees, the stock investor's contribution will go up to twenty thousand rupees. In this way, he will compensate the

⁴⁹ NCCPL Regulations 2018, Chapter 2. Definitions.

loss of the stock investor on daily basis resulting from the decrease in the value of stocks. Through this margin maintenance, the financier is protected from any expected loss. From this, it may be concluded that in margin financing, trading takes place through amount borrowed on interest.⁵⁰

A stock investor who intends to purchase a stock through margin financing is required to observe certain steps for this transaction. The first step is that he has to identify this transaction as 'leveraged buy' by using special key.⁵¹ Upon initiation of transaction, details of such initiated margin financing transaction are conveyed to financier for its affirmation. Such affirmation shall be restricted up to FPR. A financier may affirm or reject the initiated transaction but is not allowed to edit the details of an initiated transaction.⁵² On the respective settlement date of 'leveraged buy', the financier has to pay for part of settlement obligations of the stock investor pertaining to leveraged buy, as per agreed FPR, whereas the remaining amount is to be paid by the stock investor. In case of affirmation on settlement date, the financier settles margin financing transaction value directly with the stock investor and the money obligation against purchases are settled by the respective stock investor on the respective settlement date through National Clearing and Settlement System (NCSS). Upon settlement, margin financed stocks are required to be moved to the CDC margin financing blocked account of the financier as collateral against margin financing. The financier releases stocks when the stock investor settles his debt obligation. In order to protect financier from loss caused by decline in the value of security, the marked-to-

⁵⁰ Khalid Shahid, "Margin Trading and Its Impact on Investor Behavior", *Journal of Financial Markets*, vol. 22, no.1 (2023): 45-55.

⁵¹ Leveraged Buy means a buy trade executed in the Ready Delivery Contract Market through a separate function key which will be available for financing through MT Market.

⁵² NCCPL Regulations 2018, Chapter 7B..3.3(4) (5); The Securities (Leveraged and Pledging) Rules 2011, s 14(e).

market concept comes into play. This loss is calculated on daily basis.⁵³ In case of any default and/or dispute between margin financing participants on margin financing transactions or in case of non-fulfillment of any margin call by the stock investor, the stocks of the defaulted stock investor are delivered into the regular CDC account of the financier. In other words, the financier has absolute right to dispose them off.



Figure 4.6: Process Flow of Margin Financing

The diagram illustrates the process flow of a margin financing transaction, beginning with the initiation of the transaction by the stock investor, who identifies it as a 'leveraged buy'. Details of the transaction are conveyed to the financier for affirmation, which is restricted up to the FPR. On the settlement date, the financier pays

⁵³ If a stock investor has purchased a scrip for Rs. 100 with 15% margin and 85% from a financier bank and the price decrease to Rs. 95, he is required to pay 5 rupees to the financier. On next closing, if the prices further decrease to Rs. 90, he will again pay 5 rupees to the financier to compensate his loss. See, *Pakistan Stock Exchange*, "Margin Trading Regulations", <<https://www.psx.com.pk/>> (accessed 29 Sep 2024).

for part of the settlement obligations, with the stock investor settling the remaining amount through the NCSS. Margin-financed stocks are then moved to the CDC margin financing blocked account of the financier as collateral. In order to maintain margin, marked-to-market losses are calculated daily, with the stock investor required to compensate for any decrease in the value of stocks. In case of default or dispute, stocks are transferred to the regular CDC account of the financier, who has the right to dispose of pledged stocks. The financier releases stocks when the stock investor settles his debt obligation.

C) *Murabahah* Shares Financing (MSF)

Another significant leveraged market transaction is MSF. It was introduced by the NCCPL with the approval of SECP in September 2019 as a *Shari'ah* compliant alternative to prevailing interest-based margin financing system.⁵⁴ To accord regulatory cover to MSF, a separate section has been inserted in Chapter 7 of NCCPL Regulations 2018 titled Securities (Leveraged Markets and Pledging) Rules 2011.⁵⁵ This arrangement has been designed to finance those stocks which fall under All Shares *Islamic* Index.⁵⁶ It caters the needs of stock investors willing to avail *Shari'ah*-compliant modes to finance their transactions.

⁵⁴ SECP, "SECP Approves *Shari'ah* Compliant Financing Product For Capital Market", <<https://www.secp.gov.pk/media-center/press-releases/secp-approves-Shari'ah-compliant-financing-product-for-capital-market/?cfchljschltk=pmdUl.aOR8BKIF3gFK04YHIib187jQ1PQclhXGsEmsyQ8-1634822374-0-gqNtZGzNAPCjcnBszQq9>> (accessed 21 October 2021).

⁵⁵ Products and Services, "*Murabahah* Shares Financing (MSF)," National Clearing Company of Pakistan Limited, <<https://www.nccpl.com.pk/en/products-services/products-services-1/Murabahah-share-financing-msf>> (accessed 21 October 2021).

⁵⁶ All Shares *Islamic* Index comprises all companies on the Stock Exchange, which qualify under the prescribed *Shari'ah* Screening Criteria. Over 250 all included in this *Shari'ah* index. See, Securities and Exchange Commission of Pakistan (SECP), *Savings and Capital Markets*, (Islamabad: SECP, 2019), 154.

The newly introduced MSF arrangement also known as *Murabahah lil Amir bil Shira*⁵⁷ is based on *Murabahah* which is a sale contract in which the seller discloses the cost of the sold commodity along with profit charged on it, both components are mentioned separately. AAOIFI defines *murabahah* as selling a commodity as per the purchasing price with a defined and agreed profit. This profit may be a percentage of the selling price or a lump sum.⁵⁸ Under MSF, the seller (financier) purchases the MSF eligible stocks⁵⁹ from the regular market and after the MSF financier has completed the purchase, the purchased stocks are sold to the MSF buyer (stock investor) on *murabahah* basis with deferred payment at future date agreed between the parties at the initiation of the *murabahah* contract.

The main features of MSF include eligibility criteria for entities to act as MSF financier and MSF stock investors.⁶⁰ MSF financier includes brokerage firm of stock exchange, banking companies and financial institutions that meet the eligibility criteria which is to obtain license from State Bank of Pakistan (SBP) before offering any *Shari'ah* compliant products and services.⁶¹ Moreover, only *Shari'ah* compliant stocks can be traded under MSF.⁶² It is worthy to mention that MSF can be availed only for *Shari'ah* compliant stocks and the stocks which are declared eligible for financing by the NCCPL.⁶³

⁵⁷ *Murabahah lil Amir bil Shira* (*Murabahah* to purchase orderer) has been used by the AAOIFI in its Standard on *Murabahah* and has been widely accepted by the *Shari'ah* scholars. There is no disagreement on the validity of this type of *Murabahah*.

⁵⁸ Accounting and Auditing Organization for Islamic Financial Institutions, *Shari'ah* Standards, (Bahrain): AAOIFI, 2015, *Shari'ah* Standard No. (8) *Murabahah*, 221.

⁵⁹ It is worthy to mention that MSF is used only for stocks not for other securities. It is a *Murabahah* Shares Financing not a *Murabahah* Securities Financing. Also, it cannot be used for preference stocks because they are not permissible in *Shari'ah*. See, NCCPL Regulations, 2003, Chapter 7E: *Murabahah* Shares Financing.

⁶⁰ Ibid, Chapter 7E: *Murabahah* Shares Financing, s 7E(1)

⁶¹ Banking Companies Ordinance, 1962 (LVII of 1962), s 3(A)

⁶² NCCPL Regulations, 2003, Op. cit., Chapter 7E: *Murabahah* Shares Financing, s 7E(2)

⁶³ Ibid, Chapter 7E: *Murabahah* Shares Financing, s 7E(1)

Furthermore, both the MSF seller and MSF stock investor have to enter into master *murabahah* agreement (MMA). This is not a sale contract, it is rather a sort of memorandum of understanding between financier, stock investor and brokerage firm. The MMA specifies that the financier shall buy stocks from ready market. The stock investor gives undertaking that he will buy those stocks from the financier. MMA details terms between financier and stock investor for purchasing stocks. It includes clauses identifying parties, describing stocks, setting purchase price, defining payment and delivery terms, outlining warranties, addressing late payment/default, specifying dispute resolution, stating governing law⁶⁴ and including termination provisions.⁶⁵ These provisions are subsequently made part of contract when actual *murabahah* sale is made.

At this stage agency agreement is also made between the financier and the brokerage firm for purchase of stocks on behalf of financier as its *wakīl*. The brokerage firm acting as an agent of financier buys the stocks from the market and delivers them to the financier. Thus, all the risk relating to purchase of stocks are borne by the financier in his capacity as a principal in this arrangement. The risk is shifted to the stock investor only after the execution of the actual *murabahah* contract between the parties. After receiving delivery of stocks from brokerage firm, the financier informs NCCPL about its intention to sell those stocks to the stock investor. Thereafter, stocks are sold on *murabahah* basis, on T+2 settlement system, where stocks are delivered to the stock investor after two days. The stocks are shifted to blocked account of financier as collateral which are released to the stock investor when he makes the full payment of price. The collateral can be equal to, or above the value of stock investor amount as

⁶⁴ This clause specifies the governing law that will apply to the agreement, typically based on *Sharī'ah* principles in the case of *Murabahah* agreements.

⁶⁵ Ibid, s 7E(5).

agreed between parties and it is up to parties to agree on matching the value of stock with value of debt.⁶⁶ For example, the credit price to be paid by the stock investor is Rs. 10,000,00 the value of collateral should be one hundred thousand or above. If value of collateral falls by 10% per cent the stock investor will be required to deposit additional amount, so the value of collateral remains equal to credit price.

A stock investor who intends to avail MSF is required to observe certain steps for this financing. The process starts with the stock investor applying to the financier through an application form detailing his financing requirements, including the purpose of the financing, the desired amount and the intended stocks to be purchased. On submission of application the financier scrutinizes the stock investor's financial standing, business model and the *Sharī'ah* compliance of the proposed stocks. Upon successful completion of due diligence, the financier approves the financing request. Once the financing is approved, the financier enters into MMA with the stock investor, outlining the terms and conditions of the financing arrangement. The agreement specifies the purchase price, profit margin, payment schedule and any other pertinent details governing the transaction. Upon execution of the agreement, the stock investor, in consultation with the financier's *Sharī'ah* advisors, identifies and selects stocks that comply with *Sharī'ah* principles. The selection process entails assessing the *Sharī'ah* compliance of the stock investor's business activities, financial ratios and governance structure. After selecting the stocks, the financier purchases the selected stocks from the market or directly from the issuing company at the agreed-upon price. The financier assumes ownership of the stocks, thereby mitigating any ambiguity regarding ownership or possession in accordance with *Sharī'ah* principles. Immediately following the purchase of stocks, the financier sells the stocks to the stock investor at a

⁶⁶ Ibid, 7E (3).

predetermined markup or profit margin, which is disclosed in the MMA. The sale price comprises the original purchase price plus the agreed-upon profit margin, payable by the stock investor in instalments as per the terms of the agreement. Simultaneously with the sale, ownership of the stocks is transferred to the stock investor, ensuring full legal and beneficial ownership in compliance with *Shari'ah* principles. However, the stocks are not delivered to the stock investor rather they are shifted to financier's account with CDC, as collateral. Over the stipulated period, the stock investor fulfills the payment obligation to the financier in accordance with the agreed-upon payment schedule. Upon the completion of the payment period, the MMA concludes, with the stock investor having fully repaid the financing amount along with the agreed-upon profit. The financier closes the financing account and the NCCPL instructs CDC to transfer stocks into the account of stock investor. As regards the release of collateral, the parties may also agree that on payment of every instalment, the financier will release stocks equal to the amount of instalment. As such, on every instalment, financier will release certain quantity of stocks. Thus, the MMA will come to an end.

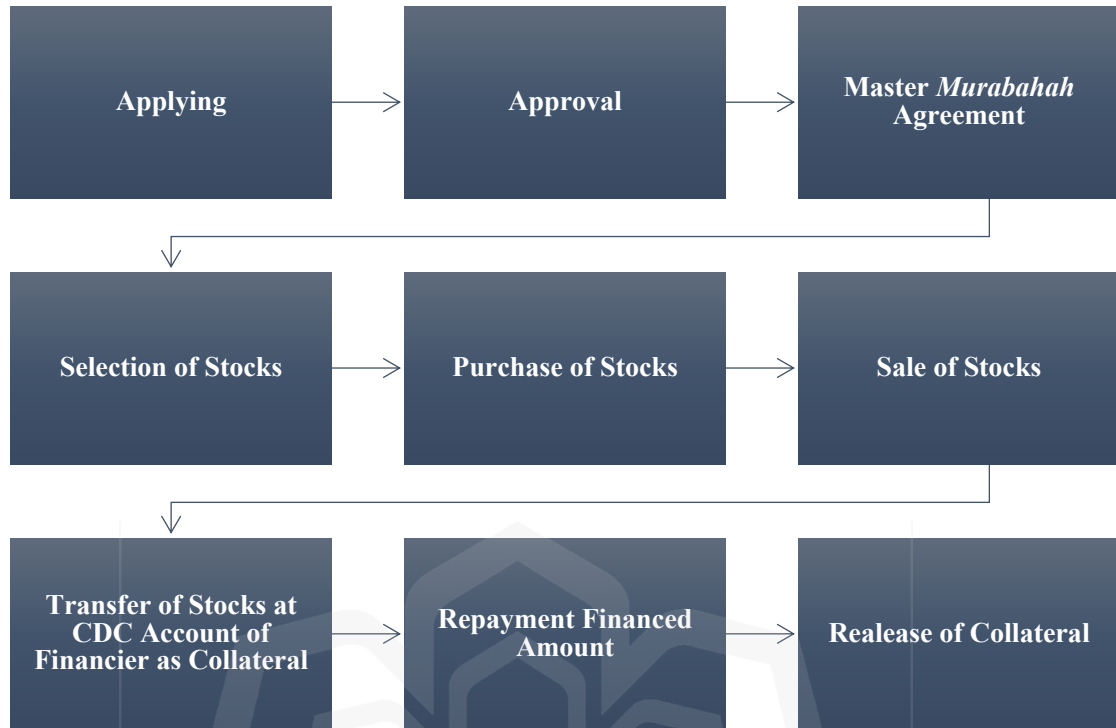


Figure 4.7: Process Flow of MSF

The diagram shows the process flow of MSF. It begins with the stock investor's submission of an application and subsequent approval by the financier. Following the approval, MMA is signed between the financier and the stock investor, outlining terms. After signing agreement, the stock investor, in consultation with *Shari'ah* advisors, selects *Shari'ah*-compliant stocks. Subsequently, the financier purchases the selected stocks and sells them to the stock investor, who discharges the payment obligation over a specified period. On sale of stocks and before settling the outstanding amount to the financier takes place the sold stocks are kept in financier's account with CDC, as collateral. Once the payment is done to the financier the said collateral is the released.

4.1.3 Futures Market Trading Practices

A futures market is a market where participants can buy and sell stocks for the future delivery of a specific stocks at a predetermined price also known as futures contract, which are standardized agreements for the future purchase of specific stocks, with the delivery set for a later date.⁶⁷ Both parties defer their obligations to a predetermined future date. The purchaser of futures does not have obligation to make the full payment at the time of contract; instead, he is required to pay only a small margin. The value of the contract fluctuates in response to changes in the price of the stock or commodity.

Futures market plays an important role in managing price risk for stock investor and provide him opportunity to use futures contracts to hedge against adverse price movements.⁶⁸ By hedging in future prices through contracts, stock investor can protect himself from potential losses due to price fluctuations. Moreover, the futures market is highly liquid and there is a high volume of trading activity which allows stock investor to enter and exit positions easily without significantly impacting prices.

The procedure for trading in the futures market involves various steps. The trading process at futures market starts with opening a futures trading account where the stock investor interested in trading stock futures contracts⁶⁹ opens a futures trading account with a brokerage firm that offers access to the futures market. Once the account

⁶⁷ Futures trading is a very common form of trading practiced in Futures Market of PSX. It is governed and regulated primarily by the Futures Market Act 2016 and Pakistan Stock Regulations 2018 and the regulations concerning clearance and settlement of futures. See, Securities and Exchange Commission of Pakistan, *Futures Market Act 2016 and Regulations Concerning Futures Trading*, (Islamabad: SECP, 2016); Pakistan Stock Exchange, *Pakistan Stock Exchange Regulations 2018*, (Karachi: PSX, 2018).

⁶⁸ The futures contracts serve as derivative financial instruments employed within capital and commodity markets, which fulfil dual purposes: speculative, where stock investor anticipates and aim to profit from favorable future price movements and hedging, where stock investor seeks to mitigate risks associated with price fluctuations in the underlying asset. See, Kamali, Hashim. *Islamic Commercial Law: An Analysis of Futures*. (Kuala Lumpur: International Islamic University Malaysia Press, 2005), 201-202.

⁶⁹ Trading in stock futures contracts is the terminology commonly used in stock market. Trading in futures contracts means when stock investor "buys" a futures contract, they are essentially entering into an agreement to purchase the underlying stocks at a predetermined price (the futures price) on a specified future date (the expiration date). See, Bacha, Omer. *Islamic Futures and Derivatives: A Comprehensive Guide*. (Kuala Lumpur: Bank Negara Malaysia, 2005), 45-47.

is open stock investor is required to deposit an initial margin with his brokerage firm to initiate trade.⁷⁰ After making the deposit the stock investor places order to buy or sell futures contracts through his brokerage accounts. These orders specify details such as the stock symbol, contract expiration date, quantity and whether it's a long (buy) or short (sell) position. Once the orders are placed by stock investor, they are matched through the futures exchange's central order matching system where buy orders are matched with sell orders based on price and time priority. Once the orders are matched, the trade is executed at the prevailing market price. At the end of each trading day, futures contracts are marked to market, profits and losses are calculated based on the difference between the contract's settlement price and the previous day's settlement price. The margin accounts are adjusted accordingly. Throughout the trading period, the stock investor must monitor his position and margin levels closely. If the value of the futures contract moves against the stock investor, causing the margin balance to fall below the maintenance margin level, the stock investor may be required to deposit additional funds into his margin account to meet margin calls. On the expiration date the futures contracts must be settled. The settlement can occur through physical delivery of the underlying stock (in the case of physically settled contracts) or through cash settlement, where the difference between the contract price and the market price is paid or received. Upon contract settlement, stock investor realizes profits or losses based on the difference between the contract's purchase price and the settlement price. Profits are credited to the stock investor's account, while losses are debited. Stock investor has the option to close their futures positions before the contract expiration date by placing

⁷⁰ The initial margin is a fraction of the total value of the futures contract and serves as collateral against potential losses.

offsetting buy or sell orders. This allows stock investor to lock in profits or limit potential losses.



Figure 4: Process Flow for Stock Trading at Futures Market

The process flow of futures market transactions can be depicted through above diagram illustrating the important sequential steps from opening futures trading account and depositing initial margin to placing orders, contract settlement and realizing profits or losses. Understanding this process flow is essential for the stock investor engaging in futures trading, as it enables effective risk management, compliance with exchange regulations and informed decision-making regarding trading strategies.

4.1.3.1 Classification of Trading in Futures Market

There are four types of futures traded at PSX which are: A) single stock futures B) single index futures C) deliverable futures D) cash settled futures.

A) Single Stock Futures

Single stock futures may be defined as contracts that allow the sale of certain stocks at a specified future date and at a predetermined price. These contracts are settled in cash, with cash difference between the futures price and the final settlement price. The

minimum trading lot for single stock futures is 500 stocks of the underlying stocks. Contract is matured 90 days after the contract is listed.⁷¹

B) Single Index Futures

Single index futures contract is a standardized contract for the purchase or sale of a standardized underlying stock index on a future date, at a pre-specified futures price.⁷² Single index futures contracts provide stock investor with the opportunity to trade in the relevant index futures, instead of individually buying the individual stocks. The maturity period of single index futures is 90 days. The contracts mature or expire on the last Friday (or the preceding trading day in case of a holiday) of the expiry month, with settlement occurring on a T+1 basis. It's important to note that a distinct market exists for the trading of single index futures. Within the PSX, four prominent types of market indices are recognized: KSE-100, KSE-10, KMI-30 and All Shares *Islamic* Index. Stock market indices have been developed to track the performance of various listed stocks, according to their market value.⁷³

C) Deliverable Futures

Deliverable futures contract market is a forward contract. It is a contract to buy or sell certain stock with actual delivery on specified date in the future. Settlement of deliverable futures contracts generally occurs 30 days after the contract is purchased. Deliverable futures contract is a standardized contract. The minimum lot for purchasing

⁷¹ Bilal Ahmed, "Overview of Futures Trading at the Pakistan Stock Exchange", *Pakistan Futures Market Review*, vol. 12, no.3 (2020): 45-67.

⁷² Ayesha Hussain, "Types of Futures Contracts Traded at the Pakistan Stock Exchange: A Comprehensive Analysis", *Journal of Financial Derivatives*, vol. 18, no.2 (2019): 89-103.

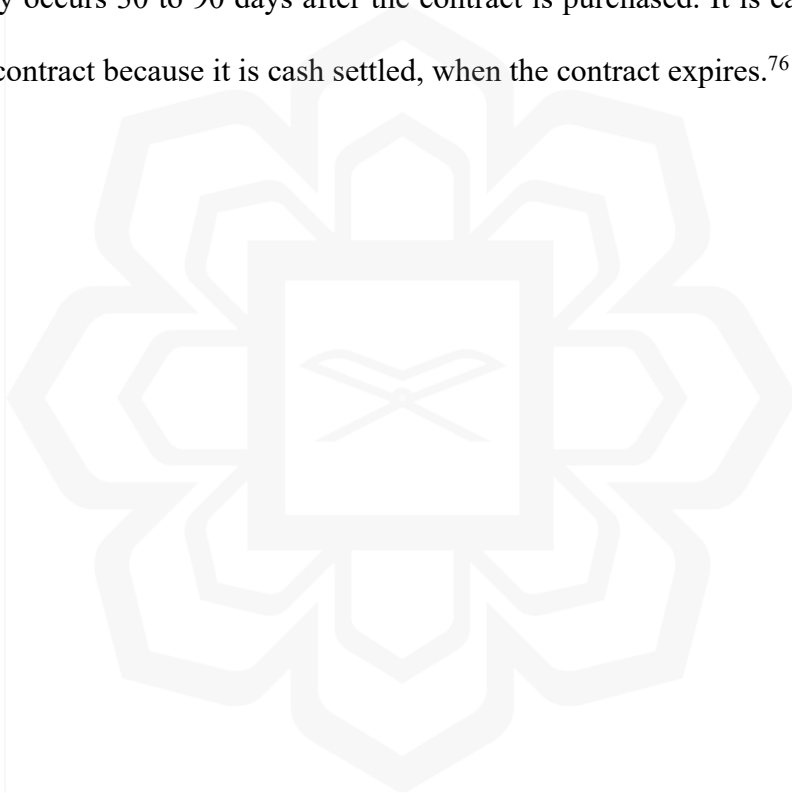
⁷³ An index is composed of a basket of stocks which capture change in the market capitalization due to the variation in price.

these stocks is normally a tradable lot of 500 stocks. Purchasing one futures contract means purchasing normally a tradable lot consisting of 500 stocks.⁷⁴

D) Cash Settled Futures Contract

Cash settled futures contracts are standardized contracts which allow a stock investor to purchase or sell certain stocks, at a certain date in the future, at a specified price.⁷⁵

No physical delivery of stocks is involved in these contracts. Contract settlement generally occurs 30 to 90 days after the contract is purchased. It is called cash-settled futures contract because it is cash settled, when the contract expires.⁷⁶



⁷⁴ *Pakistan Stock Exchange*, "Futures Contracts Listing", <<https://www.psx.com.pk/futures-contracts-listing>> (accessed 30 March 2024).

⁷⁵ At present, there has been no known activity at least for the last few years, if not more, in the 'Cash Settled Futures Contract Market' in Pakistan. All Futures Trading activities have been taking place under Deliverable Futures Contract Market Regulations only. Securities and Exchange Commission of Pakistan, *Report on Futures Trading Activities in Pakistan*, (Islamabad: SECP, 2023), 15.

⁷⁶ Fahad Khan, *Introduction to Futures and Options Trading in Pakistan*, (Karachi: Oxford University Press, 2018), 94.

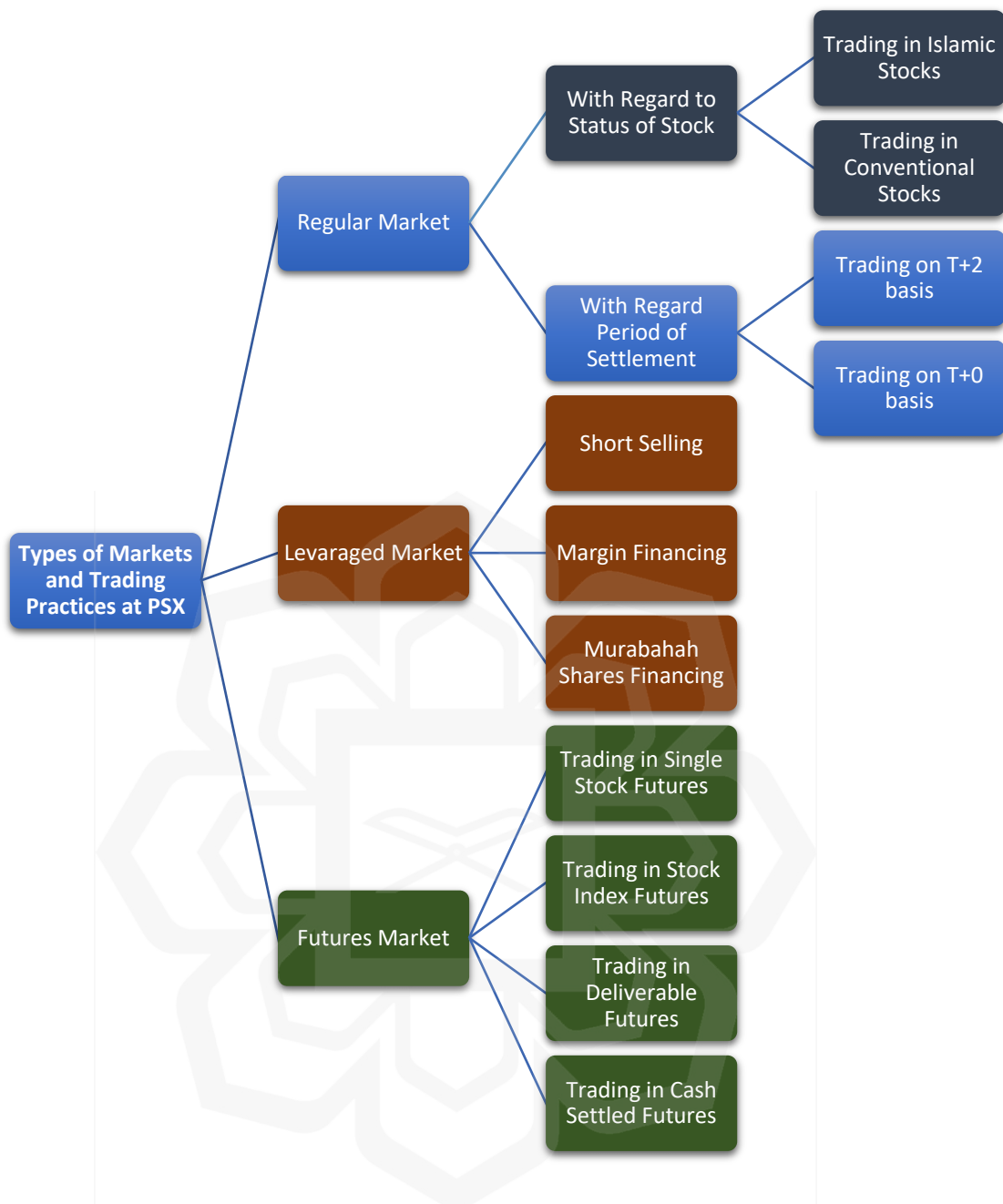


Figure 4.9: Types of Markets and Trading Practices at PSX

The diagram outlines the various types of markets and trading practices observed in the PSX. It categorizes these practices into three main markets: regular market, leverage market and futures market. In the regular market, stocks are categorized as *Islamic* or conventional and trades settles either in two days (T+2) or on the same day (T+0). The leverage market includes short selling, margin financing and MSF. The

futures market offers contracts for single stock futures, stock index futures, deliverable futures and cash settled futures.

4.2 SHARĪ'AH ISSUES IN STOCK TRADING PRACTICES IN PSX

The *Sharī'ah* issues in stock trading practices in PSX can be classified into the following categories: *Sharī'ah* issues pertaining to regular market, *Sharī'ah* issues pertaining to leveraged market and *Sharī'ah* issues pertaining to futures market.

4.2.1 Sharī'ah Issues Pertaining to Regular Market

There are various *Sharī'ah* issues involved in stock trading pertaining to regular market. These issues include: i) trading in conventional stocks ii) trading in preferred stocks ii) trading on T+2 basis iii) intraday trading iv) market manipulation and v) insider trading.

4.2.1.1 Trading in Conventional Stocks

An important *Sharī'ah* issue of stock trading practices in PSX is trading in conventional stocks which are the stocks that are issued by conventional banks, insurance companies conventional leasing companies and similar other banking and non-banking financial institutions. The core business of these companies includes many *Sharī'ah* prohibitory elements such as element of *ribā* where the conventional banks obtain deposits on the basis of interest. They pay a predetermined interest on principle amount of deposit to the depositor. They lend money to customers against affixed interest which is linked with KIBOR.⁷⁷ Thus, the core business of conventional banks is based on *ribā*. When a

⁷⁷ KIBOR stands for Karachi interbank offer rate determined by the State bank of Pakistan.

stock investor buys stocks of such institutions, he becomes partner in *ribā* based business.⁷⁸

Another *Sharī'ah* prohibitory element is element of *gharar* which is especially reflected in the business of insurance companies. The element of *gharar* inherent in the insurance exists in many forms such as uncertainty about the payment of insurance amount. This means that there is uncertainty as to whether the insured person will be able to get amount of compensation. In other words, there is uncertainty about what the insured person buys with the premium. Another form of *gharar* is uncertainty about the time of occurrence of event and the time of the payment of compensation.⁷⁹ The particular event against which insurance is required, is uncertain in nature. The parties to the contract do not know at the time of contract, whether the event will occur or not. If the event occurs it will bring pecuniary benefits in compensation for the insured and if it does not occur, he will get nothing. Thus, the acquisition of pecuniary benefits depends upon the occurrence of the event specified in the contract.⁸⁰

Another *Sharī'ah* prohibitory element is element of *qimār*. This element is reflected in the investment business of banks and insurance companies. They invest their funds in stocks and commodity futures for speculative earning. The stocks of these companies, thus represent a business which incorporates elements of *ribā*, *gharar* and *qimār* and thus they are *Sharī'ah* non-compliant stocks. Here we observe that core business of company is impermissible from *Sharī'ah* perspective.⁸¹

⁷⁸ Muḥammad Nejatullah Siddiqi, "Ribā, Bank Interest and the Rationale of its Prohibition", *Islamic Studies*, vol. 17, no.1 (1978): 53-74.

⁷⁹ Taqī 'Usmanī, *An Introduction to Islamic Finance*, (Kluwer Law International, 2002), 87.

⁸⁰ Mahmoud El-Gamal. A., *Islamic Finance: Law, Economics and Practice*, (Cambridge University Press, 2006), 63.

⁸¹ Feisal Khan, *Islamic Banking in Practice*, (Edinburgh: Edinburgh University Press, 2015), 74.

Sometimes core business of a company that has issued stocks is *Sharī'ah* compliant companies, such as pharmaceutical company, or sugar industries, but it has borrowed funds from conventional banks against interest or they have placed funds with conventional banks and earn interest on it or they have invested funds in *Sharī'ah* non-compliant securities.⁸² The stocks of such companies are also considered *Sharī'ah* non-compliant, if the interest-based borrowing and lending exceeds prescribed ratios. Trading in such stocks is also impermissible from the perspective of *Sharī'ah*.⁸³

SAC of the SC Malaysia provides rulings on trading in conventional stocks to ensure compliance with *Sharī'ah* principles. It prohibits investments in stocks issued by companies involved in non-permissible activities, such as those related to alcohol, gambling, pork, or other prohibited industries according to *Sharī'ah*. Investing in such stocks is considered impermissible and goes against *Sharī'ah* principles. Moreover, the SAC establishes screening criteria to identify *Sharī'ah*-compliant stocks, which typically involve analyzing the core business activities, revenue sources and financial ratios of companies listed on the stock exchange. Companies that meet the criteria set by the SAC are considered *Sharī'ah*-compliant and investments in their stocks are deemed permissible. Furthermore, the SAC ensures that trading in stocks complies with various *Sharī'ah* principles, including the prohibition of *ribā*, *gharar* and *maysir*. Investments in stocks must also adhere to the principles of transparency, fairness and ethical conduct in line with *Sharī'ah* principles.⁸⁴

⁸² Zubair Hasan, "Sharī'ah-Compliant Equity Investments: Constraints, Risks and Investment Strategies", *Journal of Economic Cooperation and Development*, vol. 28, no.2 (2007): 85-120.

⁸³ Munawar Iqbal and Molyneux, Philip, *Thirty Years of Islamic Banking: History, Performance and Prospects*, (Basingstoke: Palgrave Macmillan, 2005), 56.

⁸⁴ *Securities Commission Malaysia*, "Sharī'ah Advisory Council", <<https://www.sc.com.my/about-us/the-organization/our-boards/Shari'ah-advisory-council>> (accessed 30 March 2024).

4.2.1.2 Trading in Preferred Stocks

Another prominent *Sharī'ah* issue of stock trading practices in PSX is trading in preferred stocks or preference stocks. Preference stockholders are given preferential treatment when annual dividend is distributed. They receive a fixed dividend irrespective of the profit or loss of business. The dividend is fixed as percentage of the nominal value of stock e.g. 7% per year. Preference stocks have qualities of both the equity stocks and debentures.

The main *Sharī'ah* issue involved in preference stocks is that preference stockholder gets a fixed profit on his original amount without bearing any liability for loss. A *Ḥadīth* of Prophet (S.A.W.) states that the profit depends upon liability for loss. The *Ḥadīth* means that if a person wants to get profit of business, he should get ready to bear the risk and liability for loss. On the basis of this *Ḥadīth*, *ribā* bearing transactions are held unlawful in *Sharī'ah*, because the lender does not bear any liability for loss with the borrower, in case the borrowing amount is stolen or lost. On the other hand, in *mushārakah* or partnership business, a partner is entitled to profit, if any profit emerges. This is because he bears the risk and liability for loss in the business.⁸⁵

Preference stockholders are apparently equity holders and participants in the business of company on the basis of profit and loss sharing. But the fact of the matter is that they are lenders. Preference stocks are only debt instruments, on which the preference stockholders earn a fixed interest. In the same way, redeemable stockholders do not practically participate in the business of the company, because they are entitled to their capital, irrespective of the profit and loss of the company. Thus, both the preference stocks and redeemable stocks are interest bearing debt instruments. AAOIFI

⁸⁵ M. Kabīr Ḥassan and Michael Mahlkecht, *Islamic Capital Markets: Products and Strategies*, (Chichester, UK: John Wiley & Sons, 2011), 85-90.

in its verdict has also held preference stocks impermissible in *Sharī'ah*.⁸⁶ Subscribing and trading of preference stocks violates the *Sharī'ah* principle of profit and loss sharing and deprives other partners of their due share of profit.

SAC holds the view that non-cumulative preferred stocks are permissible in *Sharī'ah*.⁸⁷ This permissibility is based on the concept of *tanāzul* (voluntary forfeiture of right) by ordinary stockholders. If the company intends to raise its capital, through issuance of preferred stock and announces its intention in annual general meeting (AGM), such announcement and approval by AGM, is treated as *tanāzul* by ordinary stockholders. This means that they have expressed their willingness to withdraw their right of equal treatment in distribution of dividends.⁸⁸

4.2.1.3 Trading on T+2 Basis

Another important *Sharī'ah* issue is trading on T+2 basis. In PSX the settlement of stocks i.e. delivery of stocks and payment of money is made two days after the execution of trade. This mode of settlement carries potential *Sharī'ah* issues. In *Islamic* law of sale, a sale transaction cannot be attributed to future. According to majority of Muslim jurists the effects of a sale contract should start immediately without any delay.⁸⁹ A sale contract in the opinion of all jurists is immediately enforceable contract. If the

⁸⁶ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Sharī'ah Standard No. 12: Sharikah and Modern Corporations*, (Bahrain: AAOIFI, 2015), 224.

⁸⁷ Cumulative means unpaid profits of previous years. SAC does not allow preference stockholders to claim previous profits because if preference stockholders are given previous profits as well, then nothing will remain for ordinary stockholders. SAC states that preference stocks have priority rights in stocks, but it is only for stocks of the current year. According to Fatwa, preference stockholders will receive a certain profit, say 3% of their original amount; to this extent, ordinary stockholders have in fact surrendered their right. Above 2 or 3 percent, profit will be distributed among ordinary stockholders." *Sharī'ah Advisory Council (SAC) of the Securities Commission Malaysia, Resolutions of the Securities Commission Shariah Advisory Council*, (Kuala Lumpur: Securities Commission Malaysia, 2006), 142-143.

⁸⁸ See,

<<https://www.sc.com.my/api/documentms/download.ashx?id=871869cf-917c-4a2e-b058-82d3ed851452>> (accessed 30 March 2024).

⁸⁹ Ibn al-Qayyim, *I'lām al-Muwaqqi'īn*, (Beirut: Dār al-Jīl, 1973), 1:237.

enforcement of contract is delayed this may lead to *gharar* with regard to price fluctuation and ability of a party to deliver the subject matter of the sale. In the T+2 delivery and payment system the element of *gharar* occurs when the price of stocks changes between the date of execution of trade and settlement of trade. If the price of stocks falls, the buyer may lose his interest in the purchase of stock and try to avoid it using different excuses and thus it may cause dispute regarding the fulfilment of agreement between the parties. According to the Muslim jurists the only contract which may be made effected from a future date is the *ijārah* contract. In *ijārah* contract a person makes a lease contract today which is to start after three or four months. But it is not permissible in sales contract. That's why a sale contract is made in past sentence for example a person say I sold this book to you for this price and the other party say I bought this book for this price. The use of past tense signifies that the contract is immediately affected and enforceable. On this ground the trading of stocks on T+2 settlement basis is not consistent with classical concept of sale contract.⁹⁰

Another *Sharī'ah* issue involved in trading in stocks on T+2 basis is that in stock market the money exchange companies also trade their stocks. Recently, SBP has allowed the commercial banks to start money exchange business for which many banks have established their money exchange companies. These companies work as subsidiary to the relevant bank. The stock of such company represents the exchange of money for money. In other words, this transaction falls under *ṣarf* contract in which both the counter values are different currencies.⁹¹ According to a *Ḥadīth* narrated by Abu Sa'īd al-Khudrī (R.T.A) gold for gold and silver for silver should be exchanged hand to hand and no delay should be made in the delivery of counter values from both the sides.⁹²

⁹⁰ El-Gamāl, 40.

⁹¹ M. Kabīr Hassan and Mahlkecht, Michael, 48.

⁹² Abū al-Ḥusayn Muslim, *Ṣaḥīḥ Muslim*, (Beirut: Dār Iḥyā' al-Turāth al-‘Arabī, 2001), ḥadīth 3819.

This prohibition equally applies to the sale of currencies. According to International Fiqh Academy and AAOIFI modern paper money is like gold and silver and all the rules of *ṣarf* contract are applicable to the modern paper currency. Now the *Sharī'ah* issue is that if a stock investor has purchased stocks of a gold company or a money exchange company, will it be permissible to delay delivery of gold to him till two days? How the *Sharī'ah* instruction of, hand to hand, will be implemented in the trading of gold, silver, currencies? The AAOIFI clearly emphasizes that trading in different currencies should be hand to hand with prompt possession from both the sides.⁹³ A counter argument in favour of such delay could be that it is just a procedural delay or a system-based delay. The system currently does not have the capacity to immediately transfer the counter values. In stock market foreign investors are also involved whose funds cannot be transferred immediately. Thus, the transfer of funds takes some time. In the same way the transfer of stocks has also some procedural delays. So, such delay of two days may not be construed as the delay in the enforcement of sale. Two days maybe considered as a continuation of the same trade session. For this reason, the AAOIFI has not identified it as a *Sharī'ah* issue. The general consensus among the *Sharī'ah* scholars is that it is not a contract that comes into effect in futures rather it is a same day sale contract. The delay involved in it is only a procedural delay which does not involve any significant *Sharī'ah* issue. The researcher is of the view that the current T+2 system is acceptable from the *Sharī'ah* perspective due to the market needs which currently does not have any option other than T+2 trading settlement system. As such for practical difficulties this system is justified in *Sharī'ah*. Another argument in favour of T+2 trading system is that practically this is not a delay for two days. The reason is when a

⁹³ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Sharī'ah Standard No. 1: Trading in Currencies*, in *Sharī'ah Standards for Islamic Financial Institutions* (Bahrain: AAOIFI, 2015), 30, <<https://aaoifi.com/ss-1-trading-in-currencies/?lang=en>> (accessed 30 March 2024).

person buys stocks places a buy order and buys stocks, he is immediately intimated by the NCCPL that he has bought this many numbers of stocks. This intimation means he has in fact taken possession of the stocks although he didn't take the possession physically but still, he has taken constructive possession. In the same way seller is intimated that he has sold stocks at this much price which means that he has in fact been paid. The intimation to him means payment to him. In this way practically it is not delay of two days rather the trade becomes effected on the same day because intimation from NCCPL comes to the buyer, that he has bought this many stocks, amounting to constructive possession of stocks and intimation comes to the seller that he has sold this many stocks for this much money, which means payment to him.⁹⁴

SAC has addressed the matter of trading on T+2 basis.⁹⁵ According to their resolutions, while the transaction must be conducted on a spot basis, a settlement period of up to T+2 is permitted due to operational constraints and customary business practices (*'urf tijāri*). This means that although the trade occurs immediately (on a spot basis), the actual settlement can take up to two days. The council acknowledges the existence of *'urf tijāri*, which refers to established business customs and practices. If a T+2 settlement period is customary and widely accepted within the market, it is considered permissible from *Sharī'ah* perspective.

In response to the question: "In ready market trading is settled on T+2 system whereby counter values are delayed for two working days. Is it permissible to defer two counter-values in a sale contract? counter-values in a sale contract? Is it permissible to make a contract effective from a future date, say after two days?" majority of respondents including stock investors and brokerage firms agreed that the T+2 system

⁹⁴ Taqī 'Usmanī, *Introduction...*58.

⁹⁵ See, <https://islamicbankers.files.wordpress.com/2018/05/resolution_sac_2016.pdf> (accessed 30 March 2024).

is not contradictory to *Sharī'ah*. The contract is concluded on T+0 basis. Delivery and payment are not integral part of contract. T+2 is only a procedural or operational delay. This delay does not affect the validity of contract. The fluctuation in price during two days does not affect the transaction. For example, a respondent said:

The primary focus of *Sharī'ah* is on contract, not on deliver or payment. This delay is operational. The cheque clearance of a foreign investor takes time. Thus, it is not an intentional delay. It cannot be treated as *bāy' al-dāyn bi al-dāyn* or exchange of one future obligation with another futures obligation. In response to second question, the respondents were of the view that two days delay will be treated as 'hand to hand' transaction, because this is the requirement of system which cannot ensure prompt delivery of counter values.⁹⁶

4.2.1.4 Intraday Trading

Another *Sharī'ah* issue of stock trading practices in PSX is intraday trading which involves buying and selling stocks within the same trading day, unlike traditional investing, where stock investors buy stocks with the intention of holding them for an extended period to profit from long-term price appreciation, intraday traders aim to capitalize on short-term price movements to generate quick profits.

Now the *Sharī'ah* issue arises that can a day trader who bought stock sell them on the same day?

Divergent views exist among *Sharī'ah* scholars on this *Sharī'ah* issue. Some contemporary scholars consider it impermissible on the ground of unavailability of physical or constructive possession in such transactions. In regular market all the transactions are settled on T+2 basis which implies that the stock investor gets

⁹⁶ Views expressed by respondent no. 112.

ownership of stocks only after two days from the date of execution of trade. Hence selling them in a single trading day, without ownership and possession violates the injunctions of *Sharī'ah* and renders the transaction invalid. Thus, it is a sale of a thing without ownership and possession. Taqī 'Usmanī held that if any person buys some stocks, he cannot sell them before its ownership and possession. A stock represents undivided ownership of the assets of a company. Possession of undivided ownership is achieved only when the stocks are recorded on CDC account in the name of the buyer. As such selling a stock before its possession is not permissible.⁹⁷

A *Sharī'ah* scholar Yūsūf Shubailī also subscribes to the viewpoint and holds intraday trading impermissible. He says that the buyer is not allowed to sell purchased stocks until the stocks are transferred to his name. Selling the stocks before they are transferred to his name is not allowed in *Sharī'ah*. He cannot sell them to another party before the ownership is legally transferred to him, namely registering the stocks in his name. The Prophet (S.A.W.) deemed the sale of purchased item before taking them into possession forbidden. Furthermore, if the stocks are traded among multiple parties while still registered under the name of first seller, then this leads to dispute, conflict and loss of rights.⁹⁸

Contrary to the above view, some other *Sharī'ah* scholars hold the opinion that intraday trading is permissible. This view is held by Muḥammad ibn Sa'ad al-Osaimi,⁹⁹ Muḥammad Salih,¹⁰⁰ Ebrahim Desa'i, Isma'il Desa'i, Dār al-Ifta Leicester,¹⁰¹ and many

⁹⁷ Fatwa of Taqī 'Usmanī on Day Trading, "What You Need to Know About Day Trading in Islam," Musaffa Academy, <www.academy.mustafa.com> (accessed 8 January 2024).

⁹⁸ See, <www.fiqh.islamonline.net> (accessed 11 January 2024).

⁹⁹ See, <www.admiralmarkets.com> (accessed 11 January 2024).

¹⁰⁰ Fatwa of Muḥammad Salih, "Istifta or Query no 2487794", <www.islamqa.info> (accessed 11 January 2024).

¹⁰¹ See, <<https://seekersguidance.org/answers/hanafi-fiqh/buying-with-the-intention-of-capital-gain/>> (accessed 11 January 2024).

other scholars.¹⁰² They contend that intraday trading cannot be declared impermissible on the grounds of unavailability of possession. The possession or payments are not integral part of contract. A contract is completed by offer and acceptance. These elements do exist in this case. It is worthy to mention that, in intraday trade, a transaction is immediately recorded and effected in trader's account with the brokerage firm. An intraday trader, when he places order to buy and it is accepted by some party, the contract is concluded. It is irreversible contract. The contract is instantly recorded in trader's account with the brokerage firm. The stock investor is informed by the brokerage firm about the transaction. The intraday trader takes liability and risk arising from the contract. Thus, it is technically a valid contract. It should not be confused with short selling or futures contract. From the perspective of *Shari'ah* law of contract, it is an enforceable contract. Once a stock investor buys a stock, PSX intimates the transaction to the brokerage firm and the purchase is recorded in the stock investor's account. This recording serves as constructive possession, as the payable amount is also debited from the trader's account. Consequently, the trader gains ownership and the right to dispose of the stocks, assuming all associated risks and liabilities. Usually in stock market, getting stocks into stock investors' account with brokerage firm and having a right of disposal on those stocks, is considered sufficient possession which may be considered as constructive possession. Thus, there is almost certainty of settlement of stocks and there remains no *gharar* with respect to availability and delivery of stocks. This is in line with the opinion of Ibn al-Qayyim and Ibn Taymiyyah on the famous *Hadith*: "Do not sell what you do not have". The assurances from the

¹⁰² See, <www.Islamqa.org/Fatwa103462>. (accessed 11 January 2024).

stock market and available remedies narrow down any possibility of dispute to negligible. This makes day trading a permissible transaction.¹⁰³

However, in Pakistan, following the *Fatwa* of Taqī ‘Usmanī, the *Sharī’ah* scholars generally hold day trading impermissible. In their view, the main reason for its impermissibility is absence of ownership and possession. The respondents for this research have also divided opinion on this issue. The respondents from the category of *Sharī’ah* advisors generally subscribe to the viewpoint of Taqī ‘Usmanī. Six out of seven respondents from this category held the view that intraday trading is not compatible with *Sharī’ah* because it is a sale without ownership and possession.¹⁰⁴ One respondent was of the view that intraday trading meets requirements of a valid contract. The buyer of stock can sell it further even if he does not take his possession. Once the offer or order of stock investor is matched with the order from stock investor party, the contract is concluded. Both parties take liability and responsibility of counter value.¹⁰⁵ Respondents from the category of law experts and academicians did not see any *Sharī’ah* issue in it. The opinions of market participants including stock investors and brokerage firm were divided. They acknowledged that this is a full fledged contract however it should be discouraged and avoided because it is a mere speculative activity.¹⁰⁶ One respondent from this category was of the view that intraday trading does not meet the *Sharī’ah* requirement of possession thus it is impermissible.¹⁰⁷ From this it maybe concluded that to some respondents intraday trading is impermissible on account of absence of possession. To some others it is not recommended because it is a

¹⁰³ Talal DeLorenzo Yusūf, "The Permissibility of Day Trading Stocks", *The Muslim World*, vol. 94, no.3 (2004): 307-318.

¹⁰⁴ Views expressed by respondents no. 101, 103,104,105,106, 111.

¹⁰⁵ Views expressed by respondent no. 102.

¹⁰⁶ Respondents 116, 117, 118.

¹⁰⁷ Respondent 115.

speculative activity though it is a valid contract and according to some others there is no *Sharī'ah* issue in intraday trading.

The researcher recommends that the *Sharī'ah* compliant counter should be activated where the stocks move into ownership and custody of buyer immediately after the execution of trade enabling him to further sell it. This will automatically solve the issue of intraday trading.

4.2.1.5 Market Manipulation

Another important *Sharī'ah* issue of stock trading practices in PSX is market manipulation. In stock market, the brokerage firms sometimes resort to manipulative activities that raise *Sharī'ah* issues. Market manipulation is defined as the intentional conduct of an individual or group with the intention of deceiving stock investor by regulating or artificially affecting the market for that stock.¹⁰⁸ In a USA case law *Cargill inc. vs. Hardin*,¹⁰⁹ market manipulation has been defined as an activity, scheme or artifice that purposefully affects the value of a financial instrument and brings change in actual price. The Securities Act 2015 mentions the acts that constitute market manipulation and provides that a person is deemed to have committed market manipulation when he places an order, in the listed securities of a company that (i) increase or are likely to increase, their price with the intention of inducing another person to purchase or to refrain from selling securities issued by the same company or a related company; (ii) reduce or are likely to reduce, their price with the intention of inducing another person to sell or to refrain from purchasing, securities issued by the

¹⁰⁸ Markham Jerry W., *Law Enforcement and the History of Financial Market Manipulation*, (Routledge 2014), 54.

¹⁰⁹ *Cargill inc. v Hardin* 452 F.2d 1154 (8th Cir. 1971).

same company or a related company; (iii) stabilize or are likely to stabilize, their price with the intention of inducing another person to sell, purchase or subscribe for or to refrain from selling, purchasing or subscribing for, securities issued by the same company or by a related company; or (iv) has the effect of misleading stock investor who trade in securities on the basis of closing prices.¹¹⁰ This description of market manipulation as contained in the Act shows that the dominant feature of market manipulation is placing order for purchase or sale of certain financial instrument that is likely to increase price or reduce price or stabilize price with the intention to induce any other person to buy or sell it. In other words, market manipulation involves transactions or orders that give false signals as to demand, supply and price of instrument and alter its price to an abnormal and artificial level.

Market manipulation raises many *Shari'ah* issues and contradicts many *Shari'ah* rulings such as prohibition of *taghrīr* (deception and misrepresentation), prohibition of *najash* or *tanājush* (artificially raising the price of an object) and prohibition of *ghabn faḥīsh* (exorbitant profit). *Taghrīr* is to present an object in a manner that does not accord with the fact, by assigning to it such attribute which does not exist in it, the sole purpose being to induce a real buyer to make transaction on it.¹¹¹ Zarqā' describes *taghrīr* as it is to induce a contracting party, through deceptive means, to enter contract, without which he would have not entered it.¹¹²

Taghrīr includes false statements about the stock and the issuing company such as the statement that company is increasing its capital and it is expanding its business by launching new projects which is likely to increase profitability of the company. Thus,

¹¹⁰ Securities Act 2015, s 113.

¹¹¹ 'Ali Ḥaydar, *Durar al-Hukkam Sharḥ Majallah al-Aḥkām*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1991), 1:111.

¹¹² Mustafa Aḥmad al-Zarqā', *al-Madkhal al-Fiqhi al-'Ām*, (Beirut: Dār al-Fikr, 1967), 1:379.

when a stock investor buys stocks of that company relying on that misleading statement of brokerage firm, he has in fact exposed himself to *taghrīr* by conduct. The example of this type of *taghrīr* in classical *Islamic* law is *taṣriyyah*. It is to tie the udders of an animal to allow the animal's milk to accumulate in the udders to give a false impression to the prospective buyer false impression about her productive milk yield. The Prophet (S.A.W.) has said do not tie up udders of she-camel or sheep. If anyone among you buys a she-camel or sheep whose udders have been tied up, has option after milking it either to retain it or to return along with a measure of dates (in lieu of milk consumed by the buyer).¹¹³

Islamic law requires from the seller to disclose defect of commodity to the buyer if he knows about it. He is not allowed to sell defective goods. Thus, if a seller or brokerage firm of stocks sells stocks while he knows that news about the performance of company is untrue, he is like a person who sells defective commodity.¹¹⁴ The Prophet (S.A.W.) said that the parties to the contract are entitled to cancel the contract so long as they do not separate. So, if they are honest and truthful and disclose defect of commodity, they will be blessed in trade but if they lied and concealed defects of commodity, they will be deprived of blessing (*barakah*) in their sale.¹¹⁵ Anything that can cause a decline in the prices is considered as defect amongst traders. The Muslim jurists acknowledge the right of party that has suffered lesion as a result of *taghrīr*, to cancel the contract. In the opinion of some jurists, the defrauded party can only claim compensation for his loss. He cannot cancel the contract.¹¹⁶ In case of deceptive practice

¹¹³ Muḥammad ibn Isma‘il Bukhārī, *Saḥīḥ Bukhārī*, (Beirut: Dār al-Kitāb al-Arabi, 1323 A.H.), ḥadīth no. 2150; al-Qushairi An-Nais Abūri, Abūl Ḥusain Muslim ibn al-Ḥajjaj, *Saḥīḥ Muslim*, (Beirut: Dār Ihya al-turath al-Arabi, 1330 A.H.), ḥadīth no. 1515.

¹¹⁴ Anees Tahir, Aḥmad Azam Othman and Aiman Nariman Mohd. Sulaiman, "Legal Regime on Market Manipulation in Pakistan Stock Market: An Evaluation from *Sharī'ah* Perspective", *Law and Social Policy*, vol. 5, no.1 (2023): 12.

¹¹⁵ Al-Bukhārī, ḥadīth no. 2079; al-Muslim, ḥadīth no. 1532.

¹¹⁶ Ibn Qudāmah al-Maqdisi, *al-Mughnī*, (Beirut: Dār al-Fikr al-Mughnī, 1985), 1:267.

of *talaqqi al-rukbān* (meeting riders from village), the Shafi'i and Ḥanbali jurists acknowledge right for villager vendor to cancel the contract.¹¹⁷

Najash is another *Sharī'ah* prohibition that applies to the market manipulation by the brokerage firms. The act of *najash* is generally affected through exaggerating the quality of object and assigning to it such attributes which it does not carry. Here, these prohibitions and their relevance to market manipulation are discussed.

Najash is to harm a contracting party through deceptive statement or assertion about the commodity and to sell it to him at inflated unreal price.¹¹⁸ The Mālikis define it in the similar words: "*Najash* is to offer an inflated unreal price, while the offeror does not intend to buy it, his sale intention being to persuade the other party to offer further higher price".¹¹⁹ Ibn Humām says that if a seller asserted that he has been offered this much price and the buyer relying on his words, bought the commodity and then it was proved he was liar in his statement about the price, the sale is valid, however, the buyer has option to cancel it or execute the trade. The reason for this right or option is that the seller has committed *najash* (artificial raising the price).¹²⁰ In the opinion of many jurists, the one who practices *najash*, does not himself intend to buy the commodity. He only intends to induce the real buyer to buy it. It generally happens in false bidding in collusion with the seller, to raise the price without intending himself to buy it. The purpose of this false bidding is just to artificially raise the price in front of real buyer.

¹¹⁷ Ibid, 313.

¹¹⁸ Kamāl al-Dīn Muḥammad ibn 'Abd al-Wahid ibn 'Abd al-Ḥamīd ibn Mas'ūd al-Siwasi, *Fath al-Qadīr*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 5:239; Abū Zakariyā Yahya Sharaf al-Nawawi, *Sharḥ al-Nawawi 'ala Muslim*, (Cairo: Dār al-Ḥadīth, 1996), 3:416; Ibn Qudāmah al-Maqdisi, *al-Mughnī*, (Beirut: Dār al-Fikr al-Mughnī, 1985), 6:304.

¹¹⁹ Al-Kharashi, *Sharḥ al-Kharashi 'ala Mukhtaṣar Khalil*, (Beirut: Dār al-Fikr, 1994), 5:82-83; al-Ḍasūqī, Muḥammad, *Hashiyah al-Ḍasūqī 'ala al-Sharḥ al-Kabīr*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1996), 3:68.

¹²⁰ Ibn Qudāmah, *Al-Mughnī*, 6:304.

According to Ibn ‘Abidin, such conduct is rather commendable because it saves the vendor from harm and at the same times does not harm the buyer because he will be buying at fair price.¹²¹ *Najash* is a matter of common occurrence in the stock markets. The brokerage firm and big stock investor through rumors, fake news about the future profitability of the company and collusion among themselves and affecting frequent transactions on the same stock, raise the price, so that the real buyer is desired inflated price, so that the real buyer is deceived and buy it at their desired inflated price, which is in fact an unreal price. *Najash* has been severely prohibited in *Islamic* law. It is a form of ‘unlawful appropriating others property’. The Prophet (S.A.W.) has forbidden *najash* or *tanājush*.¹²² One of the companions of the Prophet (S.A.W.) ‘Abdullah Ibn Abī ‘Aowfa equates the *naajish* (practitioner of *najash*) with the eater of *ribā*.¹²³ Bukhari says that *najash* is a deception which is not permissible. The Muslim jurists have different views on the effect of *najash* on transaction. Al-Shafi‘i holds the opinion that the transaction itself is permissible. The sinful act of another person i.e., *naajish* (the one who gave false bid and falsely raised price) does not affect the validity of transaction. However, the act of *naajish* is an act of sin and disobedience.¹²⁴ However, the contract is non-binding. The buyer has the right to cancel the contract if he so desires. The Ḥanafis maintain that the transaction is valid and enforceable and the buyer has no right to revoke it.¹²⁵ Ḥanbalis regard it as invalid contract.¹²⁶ The Mālikis, consider it a valid, but a non-binding contract and acknowledge the right of buyer to cancel it, if he so desires. The opinion of Mālikis and Shafi‘is appears to be a preferred

¹²¹ Muḥammad Amīn Ibn ‘Umar ibn ‘Abd al-‘Azīz ibn Aḥmad, 4:132.

¹²² Ibn Al-‘Amir Al-San‘aani, *Subul al-Salām*, (Beirut: Dār al-Kutub al-‘Ilmiyyah, 1999), 3:18.

¹²³ Ibn Hajar al-‘Asqalānī, *Fath al-Bāri*, (Beirut: Dār al-Ma‘rifah, 1989), 4:446.

¹²⁴ Abū ‘Abdullah Muḥammad bin Idris Al-Shafi‘i, *Al-Umm*, (Cairo: Dār al-Ma‘rifah, 1989), 3:109.

¹²⁵ Muḥammad Ameen Ibn Abidin, *Radd al-Muhtār ‘ala al-Durr al-Mukhtār*, (Beirut: Dār al-Kutub al-‘Ilmiyyah, 1996), 5:143.

¹²⁶ Ibn Qudāmah. *Al-Mughnī*, 6:305.

opinion. It gives the deceived party an opportunity to avert harm by exercising the option to cancel. He may choose otherwise as well. The Prophet (S.A.W.), in case of *taṣriyyah* and *talaqqi al-rukbān* gave the harmed party right to choose between revocation and execution of contract. Thus, he made these transactions voidable at the option of misrepresented party.

Now the question is: Can such option or right be given to a party who has incurred loss due to market manipulation practiced by the brokerage firm? In the modern stock markets, many parties are involved in price manipulation which sometimes cannot be identified. The speculator, who has practiced manipulation, generally immediately sells his stocks after creating artificial rise. The innocent buyer also wants to get rid of those stocks. In such a situation, giving an innocent party the right of cancellation does not appear to be practicable. He is similar to the purchaser of a defective commodity who knows about the defect after its sale to a third party, when he is no longer owner of that commodity. In *Islamic* law, such buyer has no right to return it to the first seller.¹²⁷ However, some evidence from classical *Islamic* law establishes that if an agent or brokerage firm has deceived a buyer with the consent of owner of commodity, then the deceived party has the right to claim compensation of loss. Thus, in the instant case of market manipulation (*najash* or *tanājush*), the innocent buyer has the right to claim compensation from the owner of the stock. Ibn Abidin says that the buyer who has suffered excessive lesion (*ghabn faḥīsh*), as a result of deceit and deception by the brokerage firm (*simsār*) has the right to exercise *Khiyār al-ghabn* (option of lesion).¹²⁸

¹²⁷ 'Ala' al-Din al-Kasani, *Badā'i' al-Sanā'i'*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1996), 5:298.

¹²⁸ Ibn 'Abidin, *Al-Uqūd al-Durriyah fī Tanqih al-Fatawa al-Hamadiyyah*, (Beirut: Dār al-Ma'rifah, 1300 H), 1:269.

In the case of stocks bought as a result of deception and price manipulation, if it is difficult for the buyer to identify the seller, then he has the right to place responsibility on the brokerage firm, because he is instrumental in this market manipulation. Some Mālikis subscribe to this view.¹²⁹

4.2.1.6 Insider Trading

Another *Sharī'ah* issue of stock trading practices in PSX is insider trading. Insider trading may be defined as the use of insider information that is precise, sensitive and has not been made available to the public about a company or stocks in order to make a profit or avoid loss through trading activity.¹³⁰

Insider trading raises many *Sharī'ah* issues such as it is a form of injustice because they infringe the rights of innocent stockholders who do not know that the price of stock declared in the market is not the real price, but it has been artificially inflated and raised through collusion by the shrewd brokerage firms and stock investor. This will be against the concept of justice on which *Sharī'ah* lays great emphasis and it has been emphasized in the *Qur'ān*. The *Qur'ān* says: “Behold! God enjoins justice and the doing of good”.¹³¹ The *Qur'ān* also says: “Be just, that is nearest to piety”.¹³² It further says: “You shall inflict no injustice and shall suffer none”.¹³³

Furthermore, Ibn al-Qayyim says about concept of justice that verily, the *Sharī'ah* is founded upon wisdom and welfare for the servants in this life and the afterlife. In its entirety it is justice and every matter which abandons justice for tyranny

¹²⁹ Wansharasi Aḥmad ibn Yahya, *Al-Mi'yar al-Mu'rib*, ed. Muhammed Hijji (Beirut: Dār al-Maghrib al-Islāmī), 8:143.

¹³⁰ J. Armour, *Principles of financial regulation*, (Oxford University Press, 2016), 182

¹³¹ Al-Nahl: 90.

¹³² Al-Mā'idah: 8.

¹³³ Al-Baqarah: 279.

is not a part of *Sharī'ah* even if it was introduced therein by some remote interpretation.¹³⁴

Moreover, the insider trading inflicts great harm on the small and innocent stock investor. The insiders earn huge profits at the expense of small stockholders, stock investor and general market participants. The ordinary stock investor and small stockholders generally become victim of this abusive practice. The big stockholders and stock investor, trade on the basis of general trading pattern developed artificially by the insiders. The insider violates the *Islamic* principle of prevention of harm as the Prophet (S.A.W.) said: “There should be neither harming nor reciprocating harm”.¹³⁵ He (S.A.W.) also said: “Do not cause harm or return harm”.¹³⁶ This *Ḥadīth* of Prophet (S.A.W.), which is also recognized as a maxim in *Islamic* law and been interpreted in two ways: (i) Harm is not allowed whether as an initiative or in response (ii) No harm should be caused and none should be suffered. It also emphasizes the importance of avoiding harm to others in various forms, including physical harm, financial harm and harm through words or actions. Muslims are encouraged to treat others with kindness, compassion and fairness and to refrain from actions that may cause harm or injustice to others.

The avoiding of harm is further addressed in the maxim: “*Al-Darar Yuzāl*” (Harm has to be redressed).¹³⁷ This maxim suggests that when some harm is inflicted, the offender has obligation to compensate the loss, he has caused. Applying this maxim to the practice of insider trading, it may be concluded that the maxim prohibits insider

¹³⁴ Muḥammad Ibn Abī Bakr Ibn Ayyūb Ibn Sa'd ibn Harīz Ibn Makkī Zayn al-Dīn al-Zur'ī Ibn Ayyūb, *I'lām al-Muwaqq'in*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 311.

¹³⁵ Abū 'Abd Allāh Muḥammad ibn Yazīd Ibn Mājah al-Rab'ī al-Qazwīnī, *Sunan Ibn Mājah*, ed. Muḥammad Fu'ād 'Abd al-Bāqī (Cairo: Dār Iḥyā' al-Kutub al-'Arabiyya, 1952), ḥadīth 2340.

¹³⁶ Ibid, ḥadīth 2341.

¹³⁷ Aḥmad Al-Khudari, *The Foundations of Islamic Law*, (Cairo: Dār al-Ma'arifah, 2002), 145-150.

trading and suggests that when harm occurs, appropriate measures should be taken to redress the harm. Thus, the offender should be made liable to compensate for the loss of innocent stock investor. This goes without saying that market inside trading activity is an act of injustice and inequality.

Furthermore, the insider trading constitutes act of misrepresentation. The colluding brokerage firm artificially increases the price which is not the real price. This is a form of misrepresentation. The misrepresentation in the context of stock is to inflate and raise the value of stock which is not its real value. This is a fact that insiders in collusion with brokerage firms inflate and exaggerate the worth of a stock which does not correspond to the fact. One of the forms of fraud is non-disclosure of the defect of commodity. The Prophet (S.A.W.) also said: “If both the parties spoke the truth and described defects of the goods, then they would be blessed in their transactions and if they told lies and hid something, then the blessing of their transaction would be lost”.¹³⁸

The practice of insider trading has been condemned by various contemporary Muslim scholars such as Yūsūf al-Qaraḍāwī, Taqī ‘Usmanī and Monzer Kahf. Al-Qaraḍāwī considers insider trading as a form of deception and betrayal of trust, which contradicts the principles of honesty and fairness in *Islam*. He emphasizes the importance of accountability and integrity in financial transactions, urging Muslims to adhere to ethical standards derived from *Islamic* teachings. He believes that insider trading undermines the integrity of financial markets and wear down trust among stock investors, ultimately harming society as a whole.¹³⁹ ‘Usmanī declares it as a violation to the principle of transparency, fairness and justice in financial transactions. He argues that insider trading involves exploiting privileged information to gain an unfair

¹³⁸ Al-Bukhārī, ḥadīth no. 2079.

¹³⁹ Yūsūf Al-Qaraḍāwī, “Islamic Finance: Ethical Underpinnings and Future Prospects”, *Journal of Islamic Economics and Finance*, no.1 (2005): 13-29.

advantage over other market participants. He asserts that *Islam* prohibits such practices that result in unjust enrichment at the expense of others and stresses the need to act with integrity and uphold ethical standards in financial dealings, refraining from any form of deception or exploitation.¹⁴⁰ Meanwhile, Kahf also asserts insider trading has adverse effects on market efficiency and fairness. He argues that insider trading distorts market prices and allocates resources inefficiently, leading to an unfair distribution of wealth. He emphasizes the importance of maintaining transparency and equal access to information in financial markets, in line with *Islamic* principles of justice and equity. He calls for regulatory measures to prevent insider trading and ensure the integrity of financial markets in accordance with *Islamic* ethics.¹⁴¹

In short, insider trading is impermissible in *Sharī'ah* as it involves elements of injustice, harm, misrepresentation, deception, betrayal of trust and so on so forth.

4.2.2 *Sharī'ah* Issues Pertaining to Leveraged Market

There are various *Sharī'ah* issues involved in stock trading pertaining to leveraged market. These issues include: i) short selling and ii) margin financing.

4.2.2.1 Short Selling

An important *Sharī'ah* issue of stock trading practices in PSX is short selling. The practices concerning short selling in PSX have some *Sharī'ah* issues such as it is a sale without ownership, borrowing of stocks, borrowing with interest and borrowing with undue benefit to the lender.

¹⁴⁰ Taqī 'Usmanī, *Introduction...* 112-115.

¹⁴¹ Monzer Kahf, *The Islamic Economy: An Analytical Study of the Functioning of the Islamic Economic System*, (Beirut: Maktaba al-Falāh, 1984), 78-80.

Short selling involves a sale of a thing without ownership, as the short seller does not own or possess the stocks that he sells. The majority of Muslim jurists prohibit the sale of a thing without ownership based on the *Ḥadīth* of the Prophet (S.A.W.): “It is narrated by Ḥakim ibn Ḥizām (R.T.A.) 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”.¹⁴² The *Sharī’ah* scholars argue that short selling of stocks is not allowed because it involves selling a thing which is not owned and possessed by the seller thus, it is prohibited in *Sharī’ah*. The Ḥanafī, Mālikī, Shafī’i and Ḥanbali schools of thought also consider the sale of a thing without ownership to be invalid and prohibited, except in the case of *salam* (advance payment sale) and *istisnā’* (manufacturing sale) under certain conditions, such as the specification of the product, the price, the delivery date and the quality.¹⁴³

Many contemporary *Sharī’ah* scholars also held the view that selling stock before owning them is not permissible because it involves *gharar* (uncertainty), deception and injustice and may lead to disputes and conflicts. They also cite the *Qur’ānic* verse that says: “O you who have believed, do not consume one another’s wealth unjustly but only [in lawful] business by mutual consent”.¹⁴⁴

The AAOIFI also prohibited short selling of stocks and states that it is not permissible to sell stocks that the seller does not own (short selling) and the promise of a brokerage firm to lend these at the time of delivery is of no consequence.¹⁴⁵ The

¹⁴² Ibn Maja, Kitāb al-Tijarat, ḥadīth no. 2187.

¹⁴³ Anees Tahir, Aḥmad Azam Othman and Aiman Nariman Mohd. Sulaiman, “*Sharī’ah* Issues on Short Selling Practice in Pakistan Stock Exchange: A Way Forward”, *Pakistan Journal of Islamic Research*, vol. 2, no.24 (2023): 16.

¹⁴⁴ Al-Nisā’: 29.

¹⁴⁵ *Sharī’ah* Standard No. 21 Financial Papers (Shares and Bonds), Article no 3/6.

AAOIFI has declared *salam* of stocks also unlawful. It has declared concluding *salam* contract on stocks as an impermissible contract and explained the *Sharī'ah* basis of this impermissibility in the following words:

The basis for the impermissibility of *salam* in stocks is that the subject-matter of *salam* is a debt and not an ascertained thing while in stocks of corporations nothing works except ascertainment. This is done by mentioning the name of the corporation whose stocks are desired through *salam* thereby rendering the stocks an ascertained thing and not a liability for a debt-stocks cannot, therefore, essentially be the subject-matter of the contract of *salam*. Further, *salam* in stocks implies the sale of ascertained things that are not owned and this is not permitted. In addition to this, the constant availability of specified stocks in the market and the ability of the buyer to deliver them at the end of the period is something that cannot be guaranteed.¹⁴⁶ It is worth-mentioning that Ibn al-Qayyim has interpreted the above *Ḥadīth* as inability to deliver.¹⁴⁷

The Mālikī jurist al-Bājī also maintains that the emphasis in the *Ḥadīth* is on the seller's inability to deliver, which entails risk-taking and uncertainty. If the *Ḥadīth* 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 *Ḥadīth*. The emphasis in the *Ḥadīth* 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.¹⁴⁸

¹⁴⁶ Ibid, Art. 3/4.

¹⁴⁷ Ibn al-Qayyim, 1:358.

¹⁴⁸ Abū al-Walīd Muḥammad Ibn Rushd, *al-Muqaddimāt*, (Cairo: Matb'ah al-Sa'ādah, 1907), 79.

The International *Islamic* Fiqh Academy (IIFA) has also issued a resolution that forbids short selling of stocks, stating that it is not permissible to sell stocks that are not owned by the seller, whether the seller is a brokerage firm or a customer and whether the sale is for cash or on credit and whether the seller intends to buy the stocks before the settlement date or not.¹⁴⁹

The Council of *Islamic* Ideology of Pakistan (CII) has also endorsed the prohibition of short selling of stocks in a *fatwa* (religious ruling) that states that short selling of stocks 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 stocks and does not know whether he can buy them back at a lower price.¹⁵⁰

The SAC issued a resolution that short selling of stocks is not permissible in *Sharī'ah*. The council held that short selling of stocks is not allowed as it involves selling something that is not owned by the seller and may cause harm to the market and the stockholders. The SAC based its resolution on the *Sharī'ah* principles that prohibit *gharar* (uncertainty), *maysir* (gambling) and *zulm* (injustice). The SAC argued that short selling involves selling something that is not owned by the seller that may cause harm to the market and the stockholders.¹⁵¹

From this it may be concluded that although short selling is a sale of stocks 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 stocks to the buyer. Thus, as per interpretation of al-

¹⁴⁹ See, <<https://iifa-aifi.org/en?s=riba&lang=en>> (accessed 9 Dec 2023).

¹⁵⁰ See, <<https://cii.gov.pk/Publicationss.aspx>> (accessed 9 Dec 2023).

¹⁵¹ See, <https://islamicbankers.files.wordpress.com/2018/05/resolution_sac_2016.pdf> (accessed 30 March 2024).

Baji and Ibn al-Qayyim, the prohibition in the *Ḥadīth* does not apply to short selling. It appears that emphasis of International Fiqh Academy and AAOIFI, has been on literal interpretation not on rationale and wisdom behind the *Ḥadīth*.

Furthermore, short selling involves borrowing (*qarḍ*) of stocks. Is borrowing of stocks permissible in *Islamic* law? To answer this question from the perspective of classical Muslims jurists we need to determine whether the stock is eligible to become the subject matter of borrowing. The classical Muslim jurists have divergent views regarding the eligible subject matter of borrowing. The Ḥanafī jurists hold the view that borrowing is allowed in fungible goods (*mithliyyāt*) 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.¹⁵² They base their argument on the verse of the *Qur'ān* 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”.¹⁵³ 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, stocks cannot be the subject matter of borrowing, as they are not homogenous and cannot be returned in the same or equivalent form.

¹⁵² Ibn ‘Ābidīn, 4:171.

¹⁵³ Al-Baqarah: 283.

The Mālikis¹⁵⁴ and Shafi'is¹⁵⁵ 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 *Ḥadīth* of the Prophet (S.A.W.): “It is narrated by Ḥadhrat 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. Ḥadhrat Rafi’ said that he did not find equivalent to borrowed camel, however, the closest he Ḥadhrat’ 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”.¹⁵⁶ From this *Ḥadīth* it can be established that non-fungible can also be subject matter of borrowing.

The Ḥanbalis 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.¹⁵⁷ They base their argument on the *Ḥadīth* 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 *Ḥadīth* does not specify any condition or restriction on the type of money or property that can be loaned and that it applies to all kinds of loans. According to this view, stocks

¹⁵⁴ Dārdīr, *Al-Sharḥ al-Kabīr*, (Cairo: Dār al-Fikr, 1995), 2:222; Ibn Juzā’ī, *Al-Qawānīn al-Fiqhiyyah*, (Beirut: Dār al-Kutub al-‘Ilmiyyah, 2002), 288.

¹⁵⁵ Al-Sharbinī, *Mughnī al-Muhtāj*, (Cairo: Dār al-Fikr, 1995), 2:118.

¹⁵⁶ *Ṣaḥīḥ Muslim*, Kitāb al-Musaqāt, Bāb man Istasafa Shay’an fa Qad Khayran minha, ḥadīth no. 1600.

¹⁵⁷ Ibn Qudāmah, 4:314.

can be the subject matter of borrowing, as they are a form of property that can be given and taken back.

In short it seems that Ḥanafis disallow borrowing of stocks as stock cannot become subject matter of borrowing. However, Mālikis, Shafi‘is and Ḥanbalis allow borrowing of stocks as stock is eligible to become subject matter of borrowing.

The contemporary *Sharī‘ah* scholars have different views. According to Aḥmad Sulāymān borrowing of stocks is not permissible because a stock represents assets, cash, debts and receivables. A stock also represents value of company in stock market. The borrowing of stock 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 stocks is unlawful.¹⁵⁸

Another reason for the impermissibility of borrowing of stocks is that it involves the element of *ribā*, as the borrower benefits from the dividends and capital gains of the stocks, while the lender only gets back the nominal value of the stocks. This is considered as an increase or excess over the principal amount of the borrowing, which is prohibited in *Islam*. The borrowing of stocks facilitates the practice of short selling, which is also prohibited in *Islam*, as it involves selling something that one does not own or possess.

Taqi ‘Usmanī, argue that borrowing of stocks is not permissible, because a stock 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 stocks requires that the borrower should know in detail the quantity and quality of the assets and cash

¹⁵⁸ Aḥmad Sulāymān, *Aḥkām al-Ta‘amul fī al-Aswāq al-Maliyyah al-Mu‘asirah*, (Riyad, Kunūz Ashbailiyyah li al-Nashr wa al-Touzi’ 1426H), 918; Muḥammad Islam, Sha‘bān, *Burāsah al-Awrāq al-māliyyah min Manzūr Islami*, (Damascus, Dār al-Fikr al-Mu‘asir, 1stedn., 2002), 193.

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 stocks is unlawful. He also contends that the assets that are behind the stock 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.¹⁵⁹

AAOIFI, also declared the lending of stocks as impermissible in the *Sharī'ah* and states that the lending of stocks is not permissible, 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 stocks that he borrowed, without any delay or increase. AAOIFI has provided rationale of this prohibition and stated that the basis for the impermissibility of lending the stocks of corporations is that the stock 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.¹⁶⁰

However, Yūsūf al-Qarāḍāwī, maintains that borrowing of stocks is permissible, as long as certain conditions are met. He contends that stocks 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 stocks that he borrowed, regardless of their market value or underlying assets. He,

¹⁵⁹ Taqī 'Usmanī, *Islam aowr Jadid Ma'ashi Masa'il (Islam and Contemporary Economic Issues)*, (Karachi: Idarah Islamiyyat, 2008), 25.

¹⁶⁰ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Sharī'ah Standard No. 12: Financial Paper*, (Bahrain: AAOIFI, 2015), Art. 3/4.

however, stipulates that the borrowing of stocks 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, stocks can be the subject matter of borrowing, as long as they do not involve any prohibited elements or objectives.¹⁶¹

CII also allows borrowing of stocks, as long as the borrower does not sell the stocks or use them as collateral and that he returns the same number and type of stocks that he borrowed, without any delay or increase. It also states that the borrower is entitled to the dividends and capital gains of the stocks and that he is liable for any losses or damages that may occur to the stocks during the period of the borrowing.¹⁶²

SAC also allows borrowing of stocks, in which it states that borrowing of stocks 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 *ribā*, *gharar*, or *maysir*. It also states that the borrower must return the same number and type of stocks that he borrowed, without any delay or increase and that he is not entitled to the dividends or capital gains of the stocks and that he must compensate the lender for any losses or damages that may occur to the stocks during the period of the borrowing.¹⁶³

Additionally short selling involves borrowing with *ribā*.¹⁶⁴ *Ribā* 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.¹⁶⁵ The Appellate Bench of the

¹⁶¹ See, <<https://fiqh.islamonline.net/en/wisdom-behind-prohibition-of-riba/>> (accessed 19 December 2023).

¹⁶² See, <<https://cii.gov.pk/Publicationss.aspx>> (accessed 19 December 2023).

¹⁶³ See, <https://islamicbankers.files.wordpress.com/2018/05/resolution_sac_2016.pdf> (accessed 30 March 2024).

¹⁶⁴ 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 loaned. See, *Securities and Exchange Commission of Pakistan (SECP)*, “Securities Lending and Borrowing Regulations”, 2015. <<https://www.secp.gov.pk>> (accessed 29 September 2024).

¹⁶⁵ Wahbah al-Zuhailī, *al-Fiqh al-Islāmī wa Adillatuhū*, 4:449

Supreme Court of Pakistan has defined *ribā* as any amount big or small over and above the principal amount of borrowing or debt, is *ribā* prohibited by the *Qur'ān*¹⁶⁶ and *Sunnah*¹⁶⁷ regardless of whether the borrowing is contracted for consumption or production.¹⁶⁸

Ribā is prohibited in the *Qur'ān* 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. *Ribā* also contradicts the *Islamic* principles of risk-sharing, known as *al-Kharāj bil Ḍamān* (Entitlement to profit depends upon liability for loss).¹⁶⁹ Thus, drawing any pre stipulated benefit from the borrower is prohibited in *Islam*.

¹⁶⁶ The prohibition of *ribā* is explicitly mentioned in several verses of the *Qur'ān*: Surah Al-Baqarah (2:275): "Those who devour *ribā* will not stand except as stand one whom the Devil has driven to madness (or insanity) by (his) touch. That is because they say, 'Trade is just like *ribā*,' but Allah has permitted trade and forbidden *ribā*..." This verse highlights that while trade is permitted, *ribā* is expressly forbidden, emphasizing the clear distinction between permissible profit and prohibited usury; Surah Al-Baqarah (2:279): "But if you do not do so, then take notice of war from Allah and His Messenger. But if you repent, you may have your capital sums; [thus] you do no wrong, nor are you wronged." This verse indicates severe consequences for those who engage in *ribā*, underscoring its gravity and the divine displeasure associated with it; Surah Al-Imran (3:130): "O you who have believed, do not consume *ribā*, doubled and multiplied, but fear Allah that you may be successful." Here, the verse warns against the accumulation of *ribā* and instructs believers to fear Allah and act righteously to attain success.

¹⁶⁷ The prohibition of *ribā* is also supported by numerous Ḥadīths of the Prophet Muḥammad (S.A.W.). Ḥadīth from Al-Bukhārī and Muslim: The Prophet Muḥammad (S.A.W.) said, "*Ribā* has seventy-two branches, the least of which is equivalent to having unlawful sexual intercourse with one's mother." This Ḥadīth emphasizes the severe nature of *ribā* and its serious consequences; Ḥadīth reported by Jabir bi 'Abdullah: The Prophet Muḥammad (S.A.W.) said, "Allah has cursed the one who accepts *ribā*, the one who gives it, the one who records it, and the two who witness it. They are all alike in sin." This Ḥadīth demonstrates the collective responsibility and sin associated with engaging in *ribā*, whether directly or indirectly; Ḥadīth reported by Abū Ḥuraira: The Prophet Muḥammad (S.A.W.) said, "Whatever is given as a loan with the intention of getting more in return is *ribā*." This Ḥadīth clarifies that any additional benefit gained from a loan, beyond the principal amount, is considered *ribā*.

As noted in Sahih al-Bukhari and Sahih Muslim, the Prophet Muḥammad (S.A.W.) stated, '*Ribā* has seventy-two branches, the least of which is equivalent to having unlawful sexual intercourse with one's mother' (Al-Bukhārī 1997, Ḥadīth no. 2074; Muslim 1998, Ḥadīth no. 1598).

The Prophet Muḥammad (S.A.W.) further said, 'Allah has cursed the one who accepts *ribā*, the one who gives it, the one who records it, and the two who witness it. They are all alike in sin' (Al-Bukhārī 1997, Ḥadīth no. 2179; Muslim 1998, Ḥadīth no. 1597).

He also stated, 'Whatever is given as a loan with the intention of getting more in return is *ribā*' (Al-Bukhārī 1997, Ḥadīth no. 2150; Muslim 1998, Ḥadīth no. 1599).

¹⁶⁸ Tahir Mansoori and Muḥammad Ayub, "Federal *Shari'ah* Court's Judgement on *Ribā*: An Appraisal and Some Suggestions", *Journal of Islamic Business and Management*, (2022): 1-13, <<https://doi.org/10.26501/jibm/2022.1201-001>> (accessed 30 March 2024).

¹⁶⁹ Monzer Kahf, *The Islamic Economy: An Analytical Study of the Functioning of the Islamic Economic System*, (Maktaba al-Falāh, 1984), 45–50.

The Muslim jurists are unanimous that any borrowing that entails a benefit for the lender or the borrower is *ribā* and is prohibited by the *Qur'ān* and the *Sunnah*. The only permissible borrowing in *Islam* is a benevolent borrowing that does not involve any increase or benefit and only requires the repayment of the principal amount.

According to Abū Ḥanifa and his two disciples, Abū Yūsūf and Muḥammad, 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 expectation from the lender. The basis of this ruling is the verse of the *Qur'ān* that says: “But if you repent, you may have your principal - [thus] you do no wrong, nor are you wronged”¹⁷⁰ and the *Ḥadīth* of the Prophet (S.A.W.): “Every borrowing that brings a benefit is *ribā*”.¹⁷¹

Ḥanafī jurist, al-Kasānī writes that 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.¹⁷²

Al-Shirāzī a prominent jurist of Shafi‘ī school also subscribe to the same view as al-Kasānī who says that 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 narration by Ubāyy ibn al-Ka‘ab, ibn ‘Abbās and ibn-Mas‘ūd, that they have prohibited

¹⁷⁰ Al-Baqarah: 279.

¹⁷¹ Al-Bukhārī, ḥadīth no.2311.

¹⁷² Al-Kasānī, 7:305.

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.¹⁷³

The contemporary *Shari'ah* scholars and standard-setting bodies, also endorse the above position, views and arguments on this issue. Taqi 'Usmani argues that interest-based borrowing is not permissible under any circumstances, as it involves *ribā*, which is one of the gravest sins in *Islam*. 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.¹⁷⁴

It is worthy to mention that in Pakistan while pleading the case of conventional banks in famous *ribā* case, some lawyers contended that *ribā* does not apply to commercial interest. It is applied only to the borrowing obtained for consumption and personal needs. Taqi 'Usmani, a member of appellate bench of the Supreme Court of Pakistan refuted this claim. He referred to the famous juristic principle: "*Shari'ah* rulings (*ahkam*) are based on '*illah* (effective cause) not on *hikmah* (the wisdom). He maintained that this is the increase on the principal amount of borrowing which makes the transaction invalid not the *ẓulm* (injustice) inherent in the transaction. This means that according to Taqi 'Usmani, *ribā* is deemed to have taken place when certain

¹⁷³ 'Abd al-Karīm ibn Muḥammad Shirāzī, *Al-Muhadhab*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 1:304.

¹⁷⁴ 'Usmani, 25.

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 stocks, is sufficient to make it a *ribā* transaction. Consideration will not be given to the presence or non-presence of *ẓulm*. Thus, pre-determined increase is *‘illah* while injustice is *ḥikmah*.

The CII and SAC, also favour the above view. CII states that interest is synonymous with *ribā* and that it is prohibited in all its forms, whether it is charged by banks, governments, corporations, or individuals. It also states that interest is not only a *Sharī’ah* issue, but also an economic and social issue and that it has negative effects on the development, growth and stability of the economy, as well as on the distribution, equity and justice of the society.¹⁷⁵

SAC maintains that interest is a form of *ribā* 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.¹⁷⁶

In short selling at the same time there is an undue benefit to the lender, who lends the stocks to the short seller on a condition that the short seller must deposit the proceeds of the sale of these stocks 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 stocks 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 *Sharī’ah*

¹⁷⁵ Council of Islamic Ideology, Pakistan, *Report on Interest and its Implications*, (Islamabad: Council of Islamic Ideology, 2000).

¹⁷⁶ See, <https://islamicbankers.files.wordpress.com/2018/05/resolution_sac_2016.pdf> (accessed 30 March 2024).

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 Ḥanafis, a mortgagee or pledgee (lender) can benefit from *rahn* only with the permission of mortgagor (borrower).¹⁷⁷ The Shafi'is hold the view that the creditor cannot benefit from pledged property because a *Ḥadīth* says that the both the benefit and liability of *rahn* is for its owner.¹⁷⁸ The Mālikis differentiate between the debt arising from sale or *ijārah* 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 *Ḥadīth* that every borrowing that brings benefit for lender is *ribā*.¹⁷⁹ The Ḥanbalis hold the opinion that benefit from mortgaged property is not allowed by the lender even with the permission of mortgagor.¹⁸⁰ *Rahn* is basically meant for the security of debt and not for investment and profitable use. Any profitable use of pledged property is regarded *ribā* in *Islamic* law, because of the *Ḥadīth* that “any borrowing which brings some benefit (for lender) is a kind of *ribā*”.¹⁸¹ 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. According to some Muslim scholars it is a form of “lend me and I will lend you”. The brokerage firm, in short selling, lends stocks and in turn, the short seller provides the stock price to the brokerage firm as a borrowing. Such reciprocal borrowings are prohibited. Ibn Qudāmah says that if he stipulates in borrowing that the borrower leases him his house, or lends him again, such stipulation is unlawful, because Prophet

¹⁷⁷ Ibn Abidīn, 5:343.

¹⁷⁸ Al-Shirbīnī, 2:121.

¹⁷⁹ Dārdīr, 3:246.

¹⁸⁰ Ibn Qudāmah, 4:385.

¹⁸¹ Muḥammad San'ānī, *Subul al-Salām*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1995), 3:53.

(S.A.W.) has prohibited from sale and borrowing and because a contract has been stipulated in another contract.¹⁸²

The contemporary jurists, such as Taqi ‘Usmanī,¹⁸³ ‘Abdullah Saeed¹⁸⁴ and Monzer Kahf,¹⁸⁵ have adopted the Ḥanafī 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.

The *Sharī’ah* standard setting bodies, such as AAOIFI, IIFA, CII and SAC, have different views in this regard. The AAOIFI has constructed its opinion on the Ḥanbali view and provided that 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.¹⁸⁶

IIFA also prohibits benefit from mortgaged property by the lender. However, it provides some conditions and criteria for the permissible use of mortgaged property, such as:

- a. The mortgaged property must be lawful, valuable, identifiable and deliverable and it must not be perishable, consumable, or prohibited.
- b. It must be owned by the borrower, or by a third party who agrees to pledge it on behalf of the borrower and it must not be subject to any dispute or claim by others.

¹⁸² Ibn Qudāmah, 6:437.

¹⁸³ ‘Usmanī, 25.

¹⁸⁴ ‘Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*, (Leiden: Brill, 1996), 23.

¹⁸⁵ Monzer Kahf, *Islamic Finance Contracts*, (Amman: Al Manhal, 2013), 45.

¹⁸⁶ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Sharī’ah Standards: Mortgage and Its Contemporary Applications*, (Bahrain: AAOIFI, 2006), Standard no. 39, Art. 3/2/9.

- c. It must be in the possession of the lender, or in a safe custody that is agreed upon by both parties and it must not be used or disposed of by the lender without the consent of the borrower.
- d. It must be returned to the borrower upon the repayment of the borrowing, or to the third party who pledged it and it must not be sold or liquidated by the lender unless the borrower defaults or delays the repayment of the borrowing.
- e. It must be valued at the time of the borrowing contract and the value must be agreed upon by both parties and it must not exceed the amount of the borrowing.
- f. It must not entail any benefit or charge for the lender, such as rent, profit, interest, or fee and it must not incur any cost or liability for the borrower, such as maintenance, insurance, or tax.¹⁸⁷

CII prohibits benefiting from the mortgaged property without the permission of the owner. The council further states that the lender of stocks cannot charge any interest, fee, commission, or any other form of benefit or compensation for lending the stocks.¹⁸⁸ SAC has adopted the Ḥanafī 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.¹⁸⁹

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

¹⁸⁷ See, <<https://iifa-aifi.org/en?s=riba&lang=en>> (accessed 9 December 2023).

¹⁸⁸ See, <<https://cii.gov.pk/Publicationss.aspx>> (accessed 9 December 2023).

¹⁸⁹ See, <<https://www.bnm.gov.my/-/sac-176th-meeting>> (accessed 9 December 2023).

to preferred opinion which has been upheld by AAOIFI as well, that the mortgagee cannot benefit from the mortgaged property.

The respondents from this research generally subscribe to the predominant view that short selling is not allowed in *Sharī'ah* on the basis of the *Ḥadīth*: “Do not sell what you do not have”.¹⁹⁰ Two respondents from the category of *Sharī'ah* advisors were of the view if there is absolute inability on the part of the seller to deliver subject matter of sale on the day of delivery, then such sale is prohibited. In the instant case the seller has the ability to deliver stocks to the buyer because of prior contractual arrangement, so there should not be any *Sharī'ah* issue in it.¹⁹¹

However, to facilitate certain market activities while adhering to *Sharī'ah* principles, the SAC has approved a model known as *Islamic Securities Selling Borrowing-Negotiated Transactions* (ISSBNT).¹⁹² This model serves as a *Sharī'ah*-compliant alternative to conventional borrowing and short selling. ISSBNT is structured on two outright *bāy'* transactions, two *wa'ad* (two unilateral promises or undertakings), *khiyār al-sharṭ* (stipulated option to cancel the contract within specified time) and provision of *rahn* or collateral as security for indebtedness. Under ISSNT, the approved supplier (lender in conventional short selling) sells certain *Sharī'ah* 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

¹⁹⁰ Al-Bukhārī, ḥadīth no.34:292.

¹⁹¹ Respondents 102, 107.

¹⁹² See, <[ISSBNT Introduction-Bursa Circular-1-2017.pdf](#)> (accessed 30 September 2024).

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 stocks 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. *Khiyār al-sharṭ* gives the user the right to cancel the contract within the period of *Khiyār al-sharṭ*. He may invoke this right especially on occurrence of certain event such as the security is declared *Sharī'ah* 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 model from *Sharī'ah* perspective, we observe that this is a *Sharī'ah* compliant transaction for the following reasons:

- (a) Two *Bāy'* Transactions: In the above structure, the supplier of stocks, instead of lending stocks to borrower on interests, makes *bāy'* 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 *bāy' al-'inah* is avoided.
- (b) Two *Wa'ads*: These are unilateral promises. Unilateral promises are allowed in *Sharī'ah*. 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.
- (c) *Rahn* or collateral: An important feature of this model 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 of stock both 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.

- (d) *Khiyār al-sharṭ* is an accepted *Islamic* principle, established from authentic *Aḥadīth*. *Khiyār al-sharṭ* 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 stocks. This option may be availed by the supplier as well.¹⁹³

It is recommended that the regulator should devise some *Sharī'ah* compliant alternatives for short selling. It may also consider ISSBNT as one of the alternatives to the current practice of short selling.

4.2.2.2 Margin Financing

Another *Sharī'ah* issue of stock trading practices in PSX is margin financing. Margin financing, as practiced in PSX has many *Sharī'ah* issues such as: interest-based lending,

¹⁹³ “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 10 September 2023).

mark to market losses and issue of two contracts in one contract and element of speculation. These issues are discussed in detail as follows.

Margin financing involves interest-based lending. Under margin financing system, the financier (it may be a bank or brokerage firm) lends money to the financee against a pre-determined rate of interest which is prohibited in *Sharī'ah* and the Muslim jurists are unanimous that a borrowing which entails benefit for the lender is *ribā* prohibited by the *Qur'ān* and *Sunnah*.¹⁹⁴

Moreover, margin financing involves mark to market losses. As stated earlier that under margin financing system, the financee has to maintain two margins i.e. initial margin and maintenance margin. Initial margin is generally 15 to 20% of the contract amount which the financee is required to deposit with the financier, the bank, which has agreed to provide financing. After the purchase of stock, the financee is required to maintain margin up to the value of financed amount on daily basis. Is a borrower under obligation to compensate the loss or decrease in the value of *rahn* on daily basis? Here a *Sharī'ah* issue is: Whether a borrower is under obligation to compensate the loss or decrease on the value of *rahn* on daily basis? Does *Sharī'ah* require from a borrower to give additional security/pledge after first pledge to keep the value of *rahn* equal to the amount of borrowing? In the old literature of *Islamic* law, we may not find any instances where the borrower is asked to make up the market losses. This however may be justified under the principle of mutual consent between the lender and borrower.

Furthermore, margin financing involves issue of two contracts in one contract where borrowing and agency contracts are combined, which is a form of *bāy'tān fī bāy'ah* prohibited in *Sharī'ah*. This principle is based on a ḥadīth of Prophet (S.A.W.):

¹⁹⁴ The arguments of classical and modern *Sharī'ah* scholars have been discussed in detail under short selling.

"The Prophet (S.A.W.) prohibited combining a sale and a loan in one transaction."¹⁹⁵

As stated earlier, the brokerage firm provides financing on the condition that it will buy stocks for him and charge fee for it. Thus, it is a combination of two contracts. Besides, it is a borrowing which brings benefits for the lender.

Here we observe that the brokerage firm agreed to lend him money on the condition that he makes the brokerage firm his agent for buying stocks for him. As a result, the brokerage firm buys stocks for him and receives commission on it. It is a form of two contracts in one contract which results in bringing benefit to the lender. By linking borrowing with agency, the brokerage firm, the lender intends to take benefit from borrowing in form of commission.

Additionally, margin financing involves element of speculation. Margin financing is a speculative activity where the finance wants to earn profit and make money from the borrowed amount on the expectation that the value of stocks will rise significantly and he will be able to sell at that time the purchased stocks. From the proceeds of that stock, he will return the borrowed amount with interest, pay commission to brokerage firm and still he will have sufficient profit earned from the transaction. This can sometimes be the opposite when stock values experience a significant decline. In that case he suffers loss in it. Margin financing is clearly speculative activity and it does not generate any economic activity it only promotes speculative activities in the stock market.

The respondents for this research also hold the view that margin financing practices are inconsistent with *Shari'ah* because it involves interest-based borrowing,

¹⁹⁵ Al-Bukhārī, Book of Sales, ḥadith no.2137.

beside incorporation of other *Sharī'ah* non-compliant elements. They also agreed that MSF can be an effective *Sharī'ah* alternative for margin financing.¹⁹⁶

4.2.3 *Sharī'ah* Issues Pertaining to Futures Market

There are various *Sharī'ah* issues involved in stock trading pertaining to futures market. These issues include: i) sale of a non-existent thing (*ma'dum*), ii) sale of one debt for another debt, iii) sale of a thing which is yet to be possessed by the seller and iv) it is a form of *gharar* and *maysir* (gambling).

4.2.3.1 Sale of a Non-Existent Thing (*Ma'dum*)

An important *Sharī'ah* issue in futures trading is it is a sale of a non-existent thing (*ma'dum*). A futures contract is a contract on a non-existent subject matter and where both the counter-values do not exist at the time of the contract. According to *Islamic* law, at least one counter value must exist at the time of sale as in case of *salam*. But, if both counter values are deferred to a future date, such sale is unlawful. *Salam* is allowed in the *Sharī'ah* as an exception to the general rule.¹⁹⁷ However, the non-existence of both counter-values and deferment of both counter values is not allowed. Taqī 'Usmanī maintains that futures transactions are impermissible because these transactions contain the element of *gharar* and speculation which are prohibited in *Sharī'ah*.¹⁹⁸ Wahbah Zuhayli maintains that the sale of non-existent objects or the object that may cease to

¹⁹⁶ This view has been expressed by the respondents from the category of *Sharī'ah* advisors, law experts, market participants and academicians unanimously.

¹⁹⁷ Besides *Salam*, *Istisnā'* is another exception in *Sharī'ah* where a sale of a non-existent item is permissible. It refers to a contract for manufacturing goods where the subject matter does not exist at the time of the contract but is produced and delivered later. Additionally, *Ijarah* contracts particularly those involving services or usufructs to be provided in the future are also permissible. These exceptions are allowed under specific conditions to meet economic needs while ensuring compliance with *Sharī'ah* principles.

¹⁹⁸ Taqī 'Usmanī, *Futures, options, swaps and equity instruments*, (New Horizon, 1996), 10.

exist is not valid. Thus, the sale of fruits and plants before they appear, sale of pearls in shells, milk in the udder, wool on the back of sheep and a book before it is printed, is an invalid sale.¹⁹⁹ In the analysis of Subhi Mahmassani, it amounts to unwarranted risk taking and *gharar* that creates excessive uncertainty over the prospects of fulfillment of contract.²⁰⁰ In contrast, Hashim Kamali presents a more flexible perspective. He acknowledges that while futures contracts involve elements of *gharar*, such risks are often unavoidable in modern commercial transactions and can be tolerated if managed appropriately. Kamali suggests that futures contracts could be permissible under *Sharī'ah* if structured carefully to minimize uncertainty and ensure proper documentation. This view highlights the importance of balancing commercial needs with *Sharī'ah* principles, especially in evolving financial markets.²⁰¹

IIFA has also taken this position. In one of its verdicts, it held that the futures contract provides for the delivery of a specified subject matter at some future date, with payment of price on delivery. It also stipulates that it shall end with the actual delivery and receipt of the merchandise. This contract is not permissible because of the deferment of both the possession and payment of price. It may be held permissible by structuring it on *salam* contract.²⁰²

¹⁹⁹ Wahbah Zuhāyī, 4:173.

²⁰⁰ Subhī Mahmasān, *Al-Mujibāt wa al-Uqūd fī al-Fiqh al-Islamī*, (Beirut: Dār al-‘Ilm li al-Malayin, 1983), 89.

²⁰¹ Hashim Kamali, “Islamic Commercial Law: An Analysis of Futures” in *Islamic Commercial Law: An Analysis of Futures*, (Kuala Lumpur: International Islamic University Malaysia Press, 2010), 203-204.

²⁰² OIC International Islamic Fiqh Academy, seventh session, 9-14 May 1992. Retrieved from <<http://www.fiqhacademy.org.sa/qarat/7-1.htm>> (accessed 29 January 2016).

The European Council for *Fatwa* has also endorsed the position taken by the IIFA concerning futures trading and dealing in commodities, currencies and indices in organized markets.²⁰³

On the issue of *Sharī'ah* position of stock futures, all the respondents i.e. *Sharī'ah* advisors, law experts, market participants and academicians endorsed the majority view that futures are generally impermissible, because it is a sale of a non-existent thing.

4.2.3.2 Sale of One Debt for Another Debt

Another important *Sharī'ah* issue in futures trading is it is a sale of one debt for another debt. In futures trading futures contracts are an exchange of one debt for another debt, though they appear to be a sale contract. In *Islamic* law, sale cannot be attributed to some future period. Thus, sale on futures, does not qualify to be a valid sale contract. In this contract both parties seller and buyer agree to defer both price payment and delivery of item to some future date. It is also known as *bāy' al dāyn bi al-dāyn* or *bāy' al-kālī bi al-kālī* which is prohibited in *Sharī'ah*.²⁰⁴ This deferment of both counter values i.e. delivery of the item and the final payment is the main objection raised on conventional futures transactions.²⁰⁵ The sale of debt for debt in futures trading raises several issues from the *Sharī'ah* perspective, including the potential for *ribā*, *gharar*, delays in delivery and payment and excessive speculation. *Sharī'ah* aims to promote transactions

²⁰³ "European Council for Fatwa and Research, final statement of the Twelfth Ordinary Session, 1423 AH, December 31, 2003 - 4 January, 2004", <<http://www.e-cfr.org/eng/article.php?sid=37>> (accessed 11 May 2016).

²⁰⁴ Wahbah al-Zuhayli, 179.

²⁰⁵ A. Saleh, abadi., M. Aram, "Islamic Justification of Derivatives Instruments", *International Journal of Financial Services*, vol. 4, no.3 (2002): 8.

that are based on real economic activity, fairness and transparency while avoiding activities that involve exploitation, uncertainty and speculation.

On the issue of *Sharī'ah* position of stock futures, all the respondents i.e. *Sharī'ah* advisors, law experts, market participants including stock investors and brokerage firms and academicians endorsed the majority view that futures are generally impermissible, because it is a sale of one debt for another debt.

4.2.3.3 Sale of a Thing Which is Yet to be Possessed

Another important *Sharī'ah* issue in futures trading is that it a sale of a thing which is yet to be possessed by the seller. In futures contracts, the buyer and seller generally do not take physical delivery of the counter values. The transaction ends up with netting off the positions. In respect to taking possession before sale in futures contract, Muḥammad Fahim Khan has said that futures contracts include selling items prior to taking possession.²⁰⁶ The prevailing practice of the futures transactions is prohibited, as these kinds of contracts include selling item prior to taking possession. All the leading classical jurists agreed that selling of an item prior to taking possession is prohibited.²⁰⁷

On the issue of *Sharī'ah* position of stock futures, all the respondents i.e. *Sharī'ah* advisors, law experts, market participants including stock investors and brokerage firms and academicians endorsed the majority view that futures are generally impermissible, because it is a sale of a thing which is yet to be possessed by the seller.

²⁰⁶ Muḥammad Fahim Khan, "Islamic Futures and Their Markets", *Islamic Research and Training Institute IDB*, Research Paper No. 32 (1996): 71.

²⁰⁷ Imām Al-Shāfi'ī, *Al-Umm* (Beirut: Dār al-Kutub al-'Ilmiyyah, 1996), 232; Mālik ibn Anas, *Al-Muwatta'*, (Cairo: Dār al-Kutub al-Miṣriyyah, 1950), 184; Aḥmad ibn Ḥanbal, *Al-Musnad*, (Beirut: Dār al-Fikr, 1983), 435.

4.2.3.4 Futures Contracts are a Form of *Gharar* and *Maysir*

Another important *Sharī'ah* issue in futures trading is that in futures trading futures contracts are a form of *gharar* and *maysir*. Futures contracts are generally considered as just paper transaction for the purpose of making speculative profit and not a genuine sale. In the opinion of al-Zarqā, any transaction that is based on false contract (*suwari*) or fake that is not intended to deliver item and price, is void contract.²⁰⁸ This is fully observable in conventional futures contracts, where the contracting parties do not have any intention to take delivery of the counter values and thus, it is not a genuine contract. Instead, it is a type of prohibited speculative activity with the aim to achieve maximum gains as a result of favorable price movement.

The *Qur'ān* has condemned gambling and described it as a satanic act. It says: “O ye who believe! Intoxicants and gambling, (dedication of) stones and (divination by) arrows, are an abomination, of Satan’s handwork: eschew such (abomination), that ye may prosper. Satan’s plan is (but) to excite enmity and hatred between you, with intoxicants and gambling and hinder you from the remembrance of Allah and from prayer: will ye not then abstain?”²⁰⁹

One may notice here that the text provides rationale underlining the prohibition of gambling. This rationale is that the gambling and *maysir* invoke enmity and distract the faithful from worship. The *Sunnah* takes this prohibition much further, in condemning not only gambling but also sale of *gharar*, which covers a number of meanings such as peril, risk, hazard, speculation, grave uncertainty.

In response to the question: “Is cash settlement of stock futures without actual delivery, permissible in *Sharī'ah*? What are *Sharī'ah* issues involved in this type of

²⁰⁸ Ehab M. M. Injadat, “Futures and forwards contracts from perspective of Islamic Law”, *Journal of Economics And Political Economy*, vol. 1, no.2 (2014): 241-252.

²⁰⁹ Al-Mai’dah: 90-91.

settlement?'. All respondents agreed that cash settlement of stocks without actual delivery is permissible in *Sharī'ah*. They, however, had divergent views on the grounds of impermissibility. Some respondents were of the view that the reason for its impermissibility is that *salam* (forward sale contract) cannot be affected on stocks because stocks are not fungible commodity.²¹⁰ They are identified things. Thus, stocks cannot be subject matter of forward or future sale. Other respondents were of the view that futures themselves are impermissible in *Sharī'ah* because of the incorporation of the elements of gambling and speculation in it. Thus, if futures are not valid, their settlement is also not permissible.

From the above discussion, it may be concluded that that futures trading as practiced today, is repugnant to *Sharī'ah*. It is merely a speculative activity. No genuine trade is intended by the parties. Transactions generally end in netting off the prices. This goes without saying that in futures trading the parties only settle their respective obligations by *muqāṣah*²¹¹ (and neither party pays the actual cost of the commodity).

It will not be out of place to mention here that some contemporary *Sharī'ah* scholars do not agree with the above position. In their opinion futures contracts are permissible in *Sharī'ah* as long as they are conducted for a genuine hedging purpose. They argue that there is no ambiguity or uncertainty in futures contract because the stock market or the capital market guarantees the delivery of these stocks on settlement

²¹⁰ Respondents 102, 112 and 115.

²¹¹ In Islamic finance, *muqāṣah* refers to the practice of offsetting or netting off financial obligations. It involves settling debts or financial claims by offsetting them against each other rather than making direct payments. This method is commonly used to simplify and streamline financial transactions by reducing the total number of transactions and the amount of cash that needs to be exchanged. For example, if two parties owe each other money, *muqāṣah* allows them to offset their respective debts and only settle the net amount. This practice can be beneficial in reducing transaction costs and avoiding unnecessary cash flow problems. See, Khan Muḥammad, *Islamic Financial Instruments: Principles and Practices*, (London: Islamic Finance Publications, 2019), 150.

date. So, there is no uncertainty in the transaction. They also do not agree that this is a sale of debt with debt.²¹²

4.3 LEGAL ISSUES IN STOCK TRADING PRACTICES IN PSX

The legal issues in stock trading practices in PSX can be classified into the following categories: legal issues pertaining to regular market, legal issues pertaining to leveraged market and legal issues pertaining to futures market.

4.3.1 Legal Issues Pertaining to Regular Market

There are various legal issues involved in stock trading pertaining to regular market. These issues include: i) legal nature of preference stocks contract ii) market manipulation and iii) insider trading.²¹³

4.3.1.1 Legal Nature of Preference Stocks Contract

An important legal issue of stock trading practices in PSX is legal nature of preference stocks and legal rights attached to this class of stocks which has been a subject matter of debate among lawyers and professionals. The debate focusses on two main legal issues. Firstly, what is the true nature of preference stocks? Are they equity instruments conferring real rights of participation in management and profits of company or are they merely a form of fixed interest borrowing security issued by the company? Secondly, do preference stocks constitute a hybrid legal instrument that combines the attributes of both equity and debt with a unique and varying character of its own?

²¹² Hashim Kamali, "Islamic Commercial...", 203-204.

²¹³ Since in Pakistani law, market manipulation and insider trading are treated as two independent concepts, the researcher has discussed them as two separate legal issues.

Preference stocks are generally understood as a class of ownership in a corporation that has a higher claim on the company's assets and earnings than common stock. They have a dividend that must be paid out before dividends to common stockholders and these dividends can be fixed or floating, depending on the terms of the issuance. Preference stocks hold a higher rank than common equity within a company's capital structure. In the event of liquidation, preference stocks are settled completely before any claims can be made by common stockholders.²¹⁴

The determination of legal nature of preference stocks largely depends on the legal rights on preference stocks. Thus, it is pertinent to discuss legal rights attached to preference stocks. The legal rights attached to preference stocks have been debated by the jurists and the courts. There is almost consensus among them that preference stockholders have right to a fixed percentage dividend in priority to the payment of any dividend on the other stocks and in case of liquidation their claims are settled before the settlement of any claim by ordinary stockholders. It is worthy to mention that the nature of capital structure of a company is generally defined in company's memorandum of association. The memorandum of association explains how the company will raise capital i.e. through debt-based instruments or through issuance of ordinary stocks or preference stocks and what rights will be enjoyed by preference stockholders. However, there is still a grey area of rights in the context of preference stocks which raises legal issues. One legal issue is: whether a preference stockholder is entitled to surplus assets of company,²¹⁵ beside cumulative preferential dividends in case of liquidation?

²¹⁴ Loth Richard, "Understanding Preferred Stocks," *Investopedia*, 15 January, 2023.

²¹⁵ Surplus assets are all amounts which are surplus to the net total of debts, liabilities and paid-up capital to be distributed by way of dividend in favor of the ordinary stockholders before the commencement of a liquidation.

In *Habib Bank Limited v. Industrial Credit and Investment Corporation of India*,²¹⁶ the issue of preference stocks was discussed in the context of the rights of stockholders upon liquidation. The court held that preference stockholders have a preferential right to the repayment of their capital and arrears of cumulative dividends before common stockholders but do not have an automatic right to participate in the surplus assets unless explicitly provided for in the company's articles of association.

In *Mushtaq Ahmad v. Lahore Stock Exchange*,²¹⁷ a dispute regarding the nature of stocks and the classification of preference stockholders was discussed. The court reaffirmed that the rights of preference stockholders, including dividend entitlement and participation in surplus assets, must be clearly stipulated in the company's constitution or articles of association. In the absence of such stipulations, preference stockholders are not entitled to claim any surplus assets or participate in profits beyond their fixed dividends.

In case of *Re Isle of Thanet Electricity Supply Co., Ltd.*²¹⁸ where the preference stockholders were expressly entitled to participate as regards dividends, they were nevertheless held not entitled to participate in surplus assets because they had been given a preferential right to a return of capital and arrears of fixed preferential dividends. This means they were given right to get back their original investment.²¹⁹

They also refer to those assets that exceed the needs of the business for its normal operations. These are assets that the company owns which are not required for its day-to-day activities or for the fulfilment of its core business goals. Surplus assets can be in various forms, such as extra cash, unutilized property, equipment, or inventory. They are essentially resources that are not essential for the current functioning or future strategic plans of the business. See, Smith John, *Corporate Finance: Theory and Practice*, (New York: Wiley, 3rd edn., 2018), 215.

²¹⁶ *Habib Bank Limited v Industrial Credit and Investment Corporation of India* [1994] PLD 344.

²¹⁷ *Mushtaq Ahmad v Lahore Stock Exchange* [2006] CLD 1027.

²¹⁸ *Re Isle of Thanet Electricity Supply Co., Ltd.* [1928] Ch 772.

²¹⁹ Nelson Brian, "Preferred Stocks: An Overlooked Fixed-Income Alternative", *Morningstar*, 10 March, 2022, 23.

In *Will v. United Lankat Plantations Co., Ltd.*²²⁰ the preference stockholders, who were expressly entitled to receive a cumulative preferential dividend in priority to the other stockholders, brought an action to obtain a declaration that the preference stocks were also entitled to participate in the surplus profits of company like ordinary stockholders beside fixed as well as cumulative dividends. The action was unsuccessful. The court held that: “the preference given in regulations accorded to preference stocks, was very clear and exhaustive and unless the article of association provided for participation in surplus profits available for distribution, a company could not of its own volition increase the dividend payable on its preference stocks beyond that specified in its regulations. The preference stocks cannot earn profit without incurring the risk that ordinary stock-holders bear”.²²¹ Where the preference stockholders are clearly excluded from any participation in surplus, the question of entitlement to surplus does not arise.

Thus, the basic principle on which courts relay is that rights attached to preference stocks should be clearly defined in regulations or in approved article of association. In the absence of any clarification on participation in surplus assets of company (after distribution of dividends) in case of liquidation, all stockholders whether ordinary or preference are deemed to have equal rights in participation in assets of the company. The principle was acknowledged by the *House of Lords*, in *Birch v, Cropper*,²²² dealing with the adjustment of rights among members of different classes in a winding up. Lord McNaughten dealing with the case held: “Every person who becomes a member of a company limited by stocks of equal amount becomes entitled to a proportionate part in the capital of the company and, unless it be otherwise provided

²²⁰ *Will v United Lankat Plantations Co., Ltd.* [1935] AC 17.

²²¹ *Ibid.*

²²² *House of Lords, in Birch v Cropper* [1889] AC 525.

by the regulations of the company, entitled, as a necessary consequence, to the same proportionate part in all the property of the company, including its uncalled capital". This shows that unless the regulations and article of association specify their right to participation in all income and assets, they cannot participate in surplus assets. It is worthy to mention that regulations generally do not acknowledge these absolute rights to preference stockholders.

However, jurists such as Lord Simonds and authorities in cases like *Scottish Insurance Corporation, Ltd. v. Wilsons & Clyde Coal Co., Ltd.* have presented a differing view. In some cases, the courts have acknowledged the right of preference stockholders to participate in surplus assets of company on winding up. In *Scottish Insurance Corporation, Ltd. v. Wilsons Clyde Coal Co., Ltd.*²²³ it had been decided that although the preference stockholders were not entitled to dividends in excess of that fixed and conferred preferentially, they were entitled to participate at par with the ordinary stockholders in distribution of surplus assets on a winding up.

Another legal issue is whether preference stockholders are entitled to cumulative dividends or arrears of dividends over a period of time in case of liquidation. According to some legal authorities they are not entitled to arrears of dividends or undistributed dividends of previous years in case of liquidation. In *Muhammad Munir v. Pak Libya Holding Company (Pvt) Ltd.*,²²⁴ the rights of preference stockholders in the context of cumulative dividends were examined. The court held that cumulative dividends, if stipulated, accrue over time, and in the event of liquidation, the preference stockholders are entitled to receive arrears of cumulative dividends before any distribution to

²²³ *Scottish Insurance Corporation, Ltd. v. Wilsons Clyde Coal Co., Ltd.* [1940] AC 301.

²²⁴ *Muhammad Munir v Pak Libya Holding Company (Pvt) Ltd.* [2009] CLD 880.

ordinary stockholders. However, the entitlement to such dividends depends on the explicit terms mentioned in the company's articles.

In *Re Crichton Oil Company's case*,²²⁵ the Court of Appeal held that arrears of a cumulative preferential dividends were not payable on liquidation. Some statutes provide that preference stockholders shall be entitled to receive dividends, on such terms as provided in certificate of incorporation of company and such dividends may be made cumulative.²²⁶

According to some jurists, the accumulated or cumulative or undistributed dividends of previous years were to be included in surplus assets.²²⁷ It is worthy to mention that in Malaysia, according to SAC, cumulative or undistributed dividends of previous years are not held to be the right of preference stockholders. This means that they are made part of surplus assets for distribution among all stockholders. In many cases courts held that arrears of dividends or cumulative dividends are not payable to preference stockholders.

The discussion reveals that some degree of uncertainty exists with regard to capital rights of preference stockholders on a winding up as well as entitlement to cumulative dividends especially in situations when preferential income and voting rights only have been set out in the company's regulations. The unresolved legal issue is that in case preference stocks have been created without express provisions in the regulations, will all stockholders entitled to capital entitlements (surplus profits, assets of company) equally or only the ordinary stockholders will share capital entitlements?

²²⁵ *Re Crichton Oil Company's case* [1902] 2 Ch. 86 (CA).

²²⁶ Revised Statutes of New Jersey, codified in 1937, chapter 8, s 2. See, Buxbaum Richard M., "Preferred Stock--Law and Draftsmanship", *California Law Review*, vol. 42, no.2 (1954): 243-309.

²²⁷ Korn Donald Jay, "Preferred Stocks: Income and Capital Appreciation Potential", *CFA Institute Research Foundation*, (2019).

The predominant view among jurists is that preference stocks are entitled to pre-fixed income on their investment and that they have superiority in claim of their capital investment after debt instrument holders or the creditors. Considering the above discussion on legal rights, the position of preference stocks appears to be that of a debt instrument. From a financial standpoint, preference stock bears resemblance to debt, as it offers limited potential for capital appreciation and provides returns through periodic coupon payments. The ultimate capital entitlement of the fixed-interest investor is fixed contractually while the equity stockholder is entitled to a pro rata share in the company's residual assets. Thus, it tilts more to a fixed borrowing security than an equity instrument that gives holders right to participate in the management as well as in the profit and loss and share all risk and liability of business.

4.3.1.2 Market Manipulation

An important legal issue of stock trading practices in PSX is market manipulation which is a form of misrepresentation, deception and misconduct by the brokerage firm. It violates fiduciary obligations prescribed for brokerage firm in the Securities Act 2015, the Competition Act 2010, the Securities and Exchange Ordinance 1969, the Securities Brokers (Licensing and Operations) Regulations 2016 and the Brokers and Agents Registration Rules 2001.

The Securities Act 2015 strictly prohibits market manipulative trading practices in stocks which may be performed by a number of ways such as making or publishing any statement, promise or forecast or giving any investment advice that is false, misleading or deceptive; concealment of material facts; or recording or storing in or by

means of, any mechanical, electrical or other device, information that is false or misleading in a material particular.²²⁸

The Act outlines deceptive methods used to persuade innocent and ignorant stock investors to engage in trading securities. Therefore, the use of deceptive tactics is the primary aspect of the offence of market manipulation.

In Pakistan market manipulation is considered as a criminal and civil offence. It is criminal offence, liable to a punishment of imprisonment of either description for a term which may extend to three years, or a fine not exceeding Rs. 100 million or both.²²⁹

When viewed as a civil offence, individuals or entities found guilty of market manipulation may face penalties imposed by civil courts. These penalties typically include financial fines, injunctions to cease manipulative activities, disgorgement of ill-gotten gains, or other remedies deemed appropriate by the court to restore fairness and integrity to the market.²³⁰

Civil penalties are focused on remedying the harm caused by market manipulation and deterring future misconduct. They aim to protect investors and maintain the integrity and efficiency of the financial markets.

The Competition Act 2010 also applies to stock trading and prohibits deceptive practices such as advertising promotional material that misrepresents the nature, characteristics, qualities, or geographic origin of goods, services, or commercial activities.²³¹ The Act also prohibits the abuse of a dominant position through any practice that prevents, restricts, reduces, or distorts competition in the relevant market.²³² The Competition Act 2010, however is not specific with stock market. It aims

²²⁸ Securities Act 2015, s 134.

²²⁹ Ibid, s 159.

²³⁰ Ibid, s 157.

²³¹ Ibid, s 5.

²³² Ibid, s 3.

to ensure maintenance of fairness and transparency in the market and prohibits abuse of a dominant position, including any conduct that prevents, restricts, reduces, or distorts competition within the relevant market. Given that stock trading is a commercial activity, misleading or deceptive practices in this domain fall within the scope of the Act. This ensures fairness and transparency by prohibiting acts that distort the stock market or harm stock investor interests.

The Securities Brokers (Licensing and Operations) Regulations 2016 also prohibits market manipulation and states that manipulating the demand or supply of stocks in the market or indulging in any action that can detract from transparent and standard pricing in the stocks markets; spreading rumors or disseminate false or misleading information; engaging in any investment transactions and activities that would result in manipulation of prices.²³³

The Brokers and Agents Registration Rules 2001 also forbid a brokerage firm from indulging in manipulative, fraudulent or deceptive transactions or schemes or spread rumors with a view to distorting market equilibrium or making personal gains.²³⁴

Market manipulation has been declared an offence in many cases. In an important case of market manipulation titled *SECP vs. Creative Capital Securities (Private) Limited (The Brokerage House)*²³⁵ the court held that the brokerage firm was involved in wash trade or fake trade. It was observed from the examination of trading data of Karachi Stock Exchange (KSE) during the period starting from December 01, 2014, to December 22, 2014, that Muhammad Naveed, Rizwan, Zubair and Zeb Un Nisa bearing stock investors codes SMI. (Z05 & 265), ZM01 and 2804, respectively, the stock investors of Creative Capital Securities (Private) Limited “The Brokerage

²³³ The Securities Brokers (Licensing and Operations) Regulations, 2016, s 28.

²³⁴ The Brokers and Agents Registration Rules, 2001, 3rd Schedule.

²³⁵ *SECP v Creative Capital Securities (Pvt) Limited (The Brokerage House)* [2020] CLD 998.

House", TREC Holder of KSE, have been engaged actively in placing huge orders in various scrips at KSE. An examination of the orders' level and trade level data indicated that the volume of trades executed by such stock investors was very low as compared to the orders placed by them. It was also revealed that a large portion of orders were deleted within 05 seconds after the placement of the same. Based on the above, the SECP held that the brokerage house was involved in creating a false market and artificially raising the price of the security. Thus, in exercise of the powers conferred upon SECP under section 20 of the Securities and Exchange Ordinance 1969, the SECP issued prohibitory order under section 20 of the Securities and Exchange Ordinance 1969 and directed the brokerage home to prohibit such trading Practices through its terminals.

Another case of market manipulation is *SECP vs. Mr. Muhammad Anis*,²³⁶ in which the court held that the brokerage firm was involved in improper matched order. The SECP initiated the proceedings through Show Cause Notice (SCN) No. SMD/MSW/FR-SA/69/2014-728, dated October 15, 2014, against Mr. Muhammad Anis, a Karachi Automated Trading System ("KATS") Operator of Fawad Yousaf Securities (Pvt.) Ltd (FYSL) for alleged involvement in abusive manipulative practices.

The SECP also reviewed trading record of Mrs. Sana Anis, UIN 45504-1002649-, a stock investor of Munir Khanani Securities (Pvt.) for the period from April 15, 2011, to August 24, 2014. The investigation revealed that considerable amount of her trading matched with the trading of stock investors of Fawad Yousaf Securities (Pvt.) Ltd. The record exhibited that most of the trades were 100% matched with the trades executed through Mr. Muhammad Anis for the stock investors of FYSL.

²³⁶ *SECP v Mr. Muhammad Anis* [2017] CLD 1468.

NADRA data of Mrs. Sana Anis revealed that she is wife of Mr. Muḥammad Anis, who works with FYSL as KATS operator. Furthermore, Standard Account Opening Form of Mrs. Sana Anis showed that Mr. Muḥammad Anis is her nominee. Mr. Muḥammad Anis and Mrs. Sana Anis also have a joint bank Account # 1-2-13-20311-714-103605 maintained with Summit Bank Limited.

The examination of record available with the SECP and deliberation made during the hearing proceedings, the SECP held that Mr. Anis and Mrs. Sana Anis were involved in improper order matching. Therefore, in exercise of powers under Section 15E (3) of the Ordinance, SECP imposed a penalty of Rs 100,000/- (Rupees one hundred thousand only) on Mr. Muḥammad Anis for passing material information pertaining to the orders of stock investors of FYSL to his wife Mrs. Sana Anis.

Another case of market manipulation is *SECP vs. HH Misbah Securities (Pvt) Limited (The Brokerage House)*,²³⁷ TREC Holder of KSE, where it was observed from the examination of trading data of Karachi Stock Exchange (KSE) during the period between December 01, 2014 and December 22, 2014 that certain individual stock investors of HH Misbah Securities (Pvt) Limited (The Brokerage House), TREC Holder of KSE, have been actively placing orders in various scrips at KSE. The review of the order level and trade level data indicated that quantum of trades executed by such stock investors were very in few proportions to the orders place. The detailed review of the order level data of the stock investors of the Brokerage House namely, Muḥammad Sharjeel and Muzzamil Inyatullah, showed that they placed significant quantum of buy/sell orders in various scrips during the period and out of which a large proportion was deleted within 10 seconds after the placement of the same. Based on this the SECP held that the practice adopted by the stock investors of the Brokerage House was in

²³⁷ *SECP v HH Misbah Securities (Pvt) Limited (The Brokerage House)* [2017] CLD 255.

conflict with the fair market practice. The stock investors indulged in a practice of placing large sums of orders without any intention to purchase/sell the same. SECP observed that such pattern was intended to persuade general public for trading in these stocks and to create a false and misleading appearance of active trading in any security.

It may be concluded that market manipulation under the law, is a serious legal offence. Despite the existence of strict legal provisions against market manipulation in Pakistan, such practices continue due to several factors. These include weak enforcement mechanisms, loopholes in regulatory frameworks, limited monitoring capacities, and the sophisticated tactics employed by manipulators to evade detection. Additionally, conflicts of interest, lack of transparency, and inadequate internal controls within brokerage firms contribute to the persistence of such offences. Strengthening regulatory oversight, enhancing technological surveillance, and imposing stricter penalties could help mitigate these issues and ensure fair and transparent stock trading practices.

4.3.1.3 Insider Trading

Another important legal issue of stock trading practices in PSX is insider trading which amounts to misrepresentation, deceit, fraud and mischief. It violates a number of laws such as the Securities Act 2015 and the Securities and Exchange Ordinance 1969.²³⁸

The Securities Act 2015 provides framework for the regulation of insider trading and covers a number of important features of inside information abuse and insider trading. The features include insider information definitions, insiders, prohibited activities, duties of intermediaries, duties of public listed companies, civil-criminal

²³⁸ The latest version of the ordinance can be found on the SECP website <<http://www.secp.gov.pk>>

penalties/liabilities, exceptions or defenses and disclosure requirements and procedures.²³⁹

The Act prohibits insider trading and explains different scenarios of it²⁴⁰ and defines inside information as any info that's not public yet but could affect the stock prices if it was.²⁴¹ It also lists down who are the insiders, that include company directors, executives and people who have access to secret information because of their job or through other means.²⁴²

The Securities and Exchange Ordinance 1969 also prohibits trading of the securities based on inside information and states that no person, for the purpose of inducing, dissuading, effecting or preventing in any manner influencing or turning to his advantage, the sale or purchase of any security, directly or indirectly should do any act or practice or engage in a course of business, or omit to do any act which operates or would operate as a fraud, deceit or manipulation upon any person, in particular being a director or an officer of the issuer of a listed equity security or a beneficial owner of not less than ten percent of such security who is in possession of material facts omit to disclose any such facts while buying or selling such security.²⁴³

The Ordinance prescribes civil liability for the offence of insider trading and provides that any person who contravenes subsection (1) of section 15A shall, on being found guilty of contravention by the Commission, be liable to fine, which may extend to ten million rupees or three times the amount of gain made, or loss avoided by such person, or loss suffered by another person, whichever amount is higher. The Ordinance also provides that where an insider person discloses inside information to any other

²³⁹ Securities Act 2015, Part X, s 128-131.

²⁴⁰ Ibid, s 128.

²⁴¹ Ibid, s 129.

²⁴² Ibid, s 130.

²⁴³ The Securities and Exchange Ordinance 1969, s 17.

person who is not required to possess such information for any reason, the insider person shall be liable to fine, to be imposed by the Commission, which may extend to thirty million rupees.²⁴⁴

From this section it is evident that the law prescribes civil liabilities for involvement in insider trading. Since insider trading is a white-collar crime all over the world mere civil liability weakens the enforcement action by the regulator. The criminal penalties should also be imposed on the persons indulging in insider trading practice. This can effectively curb this abusive practice.

Insider trading based on material non-public information is a fraudulent act committed by the offending insider against stockholder or stock investor. The Ordinance makes it clear that the law regards insider trading as an act of fraud. However, the Contract Act 1872 limits fraud to breach of contractual relationship. In the context of insider trading there is no contractual relationship between the insider and the stockholder. The stock market transactions by their very nature are faceless. A stock changes hand daily hundreds and thousands of times. The purchasers generally do not know the sellers. Absence of contractual relationship should not be a valid defense for the offending insider. The offending insider should be liable to any person who has purchased or sold a security relying on the available information for damages caused to him. The innocent trader trades according to the market price based on publicly available information as such stock investor reliance on any public material misrepresentation is a sufficient ground for giving him a right to claim damages from offending insider.²⁴⁵

²⁴⁴ Section 15 E, Securities and Exchange Ordinance, 1969 [Ordinance No. XVII of 1969] [28 June, 1969 as amended up to 2012], s 15, <<http://www.secp.gov.pk/laws/ordinances>>.

²⁴⁵ "Insider Trading and Fraud" in *Securities Market Regulations in Pakistan*, ed. Tariq Mahmood (Lahore: Pakistan Law House, 2020), 78-79.

Like any other capital market insider trading occurs in Pakistani capital market as well. But to determine the extent to which the insider trading occurs in Pakistan is a daunting task. It is partly due to the deficiency of the evidence in support of insider trading allegations and the weak enforcement mechanism. To establish insider trading becomes more difficult when the insiders conceal the act and trade through relatives, friends and fictitious names to avoid detection. The insider trading laws also suffer from many lacunas and deficiencies which need to be addressed but the fact remains that the insider trading is an act of fraud and misrepresentation. It harms the innocent stock investor. It encourages and promotes market abuse where the big players earn huge profits at the cost of small traders and stock investor.²⁴⁶

Insider trading has been held illegal and an offence in Pakistan. A notable case of insider trading is '*Irfan Aslam vs. SECP*,²⁴⁷ where Shaheen Cotton Mills Limited (SCML) a Public Limited Company sold all of its holding of 2,608,200 stocks of another Public Limited Company named Shahzad Textile Mills (STML) from July 30, 2009, to August 24, 2009 (Period under Review). Scrutiny of Karachi Stock Exchange trading data it was discovered that 2,548,200 stocks out of 2,608,200 stocks were purchased by the respondent. He acquired 2,148,200 stocks of STML. from SCML through Karachi Automated Trading Data (KATS). Another off-market cross transaction between respondent and SCML. resulted in purchase of 400,000 stocks by respondent. In both deals through KATS an off-market cross transaction from SCML same terminal ID was used.

The respondent continued to place order to purchase stock of STML on KATS. The respondent holds 34.51% stocks of SCML and 15.66% of STML. He was the

²⁴⁶ Nashit Farid, *Enforcement of Securities Law in Pakistan: Challenges and Reforms*, (Islamabad: National Book Foundation, 2021), 105.

²⁴⁷ See, <<https://www.secp.gov.pk/ur/document/order-irfan-aslam-2010/>> (accessed 25 June 2023).

brother of Mr. Imran Aslam, who was CEO of STML and a director at SCML. Interestingly, father of the respondent was CEO of SCML and a director at STML simultaneously. After STML stocks were purchased by the respondent the STML stock price increased significantly from Rs. 1.56 per stock to Rs. 6.00 per stock. In the mean while STML notified KSE regarding a meeting to be held on October 5, 2009, about financial results of the company. In the same meeting a, decision to merge SCML and STML was passed in the BOD meeting. Scrip of SCML had a thin trading history on KSE but the said transactions were substantially significant. On KATS²⁴⁸ these transactions were 91.12% of the total market trading activity. Due to these suspicious and dubious transaction the commission sought the investigation from brokerage firm.

It was disclosed that the Director Imran Aslam had the sole authority to operate the SCML brokerage account. Moreover, the respondent paid an amount of Rs 4,810,000 to brokerage firm for purchase of STML stock. Respondent maintained his bank account jointly with Mr. Imran Aslam. The respondent was issued a show cause notice to seeking explanation on contravention of SEO 1969 S-15 for insider trading. The respondent denied that there was any pre-arranged manner for this transaction. It was argued that financial results and stock price of other textile sector companies increased as well. The respondent claimed to have no knowledge about financial results of STML and there was no proof of inside information being disclosed by Mr. Imran Aslam to respondent as per show cause notice.

It was also claimed that Mr. Imran was authorized to maintain the bank account of respondent in any emergency and unforeseen event only. The written reply at first and second hearing contained numerous contradictions. The respondent failed to provide satisfactory answers to important questions like the main reason of sudden price

²⁴⁸ Karachi Automated Trading Data.

surge, was the respondent an insider at the time of transaction or if the inside information was disclosed to respondent by Mr. Imran Aslam. The circumstance, market data analysis and price surge after announcement of financial results of STML in four trading day's exhibits that there existed an inside information abuse. The Commission imposed a penalty of Rs.1,000,000 and the respondent was ordered to pay a sum of Rs. 11,541,140 to SCML as compensation of the loss caused. The above case may be broadly categorized as abusive manipulative practice. In this case market manipulation is caused by insider information not available to public and common stock investor.

In *SECP v. Zafar Moti (Trading Affairs of Crescent Standard Investment Bank Ltd.)*,²⁴⁹ a prominent stock trader, was involved in trading stocks of Crescent Standard Investment Bank Limited (CSIBL) based on inside information regarding the company's financial instability. The SECP took enforcement action against Moti and other executives for engaging in insider trading. The SECP's investigation found that the respondent's trading activities occurred while possessing non-public material information, thereby breaching the Securities Act 2015. The court upheld the penalties imposed by SECP, reinforcing the legal framework to prevent insider trading.

In *SECP v. Tahir Iqbal (Insider Trading in Azgard Nine Limited)*,²⁵⁰ Tahir Iqbal, an executive at Azgard Nine Limited, was found to have engaged in insider trading by selling stocks in the company while in possession of non-public financial information. The SECP issued a fine and disqualification of the executive from serving in any listed company. The case emphasized the role of SECP in curbing insider trading and protecting the integrity of stock trading practices.

²⁴⁹ *Irfan Aslam v SECP* [2012] CLD 1283.

²⁵⁰ *SECP v Zafar Moti (Trading Affairs of Crescent Standard Investment Bank Ltd)* [2016] CLD 1061.

In *SEC v. Texas Gulf Sulphur Co.*,²⁵¹ the Securities and Exchange Commission (SEC) investigated trading activities surrounding Texas Gulf Sulphur's exploration activities in Canada. The company had discovered significant mineral deposits but had not yet made this information public. Before the public announcement, several insiders, including executives and employees, purchased stocks of Texas Gulf Sulphur stock, capitalizing on their knowledge of the discovery. Upon the public release of the information, the stock price surged, prompting the SEC's investigation.

The SEC alleged that the insiders violated federal securities laws by engaging in illegal insider trading. The central question was whether the insiders had breached their duty to disclose the material non-public information before trading. The court ruled in favour of the SEC, affirming that the insiders' failure to disclose the information constituted a violation of securities laws. This case established the principle that corporate insiders have a duty to refrain from trading on material non-public information and underscored the SEC's authority to regulate insider trading.

Another important case of insider trading is *United States v. O'Hagan*,²⁵² which introduced the "misappropriation theory" of insider trading liability. James O'Hagan, a partner at a law firm, obtained confidential information about a potential tender offer for Pillsbury Company through his firm's representation of Grand Metropolitan PLC. Despite not being directly affiliated with either company, O'Hagan used the confidential information to trade securities for personal gain, including purchasing call options and stock in Pillsbury.

The SEC charged O'Hagan with insider trading, arguing that he had misappropriated confidential information for securities trading purposes. The case

²⁵¹ *SECP v Tahir Iqbal (Insider Trading in Azgard Nine Limited)* [2017] CLD 849.

²⁵² *SEC v Texas Gulf Sulphur Co.* 401 F.2d 833 (2d Cir. 1968).

raised the question of whether individuals who are not traditional corporate insiders but misappropriate confidential information can be held liable for insider trading. The Supreme Court ruled in favour of the SEC, establishing the misappropriation theory and expanding the scope of insider trading liability. This landmark decision clarified that individuals who misuse confidential information for securities trading purposes, regardless of their relationship to the company, can be prosecuted for insider trading.

From the above discussion, it is established that insider trading is a serious legal issue which has invoked many legal proceedings against the insiders and brokerage firm involved in the insider trading activities. Further strict actions are needed to curb such practices and restore the confidence of a common stock investor in the market.²⁵³

4.3.2 Legal Issues Pertaining to Leveraged Market

There are various legal issues involved in stock trading pertaining to leveraged market. These issues include: i) blank sale and ii) short and distort.

4.3.2.1 Blank Sale

A significant legal issue relating to stock trading in PSX is a blank sale, also known as naked shorting, which is defined in the Regulations for Short Selling under Ready Market 2002 as a sale by a party that does not own stocks, or the sale does not constitute a sale with pre-existing interest or as a sale by a party that does not enter into a securities borrowing contract to meet delivery arrangements.²⁵⁴

²⁵³ Suggested actions include enhancing SECP's monitoring and surveillance systems, imposing stricter penalties such as higher fines and longer imprisonment, enforcing mandatory disclosure requirements for companies and brokerage firms, strengthening corporate governance through internal audits and controls, launching public awareness campaigns about insider trading implications, and conducting regular independent audits. The primary responsibility for implementing these actions lies with the SECP, stock exchanges, and corporate entities.

²⁵⁴ The Karachi Stock Exchange Limited Regulations for Short Selling under Ready Market 2002.

During the last two decades PSX witnessed three major market crises.²⁵⁵ These crises have been marked by allegations of blank sale by the brokerage firm.²⁵⁶ Blank sale was mainly responsible for this crisis where it caused sharp decline in the market, as the market witnessed serious settlement defaults, forcing the SECP to require brokerage firm to tender actual delivery of stocks by borrowing stocks.²⁵⁷

In blank sale, the brokerage firm sells stocks on his proprietary account or on stock investor's account, when the brokerage firm neither owns the stock nor has the ability to get them from someone else.²⁵⁸ Blank sale resembles short sale in a way that in both the seller first sells the stocks at higher price and then buys them back at lower price, netting the difference. It is different from short sale in that in case of blank sale, the seller sells stocks while he does not own them, nor he has any prior commitment from any brokerage firm that he will lend him those stocks on settlement day. Thus, it is absolute inability on the part of blank seller to deliver sold stocks. On the other hand,

²⁵⁵ The three major market crises that Pakistan Stock Exchange (PSX) witnessed in the last two decades are: KSE-100 Index Crash (2008): This crisis occurred in the wake of the global financial crisis of 2007-2008. The Karachi Stock Exchange (now part of PSX) experienced a sharp decline in its benchmark KSE-100 index due to a combination of factors including global economic downturn, political instability and allegations of market manipulation and Abuse by brokerage firms.

Stock Market Crash (2017): In 2017, the Pakistani stock market faced another significant downturn characterized by a steep decline in stock prices and trading volumes. This crisis was also associated with allegations of market manipulation and Abuse, particularly involving practices like blank selling (short selling without actually possessing the securities) which contributed to settlement defaults and exacerbated the market decline.

Stock Market Crash (2020): The COVID-19 pandemic triggered a global financial crisis in 2020 and the Pakistani stock market was not immune to its effects. The PSX experienced sharp declines in stock prices and trading activity as investor sentiment was severely impacted by the economic uncertainties arising from the pandemic. Similar to previous crises, there were allegations of market Abuse, including practices like blank selling, exacerbating the market turmoil.

In each of these crises, blank selling, also known as short selling without actual possession of securities, was identified as a major contributing factor leading to market Abuse and exacerbating the downturns in the stock market. As a response to these crises, regulatory authorities like the Securities and Exchange Commission of Pakistan (SECP) have taken measures to address issues related to settlement defaults and require brokerage firms to ensure actual delivery of stocks by borrowing securities.

²⁵⁶ Securities and Exchange Commission of Pakistan; "Annual Report 2001: Securities and Exchange Commission of Pakistan", <www.secp.gov.pk/document/annualreport-2001> (accessed 28 September 2021).

²⁵⁷ Ibid, Annual Report 2001.

²⁵⁸ Syed Irtiza Ali, *Moral Neutralization in Pakistan's Capital Markets: A Study of Market Abuse*, (University of Pennsylvania, 2017), 3

in short selling, the seller has prior borrowing arrangement, enabling him to make delivery of sold stocks. In blank sale the seller does not locate and borrow the stocks before selling them, which means they are not ensuring that there are stocks available to be borrowed in the first place. Moreover, the seller also enters into the transaction without having the stocks in hand, hoping to acquire them later to cover the short position. This can lead to a "failure to deliver" situation, where the seller is unable to deliver the stocks to the buyer within the specified settlement period. Furthermore, blank sale is considered illegal or highly regulated in many jurisdictions.²⁵⁹ Regulators aim to prevent manipulative practices and maintain the integrity of the financial markets. Blank sale can also potentially distort stock prices and increased volatility. If the stock's price rises unexpectedly, he may face significant losses since they have to buy the stocks at a higher price to cover the short position.

Blank sales under the Regulations for Short Selling under Ready Market 2002 are not allowed,²⁶⁰ and a fine of Rs. 50,000 or 3 percent of the sale amount whichever is higher, along with forfeiture of profit is imposed. The burden of compliance with this Regulations rests with the brokerage firm not the stock investor because it is the brokerage firm who can make the stock investor compliant because it is the brokerage firm who can make the stock investor to remain compliant with the Regulations. Besides, it is difficult for the regulator to take action against individual stock investors.

Blank sale has serious implications for the market and the stock investor. The blank seller manipulates the prices. It sells stocks at an artificially inflated price and

²⁵⁹ Frankel Tamar, *Regulation of Brokers, Dealers, and Securities Markets*, (Boston: Little, Brown and Company, 1991), 245.

²⁶⁰ Ibid, s 4.

then misleads others into thinking that prices are falling. Once the price drops, the blank seller squares himself at point.²⁶¹

Moreover, blank sale is a sort of speculation where the blank seller is speculator not a genuine trader. He sells naked on the expectation that the price will fall later on and will make profit from the difference. But the market may move against him. In that case, he would have to square a substantial loss. For instance, he sells 100 stocks of Oil and Gas Corporation of Pakistan, each for Rs. 30. Then the price drops to Rs. 25. He has earned profit of 5 rupees. But it is also likely that price moves upward to 35 rupees per stock. Now he will bear a loss of 5 rupees per stock. Thus, he exposes himself to substantial price risk. This sometimes leads to serious defaults, seizure of his margins, imposition of penalty on the brokerage firm facilitating blank sale. Blank sale also creates negative impression about the market and shatters the confidence of stock investor in the stock market. The blank sale, was mainly responsible for this crisis, which caused sharp decline in the market, as the market witnessed serious settlement defaults, forcing the SECP to require brokerage firm to tender actual delivery of stocks by borrowing stocks from the market.²⁶²

In *Shahzaib Ali v. Securities and Exchange Commission of Pakistan (SECP)*,²⁶³ the SECP imposed fines on several brokerage firms for their involvement in blank sales. Shahzaib Ali, a brokerage firm, was found guilty of engaging in blank sales in violation of the SECP's Regulations for Short Selling under Ready Market 2002. The firm was penalized for selling stocks without owning or borrowing them, which led to market

²⁶¹ "Blank and Short Selling: What, why and why not? Dawn", Feb 2003.
<https://www.dawn.com/news/83488/blank-and-short-selling-what-why-and-why-not> (accessed on 12 September 2024)

²⁶² Ibid, Annual Report 2001.

²⁶³ *Shahzaib Ali v Securities and Exchange Commission of Pakistan (SECP)* [2015] CLD 1134.

manipulation and caused a significant decline in stock prices. The court upheld the SECP's action, reinforcing the regulatory measures against naked shorting.

In *Securities and Exchange Commission of Pakistan v. BMA Capital Management*,²⁶⁴ BMA Capital Management was charged with facilitating blank sales during a market crisis. The SECP argued that BMA's practice of selling stocks without borrowing them or ensuring their availability contributed to market volatility and settlement failures. The court ruled in favor of the SECP, emphasizing the importance of adhering to short selling regulations and deterring practices that distort stock prices and harm stock investor confidence.

In *Securities and Exchange Commission of Pakistan v. Jahangir Siddiqui & Co. Ltd.*,²⁶⁵ Jahangir Siddiqui & Co., a brokerage firm, was accused of engaging in blank sales and manipulating stock prices by artificially inflating stock values through naked shorting. The SECP argued that these practices led to market instability and undermined stock investor trust. The court found Jahangir Siddiqui & Co. in violation of the SECP regulations and imposed significant fines, highlighting the legal and financial risks associated with blank sales.

In *Securities and Exchange Commission of Pakistan v. Arif Habib Securities Ltd.*,²⁶⁶ Arif Habib Securities Ltd. was involved in blank sales during a market downturn, contributing to a sharp decline in stock prices. The SECP took legal action against the firm, arguing that its failure to comply with short selling regulations and its involvement in blank sales exacerbated the crisis. The court upheld the SECP's decision to impose penalties, reinforcing the regulatory framework for short selling and blank sales in Pakistan.

²⁶⁴ *Securities and Exchange Commission of Pakistan v BMA Capital Management* [2009] CLD 589.

²⁶⁵ *Securities and Exchange Commission of Pakistan v Jahangir Siddiqui & Co. Ltd* [2011] CLD 789.

²⁶⁶ *Securities and Exchange Commission of Pakistan v Arif Habib Securities Ltd* [2010] CLD 1122.

4.3.2.2 *Short and Distort*

Another important legal issue of stock trading practices in PSX is short and distort. Short and distort involves short selling of a stock and spreading false or misleading information to drive down its price. It is typically considered market manipulation and may be viewed as a form of securities fraud. The term mischief in legal contexts is used to convey the meaning of causing harm, damage, or interference and thus, may be applied to short and distort practices that cause harm to the market and other market participants.²⁶⁷ Short and distort often involves naked short selling, where a stock investor sells shares without borrowing or ensuring their availability. In a typical short sale, a stock investor borrows stocks from a brokerage firm or another entity and sells them on the market with the expectation that the stock's price will decrease. The stock investor intends to buy back the stocks later at a lower price, return them to the lender and profit from the difference.²⁶⁸

In *Overstock.com, Inc. v. Goldman Sachs & Co.*,²⁶⁹ a notable case of an alleged short and distort scheme which involves *Overstock.com* and a hedge fund manager named Marc Cohodes where in 2005, Cohodes, managing partner at Rocker Partners LP, was accused of participating in a campaign to spread false and misleading information about Overstock.com in an attempt to profit from short selling the company's stock. In this case, Cohodes and others reportedly took a significant short position in Overstock.com, betting that the company's stock price would decline. Cohodes and his associates were accused of spreading negative information about Overstock.com, including allegations of accounting irregularities and financial

²⁶⁷ Black's Law Dictionary, *Mischief*, (St. Paul: Thomson Reuters, 11th edn., 2019), 1203.

²⁶⁸ Coffee John C., "Market Manipulation and the Administrative State: The SEC's Regulation of Exchange-Traded Funds", *Columbia Law Review*, vol. 107, no.6 (2007): 1459-1517.

²⁶⁹ 231 Cal.App.4th 513 (Cal. Ct. App. 2014), 180 Cal. Rptr. 3d 269, <<https://casetext.com/case/overstockcom-inc-v-goldman-sachs-amp-co>> (accessed 30 March 2024).

mismanagement. The campaign included public statements, articles and communications that aimed to create a negative perception of the company. The U.S. Securities and Exchange Commission (SEC) investigated the matter and filed a complaint against Cohodes and others in 2007, alleging violations of securities laws. In 2009, Cohodes settled with the SEC without admitting or denying the allegations. As part of the settlement, Cohodes agreed to pay a fine and was prohibited from engaging in certain activities related to disseminating false information about public companies.

Short and distorts is a type of mischief in common law. The term mischief is generally used in legal contexts to describe behavior that causes harm, damage to the property of any person. The Pakistan Penal Code 1860 (PPC) defines mischief in the following words: “Whoever, with intent to cause, or knowing that he is likely to cause, wrongful loss or damage to the public, or to any person, causes the destruction of any property, or any such change in any property or in the situation thereof as destroys or diminishes its value or utility, or affects it injuriously, commits act of Mischief”. The PPC prescribes punishment for acts of mischief by damaging or destroying property or killing animals. Such offences together with their aggravated forms are mentioned in PPC. It provides that whoever, with intent to cause, or knowing that he is likely to cause, wrongful loss or damage to the public, or to any person, causes the destruction of any property, or any such change in any property or in the situation thereof as destroys or diminishes its value or utility, or affects it injuriously, commits.²⁷⁰ In many jurisdictions, market manipulation and fraudulent activities associated with short and distort schemes are typically addressed through securities laws and regulations.²⁷¹ In many jurisdictions, there are specific laws and regulations that prohibit market

²⁷⁰ The Pakistan Penal Code 1860, s 425-440.

²⁷¹ In many jurisdictions such as the United States, United Kingdom, and the European Union market manipulation and fraudulent activities associated with short and distort schemes are explicitly prohibited.

manipulation.²⁷² These laws are designed to maintain the integrity of financial markets and protect stock investor. Short and distort practices, which involve intentionally spreading false information to manipulate stock prices, can be considered a form of market manipulation. Short and distort activities often involve making false statements or spreading misleading information about a security. In legal terms, this could be construed as fraudulent misrepresentation or securities fraud. Such actions can be subject to legal consequences, including civil and criminal liabilities.²⁷³

Perpetrators engaging in short and distort practices are subjected to civil and criminal charges, fines and other penalties. These consequences are intended to deter individuals and entities from engaging in activities that can harm the fair and transparent operation of financial markets.

4.3.3 Legal Issues Pertaining to Futures Market

The legal issue involved in stock trading pertaining to futures market is sale without ownership.

4.3.3.1 Sale Without Ownership

An important legal issue pertaining to futures market is trading in futures which involves sale without ownership. In futures trading, parties often agree to buy or sell assets without necessarily owning them at the time of the agreement which raises concerns about the validity of the contract since one of the basic principles of contract

²⁷² For example, in the United States, the Securities Exchange Act of 1934 (particularly Section 10(b) and Rule 10b-5) addresses market manipulation; in the United Kingdom, the Financial Services and Markets Act 2000 provides similar prohibitions; and in the European Union, the Market Abuse Regulation (EU) No 596/2014 governs such practices. See, Securities Exchange Act of 1934, s 10(b) and SEC Rule 10b-5, (U.S., 1934); Financial Services and Markets Act 2000, (UK, 2000); Market Abuse Regulation (EU) No 596/2014, (European Union, 2014).

²⁷³ Tenev Vlad and Baiju Bhatt, *The Stock Market Made Easier: A Guide to Short Selling and Manipulation*, (New York: Random House, 2019), 23.

law is that a party must have legal ownership or authority to sell the asset in question.²⁷⁴ Therefore, if challenged in court, the absence of ownership could render the contract void or unenforceable, leading to legal disputes between the parties involved. For example, if a seller in a futures contract fails to acquire the asset by the agreed-upon date, the buyer may take legal action for breach of contract.²⁷⁵

In Pakistan, the legal framework addresses sale without ownership under the Contract Act 1872, which governs contracts and agreements. Under the Act 1872, for a contract to be valid, the seller must have the legal right to sell the property. Therefore, a sale without ownership may render the contract void or voidable under this Act.²⁷⁶ Moreover, the Transfer of Property Act 1882 deals with the transfer of property and defines "property" in broad terms.²⁷⁷ According to this Act a transfer of property can only be made by someone who owns it or is legally authorized to transfer it.²⁷⁸

Furthermore, in Pakistan, the principle of 'nemo dat quod non habet' applies, which means 'no one can give what they do not have.' Therefore, if a person sells property they do not own, the contract may be void or voidable and the buyer may have legal remedies.²⁷⁹

In futures stock trading sale without ownership raises similar legal considerations as in physical property transactions such as contractual obligations, market integrity and legal remedies. These legal considerations are discussed in detail as follows.

²⁷⁴ Chatterjee S. K., and Saha S., "Futures Market: Legal Issues and Challenges in India", *International Journal of Management and Applied Science*, vol. 4, no.1 (2018): 89-92.

²⁷⁵ Contract Act 1872, s 73.

²⁷⁶ Ibid, s 27.

²⁷⁷ Transfer of Property Act 1882, s 6.

²⁷⁸ Ibid, s 41.

²⁷⁹ Smith John, "Property Law in Pakistan: Understanding the Principles", *Pakistan Legal Review*, vol. 25, no.3 (2020): 45-56.

Futures trading involves entering into legally binding contracts to buy or sell a specified quantity of a financial instrument at a predetermined price on a future date. Just as with physical property transactions, it's crucial for both parties in futures contracts to have the legal authority to enter into the agreement.²⁸⁰ If a seller in futures trading does not have ownership or the legal right to sell the underlying asset, the contract may be void or voidable under relevant contract law.²⁸¹

Moreover, in futures trading sale without ownership can undermine market integrity by introducing the risk of fraudulent or manipulative behaviour. For example, if a trader sells futures contracts for a financial instrument, they do not own in an attempt to manipulate prices or create artificial supply, it could distort market dynamics and harm other participants.²⁸²

Furthermore, in the event of sale without ownership in futures trading, parties may seek legal remedies similar to those available in physical property transactions. Buyers who enter into contracts with sellers who do not have ownership or legal authority may have grounds to rescind the contract, seek damages for any losses incurred, or pursue other legal remedies.²⁸³

In *Pakistan Mercantile Exchange Limited v. SECP*,²⁸⁴ the Pakistan Mercantile Exchange was scrutinized in light of the futures market regulations. The court examined issue of sale without ownership, highlighting that market integrity must be maintained, and contracts entered without legal rights could lead to legal and regulatory penalties.

²⁸⁰ Kolb R. W., *Futures, Options and Swaps*, (Wiley Finance, 2015), 34.

²⁸¹ Contract Act, 1872, s 27.

²⁸² Kaufman M. P., "Market Manipulation and the Misuse of Futures and Options Contracts: The Case for Structural Reform", *Journal of Banking & Finance Law and Practice*, vol. 24, no.3 (2013): 221-235.

²⁸³ *Ibid*, s 73.

²⁸⁴ *Pakistan Mercantile Exchange Limited v SECP* [2014] CLD 410.

The case sets a precedent in the regulation of futures trading and reinforces that the sale of assets without ownership in futures could be challenged.

In *National Investment Trust Limited v. Muhammad Ishaq*,²⁸⁵ the Supreme Court dealt with issues of ownership and transferability of stocks in the context of Pakistan's stock market. The court emphasized the need for actual ownership or authority to sell stocks, especially in stock trading contracts. This decision indirectly applies to futures contracts, reiterating that selling without ownership can lead to legal complications.

In the case of *re Manhattan Investment Fund Ltd.*,²⁸⁶ the court ruled on a dispute involving futures contracts where the ownership and possession of underlying assets were contested. The case underscored the importance of establishing clear ownership rights in futures trading to prevent disputes and ensure the integrity of the market.

In *Nicholas v. Scruttons*,²⁸⁷ the plaintiffs, members of the London Futures Exchange, entered into futures contracts through the brokerage firm, Scruttons, which did not actually possess the underlying stocks at the time of the transaction. Subsequently, the seller failed to deliver the stocks to Scruttons and the plaintiffs sued for damages. The court held that Scruttons, as the brokerage firm, was liable to the plaintiffs for failing to deliver the stocks, even though Scruttons did not actually own the stocks at the time of the sale.

In *Parsons v. Sutton*,²⁸⁸ the defendant, a brokerage firm, entered into futures contracts with the plaintiff, Parsons, without actually having the underlying stocks in their ownership. When the defendant failed to deliver the stocks to Parsons, the plaintiff sued for damages. The court held that the defendant was liable for breach of contract,

²⁸⁵ *National Investment Trust Limited v Muhammad Ishaq* [2000] SCMR 768.

²⁸⁶ *re Manhattan Investment Fund Ltd* [1997] BCLC 523.

²⁸⁷ *Nicholas v Scruttons* [1910] KB 437.

²⁸⁸ *Parsons v Sutton* [1895] 1 QB 683.

as they had entered into futures contracts without owning the stocks and awarded damages to the plaintiff.

In *Re Kingsford & Son*,²⁸⁹ a brokerage firm, acting as an intermediary, entered into futures contracts on behalf of a seller to a buyer without having the underlying stocks in their possession or control. The seller subsequently failed to deliver the stocks to the brokerage firm, who then failed to deliver them to the buyer. The court held that the brokerage firm was liable to the buyer for damages for entering into futures contracts without ownership and failing to deliver the stocks as contracted.

These cases show that if someone sells futures contracts without actually owning the stocks involved, they can be held responsible for any failure to deliver. This highlights the importance of making sure sellers truly own or control the assets before making any futures trades to avoid legal trouble and making sure buyers are protected.

4.4 CONCLUSION

There are various *Sharī'ah* and legal issues pertaining to actual trading at PSX in three different markets which are regular market, leveraged market and futures market. The *Sharī'ah* issues in regular market include trading in conventional stocks, trading in preferred stocks, trading on T+2 basis, intraday trading, market manipulation and insider trading. After analysing the above issues, it has been concluded that trading in conventional stocks is inconsistent with *Sharī'ah* because it contains many *Sharī'ah* prohibited elements such as elements of *ribā*, *gharar* and *qimār*. Preferred stocks as practiced in financial markets, are generally held impermissible because these stocks guarantee a fixed dividend, regardless of the company's profit or loss, which contradicts the *Sharī'ah* principle that profit must be linked to liability for loss. Trading on T+2

²⁸⁹ *Re Kingsford & Son* [1896] QB 291.

carries potential *Sharī'ah* issues. As per the *Sharī'ah* principles the effects of a sale contract should start immediately without any delay because the delay may lead to *gharar*. Intraday trading as per prevailing and dominant view, is not compatible with *Sharī'ah* since it is a sale without ownership and possession. Market manipulation falls under many *Sharī'ah* prohibitions such as *taghrir*, *tanājush*, *ghabn fahish* and fraud and deception. In market manipulation, the colluding brokerage firms artificially raise price of stocks to give false impression to innocent and less knowledgeable stockholder about high price of stocks. Insider trading raises many *Sharī'ah* issues such as it is a form of injustice because it infringes the rights of innocent stockholders who do not know that the price of stock declared in the market is not the real price, but it has been artificially inflated and raised through collusion by the shrewd brokerage firms and stockholder. It greatly harms his interest and it is in fact eating other's properties wrongfully which is considered injustice. Thus, insider trading is impermissible in *Sharī'ah* on account of incorporation of elements of fraud, deception and concealment of facts.

The *Sharī'ah* issues in leveraged market include issue of short selling and margin financing. After analysing the above issues, it has been concluded that short selling is repugnant to *Sharī'ah* for the reasons such as selling without ownership, prohibited by *Ḥadīth*, borrowing involving stocks and interest in borrowings. These practices involve *gharar*, deception and injustice, making them impermissible under Islamic law. Margin financing is also disallowed in *Sharī'ah* for the reasons such as interest-based lending, mark to market losses and issue of two contracts in one contract and element of speculation. The *Sharī'ah* issues in futures market include sale of a non-existent thing, sale of one debt for another debt, sale of a thing which is yet to be possessed by the seller and it is a form of *gharar* and *maysir*. After analysing the above issues, it has been concluded that sale of a non-existent thing is not consistent with *Sharī'ah* because

according to *Islamic* law at least one counter value must exist at the time of sale, except in the case of *salam* contracts. In a *salam* contract, the sale of a non-existent thing is allowed because it involves an advance payment for goods to be delivered in the future, thus providing certainty and eliminating *gharar*. Therefore, while the sale of a non-existent thing is typically prohibited, *salam* contracts are an exception where such sales are permitted under specific conditions. The sale of debt for debt in futures trading raises several issues from the *Sharī'ah* perspective, including the potential for *ribā*, *gharar*, delays in delivery and payment and excessive speculation. With regard to sale of a thing which is yet to be possessed by the seller all the leading classical jurists agreed that selling of an item prior to taking possession is prohibited. With regard to form of *gharar* and *maysir* it has been found that futures contracts are a form of prohibited *gharar* and *maysir*. Futures contracts are generally considered as just paper transaction for the purpose of making speculative profit and not a genuine sale.

The legal issues in regular market include legal nature of preference stocks contract, market manipulation and insider trading. After analysing the above issues, it has been concluded that with regard to the legal nature of preference stocks contract, it has been found that they are generally perceived as having priority over common stocks in terms of dividends and claims on assets upon liquidation. However, they do not typically share in surplus assets unless explicitly stated in a company's regulations or articles of association. Courts have often ruled that preference stockholders are entitled to fixed dividends and return of capital but not to surplus profits, thereby resembling fixed loan securities more than equity instruments. Consequently, preference stocks are predominantly viewed as debt instruments due to their fixed returns and limited potential for capital appreciation. With regard to the market manipulation, it has been found that it is deemed illegal under Securities Act 2015, the Competition Act 2010,

Securities Brokers (Licensing and Operations) Regulations 2016 and the Securities and Exchange Ordinance 1969. Both criminal and civil penalties are imposed for such misconduct, including imprisonment, hefty fines and injunctions, reflecting the severity of the offense and the regulator's commitment to maintaining market integrity and protecting stockholders. With regard to the insider trading, it has been found that it is illegal under the Securities Act 2015 and the Securities and Exchange Ordinance 1969, because of the fraudulent conduct that effects market fairness and stockholder's trust. The laws surrounding insider trading prescribe both civil and criminal penalties for the offenders. The legal issues in the leveraged market include blank sale and short and distort. After analysing the above issues, it has been concluded that the blank sale involves selling stocks without borrowing them or ensuring their availability, which is considered illegal and can lead to market manipulation, increased volatility and systemic risks, as evidenced by major market crises and legal cases involving regulatory enforcement against brokerage firms and individuals engaging in blank sale. With regard to short and distort it has been found that the short and distort practices, involving short selling of stocks coupled with spreading false or misleading information to manipulate prices, are considered illegal and may constitute securities fraud and market manipulation. The legal issue in the futures market is sale without ownership. After analysing the above issue, it has been concluded that sale without ownership in futures trading is illegal as per contract law principles, requiring parties to have legal ownership or authority over the underlying assets.

CHAPTER FIVE

***SHARĪ'AH* AND LEGAL ISSUES ON POST STOCK TRADING PRACTICE IN PAKISTAN**

5.0 INTRODUCTION

In the Pakistan Stock Exchange (PSX) clearing, settlement and custody of stocks are three important stages of post stock trading which are managed by the National Clearing Company of Pakistan Limited (NCCPL) and the Central Depository Company (CDC). The NCCPL serves as the clearing house, responsible for facilitating post-trade settlement and mitigating associated risks. Complementing the role of the NCCPL, the CDC facilitates the settlement of trades executed on the PSX. Upon the execution of a purchase or sale order, the CDC ensures the transfer of stocks from the seller's account to the buyer's account and vice versa, along with the transfer of funds. Additionally, the CDC also oversees the custody of stocks, safeguarding them on behalf of stock investors and ensuring their secure storage and transfer. Thus, NCCPL and CDC act as frontline organizations and infrastructure institutions for clearing, settlement and custody of stocks in PSX.

Thus, this chapter discusses post stock trading practices in PSX together with *Sharī'ah* and legal issues pertaining to these practices.

5.1 POST STOCK TRADING PRACTICES IN PAKISTAN

The post stock trading practices in PSX involve clearing, settlement and custody of stocks. In the following, they are discussed in detail separately.

5.1.1 Clearing of Stocks

Clearing of stocks is an important process that takes place in stock exchange, ensuring that trades are accurately processed and settled. In stock exchange, stocks are cleared through a specific process of clearing of stocks. The clearing of stocks can be defined as the preparation through matching, recording and processing instructions of a transaction for settlement.¹ It may also be described as the process of transmitting, reconciling and, in some cases confirming payment orders or stocks transfer instructions prior to settlement.²

Clearing of stocks has various aims such as it facilitates the smooth settlement of trades. By preparing, matching, recording and processing transaction instructions, clearing houses streamline the flow of transactions, reducing the risk of discrepancies and delays in settlement. This helps maintain confidence in the financial system and fosters a conducive environment for investment.³

Moreover, it plays an important role in risk mitigation. By verifying trade details and ensuring that both buyers and sellers have the necessary resources to fulfil their obligations, clearing houses help mitigate counterparty risk. This is particularly crucial in volatile market conditions where the failure of one party to fulfil its obligations could have ripple effects throughout the financial system.⁴

Furthermore, it helps in promoting transparency and accountability. By providing a centralized platform for trade confirmation and reconciliation, clearing houses enhance visibility into the market and ensure that trades are executed in accordance with established rules and regulations. This transparency not only fosters

¹ David Loader, *Clearing, Settlement and Custody*, (Herne Bay: Butterworth-Heinemann, 2020), 2.

² BIS (Bank of International Settlements), 2003, 13, <www.bis.org> (accessed 22 April 2024).

³ Hazen Thomas Lee, *The Law of Securities Regulation*, (St. Paul, MN: West Academic Publishing, 7th edn., 2016), 112.

⁴ National Clearing Company of Pakistan Limited Regulations 2018, Chapter 12, s 12.4-12.23.

trust among market participants but also facilitates regulatory oversight and enforcement.

It also facilitates the efficient allocation of capital by ensuring that trades are settled promptly and accurately. This allows stock investors to deploy their capital more effectively, thereby enhancing market liquidity and efficiency. Additionally, by reducing the likelihood of settlement failures and disputes, clearing houses help minimize the potential costs and disruptions associated with failed trades.

Clearing of stocks in Pakistan is operated by NCCPL through an efficient clearing system known as National Clearing and Settlement System (NCSS). NCSS is the central counterparty clearing system for transactions executed on the PSX. It facilitates the clearing of trades, ensuring the efficient and smooth functioning of the stock market in Pakistan.⁵

Clearing of stocks involves several essential steps that help to validate, reconcile and finalize trades executed within the exchange. These steps are similarly applicable to regular market, leveraged market and futures market transactions. At its core, clearing of stocks involves preparing, matching, recording and processing transaction instructions to pave the way for settlement.⁶ When a trade is made, it needs to be confirmed by both the buyer and the seller. This confirmation process helps to ensure that all the details of the trade, such as the quantity, price and timing, are accurate and agreed upon by both parties. Once the trade is confirmed, the details are sent to the NCCPL which is the clearing house⁷ and acts as an intermediary between the buyer's

⁵ NCCPL, National Clearing and Settlement System Procedures 2008, Chapter 2, s 2.1.1.1.

⁶ Clearing house primarily handles the matching, recording and processing of transactions to facilitate efficient and reliable settlement of trades within the exchange. See, Laura Kristiina Wallenius, *Securities Clearing and Settlement on Ghana Stock Exchange: A Study of an Emerging Stock Market*, (Wolverhampton: Wolverhampton Business School, University of Wolverhampton, 2009), 26.

⁷ National Clearing Company of Pakistan Limited, *Clearing and Settlement: Ensuring Timely and Accurate Trade Settlement*, (Karachi: NCCPL Publications, 2020).

and seller's brokerage firm.⁸ The clearing house verifies the trade details and makes sure there are enough stocks and funds available to complete the trade. It also calculates the obligations of each brokerage firm involved in the trade. After the clearing house verifies the trade details and obligations, it notifies the brokerage firm involved in the trade. The brokerage firm then inform their stock investors about the status of their trades and any additional information they need to know. The brokerage firm⁹ plays an important role in clearing of stocks acting as a liaison between a stock investor and clearing house. It helps to ensure that the trade takes place successfully and it's also responsible for maintaining the paperwork relating to the clearing and executing of trade.¹⁰ Brokerage firms are the backbone of the stock market because their profound knowledge and experience ensures that the stock trading and clearing of stocks is smooth, dependable and efficient. They are general TREC¹¹ holders who can trade for themselves as well as execute their stock investors' trades.¹²

National Clearing Company of Pakistan Limited, "Clearing and Settlement Process", <<https://www.nccpl.com.pk/clearing-settlement-process>> (accessed 5 August 2024); *National Clearing Company of Pakistan Limited*, "The Role of NCCPL in Pakistan's Stock Exchange", *Journal of Financial Markets*, vol. 15, no.2 (2020): 123-134.

⁸ *Securities and Exchange Commission of Pakistan (SECP)*, "Savings and Capital Markets", 27 March 2019.

⁹ In case of Pakistan, clearing broker is brokerage firm licensed for clearing function. It works in coordination with NCCPL. See, SECP, *Savings and Capital Markets*, 28.

¹⁰ Ibid.

¹¹ Trading Right Entitlement Certificate (TREC) holders are brokerage firms that hold these certificates, which grant them the right to trade securities on the PSX trading floor. These firms are authorized to execute trades on behalf of their stock investors and play a crucial role in the functioning of the stock market. See, Khan Imran, "Understanding Trading Right Entitlement Certificates (TREC) in Pakistan," *Pakistan Stock Exchange*, <https://www.psx.com.pk/trec-overview> (accessed 15 March 2021).

¹² Besides brokerage firms there is another important participant of clearing process which is non-brokerage firm clearing member. The difference between the brokerage firm clearing member and non-brokerage firm clearing member is that unlike brokerage firm clearing member the non-brokerage firm are not allowed to trade for their stock investors in the market, but they can perform all settlement-related functions for them instead. Such type of non-brokerage clearing members facilitate members that have executed large trades on behalf of non-brokerage clearing members being their institutional stock investors but find it difficult to settle such trade due to financial capacity constraints. See, Jones Sarah, "Clearing and Settlement in Financial Markets," *Financial Market Insights*, <<https://www.financialmarketinsights.com/clearing-settlement.>> (accessed 19 September 2024).

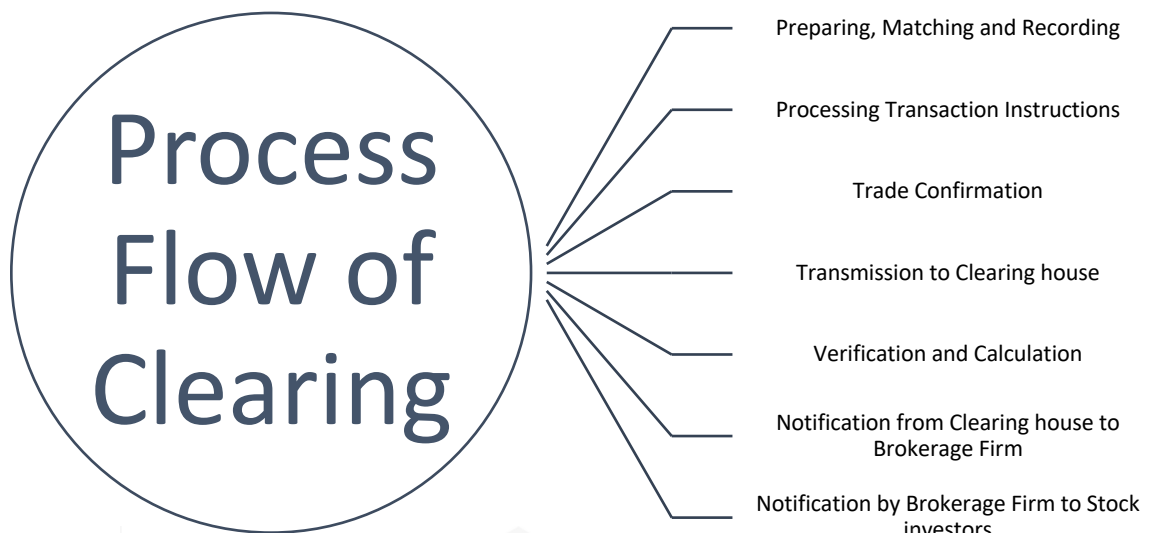


Figure 5.1: Process Flow of Clearing

The diagram illustrates the process flow of clearing in stock trading transactions, beginning with the preparation, matching and recording of trade instructions. It progresses through the processing and confirmation of the transaction, followed by the transmission of trade details to the clearing house. The clearing house then verifies and calculates the obligations, after which it notifies the brokerage firm. Finally, the brokerage firm informs the stock investors, completing the clearing process. This sequence ensures that trades are accurately settled and both parties' interests are properly addressed.

5.1.2 Settlement of Stocks

Settlement of stocks is the step where the actual exchange of stocks and funds takes place between buyers and sellers. The settlement can be defined as the exchange of cash or assets in return for other assets or cash and transference of the ownership of those

assets and cash.¹³ It may also be described as the completion of a transaction, wherein the seller transfers stocks to the buyer and the buyer transfers money to the seller.¹⁴

Settlement of stocks offers numerous benefits such as reducing counterparty risk,¹⁵ enhancing liquidity,¹⁶ facilitating price discovery,¹⁷ managing risk,¹⁸ upholding market integrity,¹⁹ promoting investment²⁰ and improving cost efficiency.²¹

Settlement of stocks in Pakistan is operated by the NCCPL through a robust and efficient settlement system known as NCSS.²² It settles trades executed on the exchange as well as trades executed between the brokerage firms outside the stock market known as off-market trades or negotiated deals. It is also responsible for settlement of post-trading obligations such as fulfilment of money obligations by the financee in margin

¹³ BIS (Bank of International Settlements), 2003, 45, <www.bis.org> (accessed 22 April 2024).

¹⁴ Ibid.

¹⁵ Settlement mitigates counterparty risk by ensuring that both parties in a trade fulfill their obligations promptly and reliably. This reduces the likelihood of defaults and instills confidence in the market participants, contributing to overall market stability. See, *International Securities Services Association (ISSA)*, "Settlement Risk Mitigation", <<https://www.issanet.org/settlement-risk-mitigation>> (accessed 5 August 2024).

¹⁶ Efficient settlement processes enhance liquidity by facilitating the timely exchange of securities and funds. This liquidity is essential for stock investors to execute trades with ease, reducing trading costs and promoting market efficiency. See, Lee Ann, "The Role of Settlement in Enhancing Liquidity", *Journal of Financial Markets*, vol. 25, no.3 (2020): 45-68.

¹⁷ Settlement contributes to price discovery by finalizing trades and incorporating them into market prices. Accurate and timely settlement ensures that market prices reflect all available information, enhancing transparency and efficiency. See, *Financial Times*, "The Importance of Settlement in Price Discovery", <<https://www.ft.com/importance-of-settlement-price-discovery>>.

¹⁸ Settlement mechanisms enable stock investors and institutions to manage their exposure to various risks, including market risk and liquidity risk. By settling trades promptly, stock investors can mitigate the impact of adverse market movements and ensure that their portfolios align with their risk preferences. See, Green Robert, "Managing Market and Liquidity Risks through Settlement Mechanisms", *Journal of Risk Management*, vol. 30, no.4 (2022): 115-134.

¹⁹ Settlement processes uphold market integrity by enforcing rules and regulations governing trading and settlement. Fair and transparent settlement mechanisms bolster trust and credibility in the financial system, fostering stock investor confidence. See, *Securities and Exchange Commission (SEC)*, "Regulations Governing Trading and Settlement", <<https://www.sec.gov/regulations-trading-settlement>> (accessed 5 August 2024).

²⁰ Efficient settlement mechanisms facilitate investment by providing a reliable framework for buying and selling securities. This encourages capital formation and supports economic growth and development. See, Williams Henry, "The Impact of Settlement Mechanisms on Capital Formation", *Economic Growth Journal*, vol. 15, no.2 (2021): 75-92.

²¹ Streamlined settlement processes reduce transaction costs for market participants, leading to cost savings and improved investment returns. See, *World Bank*, "Benefits of Streamlined Settlement Processes", <<https://www.worldbank.org/benefits-streamlined-settlement>> (accessed 5 August 2024).

²² NCSS is the national clearing and settlement system established by the NCCPL, Pakistan in order to provide clearing facility. See, NCCPL Regulations, 2018, Chapter 2 Definitions.

financing and *murabahah* shares financing (MSF). It also guarantees return of stocks borrowed by the short seller to the lender.

Settlement of stocks undertaken by the NCCPL also depend on whether it is regular market settlement, leveraged market settlement, futures market settlement and off-market settlement.

5.1.2.1 Regular Market Settlement

Regular market settlement is a settlement system for regular market known also as ready and cash market. In regular market the trade is carried out following T+2 rolling system cycle which means that the trade is settled two days after the day of execution of trade. Trades in T+2²³ days indicate that deals are finally settled after the second working day. Thus, if a trade is made on Monday, it will be settled on Wednesday and on that day the stocks will be shifted to the ownership of the buyer and money will be credited to the account of the seller.

The regular market settlement has various activities such as T+0 related activities (Trading Day), T+1 related activities (Trade Confirmation Day) and T+2 related activities (Clearing and Settlement Day). Firstly, on the stage of T+0 the stock investor places his order with the brokerage firm. The brokerage firm passes the order to the stock exchange. On matching of orders trade is executed, the stock investor passes on the trade details to the custodian. The stock exchange confirms the contract and a contract note is sent to the stock investor at the end of the day. Stock exchange also

²³ It is important to note that: “the abbreviations T+2 refer to the settlement date of security transactions that occur on a transaction date plus two days.

sends information to the clearing house so that it could determine how much buyer owes and how much seller owes.²⁴

Secondly, the T+1 is an affirmation and confirmation stage where the stock investor informs the custodian that he endorses all information regarding the trade i.e. quantity, price etc.

Thirdly, T+2 is the stage where the clearing and settlement work begins. The clearing house gets in touch with the clearing members and informs them about their counter obligations. Brokerage firm confirms the transaction. The clearing house passes on settlement instructions to the depository. The stocks are deposited to the buyers' account and the price is credited into the seller's account.²⁵

Intraday settlement is also a settlement system for regular market. In intraday settlement, trade executed by a person in same stock and for same settlement period is netted off. The netting off is allowed by the NCCPL Regulations which provide that netting shall be allowed between buy and sell positions in the same stock for the same settlement date for the same UIN stock investor. Likewise buy and sell positions of a clearing members proprietary UIN in same stock for the same settlement date shall be netted against each other.²⁶ For example, if a person A purchases 500 stocks of Oil and

²⁴ Mooney Jr., Charles W., *The Law of Securities, Commodities and Bank Accounts: The Rights of Account Holders*, (St. Paul, MN: West Academic Publishing, 2018), 55.

²⁵ In Bursa Malaysia settlement of stocks also works on T+2 rolling system cycle where the ownership of stocks is transferred after two days of the actual trade date. The steps involved in this process are as follows:

The process begins on T+0 stage when a stock investor initiates the order placement with his chosen brokerage firm which executes the trade at the exchange. On T+1 stage settlement instructions are passed on to the counter party for pre-matching. On T+2 two important activities, namely settlement of delivery and settlement of receipt take place. On the stage of settlement of delivery stocks are transferred to the brokerage firm at 11:30 Malaysian time via the CSD, whereby by 16:00 Malaysian time, the custodian receives an inter-bank payment for delivery trades. On the other hand, at the stage of settlement of receipt, the brokerage firm transfers stocks via CSD to the custodian for good value by 15:00 Malaysian time and by 16:00 Malaysian time the custodian credits the brokerage firm via interbank payment. See, *Bursa Malaysia*, "BMSC Disclosure Report 2020", <https://www.bursamalaysia.com/sites/5d809dcf39fba22790cad230/assets/5ec74d2a39fba22eca2ebde4/BMSC_Disclosure_Report_2020.pdf> (accessed 3 August 2024).

²⁶ NCCPL Regulations, Chapter 12-6. s 12.4.3.

Gas Development Company (OGDC) and sells those 500 stocks on the same day the trade obligations of both these purchase and sale transactions, are netted with no obligation to receive and deliver 500 OGDC stocks. Mere settlement of price differential on the settlement date takes place. Further in case of purchase was of 1000 OGDC stocks with sale for 500 OGDC stocks, the balance order for settlement will be to pay difference of purchase and sale amount and to take delivery of 500 OGDC stock.²⁷

The settlement process begins after the intraday traders buy and sell stocks within the trading hours of a market where they aim to profit from short-term price movements. The intraday trades are typically settled on the same day which means that the buying and selling parties must fulfill their obligations to transfer the stocks and funds involved in the trade by the end of the trading day. Sometimes in intraday trades netting takes place where intraday trades are netted against each other to determine the final obligations of each trader. Netting helps reducing the number of transactions and streamline the settlement process.²⁸

Moreover, during settlement of intraday trades involving stocks, payment is typically made through a brokerage account. If a stock investor sells stocks, the proceeds are credited to his account. If they buy stocks, the cost is debited from their account.²⁹

²⁷ *National Clearing Company of Pakistan Limited (NCCPL)*, "NCCPL Regulations for Clearing and Settlement of Trades in Pakistan Stock Market", <<https://www.nccpl.com.pk/regulations>> (accessed 17 September 2024).

²⁸ Krimminger, Michael H. and Katherine Merrill, "The Role of Central Counterparties in the Trading of Over-the-Counter Derivatives", *Journal of Financial Services Research*, vol. 46, no.2 (2014): 173-186.

²⁹ The intraday traders may be required to maintain certain margin levels to cover their positions. Margin requirements ensure that traders have sufficient funds or collateral to cover potential losses.

5.1.2.2 Leveraged Market Settlement

Leveraged market settlement is a settlement system for leveraged market transactions such as short selling, margin financing and MSF carried out at leveraged market. The leveraged market settlement takes place in two legs. Settlement in first leg, is affected on T+2 basis, meaning by that trade is settled two days after execution of trade. In this phase, this settlement is similar to settlement of regular market trades. All the leveraged market trades are settled exactly like regular market trades. But unlike regular market trades, leveraged trades need another settlement which is settlement of deferred liabilities. In second leg, these liabilities are settled as per agreement between the borrower and lender.³⁰ In case of short selling, the borrower of stocks, settles his obligation to return stocks to the lender as per schedule set in the borrowing agreement. In order to ensure return of borrowed stocks, NCCPL monitors and manages potential risks involved in the process. It obligates on the borrower to deposit purchase price in the account of lender of stocks as collateral which is released after the borrower returns the stocks to the lender. Whereas, in case of margin financing the financee is required to deposit purchased stocks in blocked status with the financier as collateral. These stocks are released to him only when he makes payment of financed funds. In order to protect financier against any loss, the NCCPL calculates profit and loss occurring in the value of stocks on daily basis. This methodology of calculating loss, is called market to market loss (MTM).³¹ The stock investor is required to provide collateral to cover his

³⁰ FSI Papers, "The Importance of Clearing and Settlement Systems for the Smooth Functioning of Financial Markets", *FSI Insights*, vol. 11, no.3 (2018): 21-38.

³¹ MTM loss means an amount payable by a stock's brokerage firm at any point in time during a trade date on account of trades executed on behalf of its stock investors as well as its proprietary unsettled position in any stock, to the company i.e. NCCPL due to the difference between the trade price, on trade-to-trade basis, of the unsettled position in each stock and the closing price of that stock and the last executed price. See, Tokenist, "Mark to Market Explained: Crucial Profit and Loss Calculations," <<https://tokenist.com/mark-to-market-explained-crucial-profit-and-loss-calculations/>> (accessed 3 August 2024).

positions and mitigate the risk of default. By maintaining sufficient collateral, stock investors reduce the likelihood of defaulting on their obligations. While in MSF the purchased stocks are also held in blocked status with the financier as collateral until the financee makes payment of the financed funds. Similar to margin financing, NCCPL may calculate profit and loss on the value of stocks using the MTM methodology to protect the financier against any loss and the financee is required to provide collateral to cover their positions and reduce the likelihood of defaulting on their obligations.

5.1.2.3 Futures Market Settlement

Futures market settlement is a settlement system for stock futures market transactions. The discussion on futures market settlement can be divided into two main categories: a) cash settled stock futures contracts and b) deliverable stock futures contracts (DFC).

a) Cash Settled Stock Futures Contracts

In PSX, most of the stock futures are settled in cash. No actual delivery is involved. They are known as cash settled stock futures contracts. Index futures are fully cash settled, since their delivery is not practicable. Single stock futures contract are largely cash settled. Single stock cash settled futures contracts, are standardized contracts to buy/sell single stock futures. They are settled in cash where the transaction ends up with the payment of difference between the buying and selling price. Settlement may take place 30, 60, 90 days after the purchase of contract.³² The cash settled contract does not impose any obligation of giving and taking deliveries of underlying stocks of expiry of contracts. The profit/loss transferred into the respective stock investor's accounts on final settlement day if their position remains open on expiry. However, the stock

³² See, <[PSX.com.pk/PSX/Product](https://www.psx.com.pk/PSX/Product)> (accessed 19 May 2022).

investor has the right to square his open position at any time before expiry and book his profit/loss in term of cash.³³

The cash settled futures are regulated by the NCCPL Regulations 2018 which provide that cash settled futures market shall be considered a separate market for the purposes of calculating exposure of a clearing member and netting shall not be allowed with ready or deliverable futures contract market. Netting shall only be allowed between buy and sell positions in the same stock for the same stock investor/associated entity and its stock investors in the same contract period. Likewise buy and sell positions in same stock in the same contract period for the proprietary trades of a clearing member can be netted against each other.³⁴

b) Deliverable Stock Futures Contracts (DFCs)

In PSX some stock futures contracts are deliverable. They are known as DFCs which are forward contracts to buy and purchase underlying stocks in future with actual delivery of counter values from both the sides. Settlement of DFCs are settled 90 days after the contract is purchased. The settlement of stock futures also requires a number of activities such as calculation of marked to market profit and loss on daily basis, maintenance of required margins, margin calls and similar other acts to protect the interest of contracting parties.³⁵

³³ Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, March 2019, 176. [extension://mjdgandcagmikhbjnilkmfnjeamfikk/https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf](https://mjdgandcagmikhbjnilkmfnjeamfikk/https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf) (accessed on 19 June 2023)

³⁴ NCCPL Regulations, 2018. s 12.4.6. <https://www.nccpl.com.pk/en/about-us-1/rules-n-regulations/nccpl-regulations-1> (accessed on 25 November 2023)

³⁵ See, Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, March 2019, 178.

[extension://mjdgandcagmikhbjnilkmfnjeamfikk/https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf](https://mjdgandcagmikhbjnilkmfnjeamfikk/https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf) (accessed on 19 June 2023)

5.1.2.4 Off-Market Settlement

Off-market settlement is a settlement system for off-market transactions.³⁶ In PSX, an off-market transaction³⁷ refers to a transaction that occurs directly between two parties outside of the regular exchange mechanism.³⁸ Off-market transactions are settled outside of the normal trading process facilitated by the stock exchange.³⁹

The settlement process for these transactions depends on the agreement between the parties involved. The payment of price may be deferred to any future date specified in the agreement. The NCCPL plays a crucial role in the settlement of off-market transactions, along with its responsibilities in settlement for regular exchange trades. For off-market transactions, NCCPL facilitates the settlement process by providing a platform for the transfer of stocks and funds between the parties involved. NCCPL offers a centralized platform where off-market transactions can be reported and settled. This platform ensures efficiency and transparency in the settlement. Brokerage firms involved in off-market transactions are required to report the details of the transaction to NCCPL, including information such as the trade price, quantity and the parties involved. It operates the CDS, which facilitates the electronic transfer of stocks between

³⁶ Off-market settlement is a settlement system for transactions occurring directly between two parties outside the regular exchange mechanism. See, Smith John, "Understanding Off-Market Deals in Stock Trading", *Financial Insights*, <<https://www.financialinsights.com/off-market-deals.>> (accessed 5 August 2023).

³⁷ Off-market transaction are also known as negotiated deal or off market deal. See, John, "Understanding Off-Market.

³⁸ These deals are typically executed for bulk trades which may not be possible on stock exchange terminals due to regulatory restrictions. When a company changes its ownership, in that case sponsors prefer to sell stocks through deals outside the market instead of selling on exchange, where selling and buying follows certain price mechanism. In off-market deals, parties are free to deal at any price they want. They have just to report to NCCPL about their deal. The stocks also need to be transferred to CDC. There is no cap on price. A stock of a company X may be sold for five rupees, for instance in off-market whose otherwise price in stock exchange may be thirty rupees. See, John, "Understanding Off-Market.

³⁹ Off-market transactions in PSX refer to trades conducted directly between parties outside the regular exchange mechanism, with settlements facilitated by NCCPL through its Central Depository System (CDS). In contrast, over-the-counter (OTC) transactions involve trading unlisted securities directly between parties without the involvement of a formal exchange or a centralized clearing entity like NCCPL, making them less transparent and riskier.

the accounts of the buyer and seller. Upon confirmation of the off-market transaction, NCCPL updates the CDS records to reflect the transfer of ownership. As the central counterparty, NCCPL provides settlement guarantee for off-market transactions, ensuring that the transaction is completed smoothly and efficiently. This helps mitigate counterparty risk and enhances stock investor confidence in the settlement process. In addition to the above, NCCPL implements robust risk management mechanisms to monitor and manage the risks associated with off-market transactions. This includes margin requirements, collateral management and monitoring of settlement obligations to minimize systemic risk in the market.⁴⁰

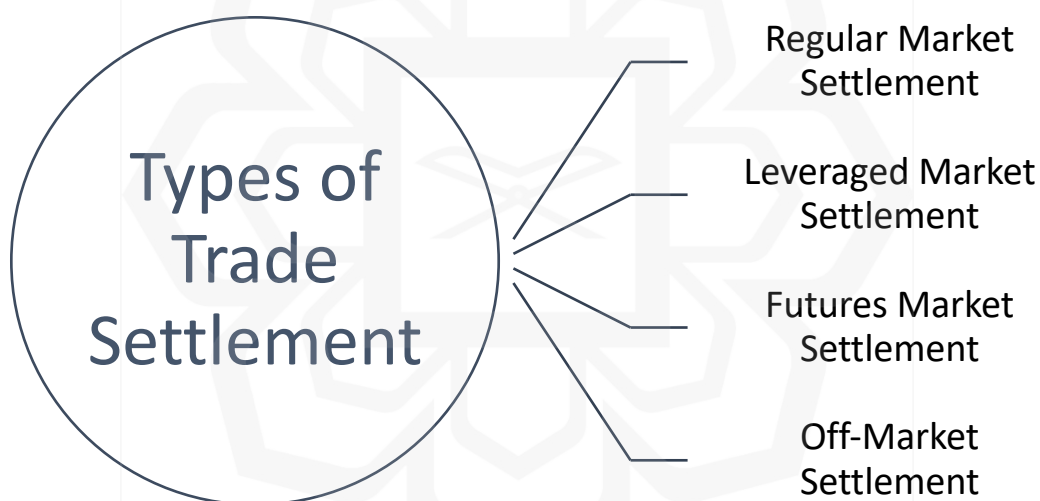


Figure 5.2: Types of Trade Settlement

The diagram depicts that the settlement of stocks facilitated by the NCCPL varies based on the type of market transaction, including regular market settlement,

⁴⁰ The NCCPL plays a crucial role in settling off-market deals by facilitating the transfer of stocks and funds between parties, providing a centralized platform for reporting and settlement, operating the CDS for electronic transfer of stocks, ensuring settlement guarantee and implementing risk management mechanisms. See, *National Clearing Company of Pakistan Limited*, "NCCPL: An Overview", <<https://www.nccpl.com.pk/overview>> (accessed 15 January 2023).

leveraged market settlement, futures market settlement, and off-market settlement. Regular market settlements follow a T+2 cycle, meaning trades are settled two days after execution, with activities categorized into T+0 (trading day), T+1 (confirmation day) and T+2 (settlement day). Leveraged market settlements involve transactions like short selling and margin financing, where deferred liabilities are settled beyond the T+2 phase. Futures market settlements are either cash-settled or deliverable stock futures contracts, with positions finalized through profit/loss or stock delivery. Off-market settlements occur outside the regular exchange, where the NCCPL ensures a smooth transaction process and mitigates risks through a centralized platform. Each settlement type follows distinct processes to ensure timely and efficient trade completion while mitigating counterparty risks.

Settlement of stocks involves several key steps that culminate in the transfer of ownership and the fulfilment of contractual obligations. These steps are similarly applicable to regular market, leveraged market and futures market transactions. The settlement of stocks begins with the physical transfer of stocks from the seller to the buyer and the transfer of funds from the buyer to the seller.⁴¹ The buyer receives the stocks bought by him according to the specification and quantity mentioned in the trade agreement executed at the stock exchange on the trading day and the seller receives the price of sold stocks. Central to this process is the role of central counterparties, such as NCCPL, which assumes the role of a central counterparty.⁴² It becomes buyer to each

⁴¹ Goodhart Charles and Dirk Schoenmaker, *The Clearing House: A Survey of Centralized Securities Settlement Systems*, (Cambridge: Cambridge University Press, 1998), 67.

⁴² NCCPL is an important participant of settlement process assuming the role of central counterparties, guaranteeing the completion of trades and mitigating counterparty risk. On settlement date, NCCPL settles money obligations through auto pay and collect system whereby buying brokerage firms' bank accounts are automatically debited while crediting selling brokerage firms' bank accounts. The stock delivery obligations are also settled through an automated system whereby stocks are automatically picked from the account of respective seller with central depository system (CDS) and delivered into the CDS account of the buyer. NCCPL also manages the risks involved in settlement employing different strategies for mitigation of risk. See, National Clearing Company of Pakistan Limited "Settlement

seller and seller to each buyer⁴³ and facilitates the transfer of funds between the accounts of the buyer and seller's brokerage firms. It ensures delivery of stocks to buyer and payment of price to seller.

Since all brokerage firms resort to NCCPL for settlement of stocks, it is presumed that every seller has surrendered his rights and obligations in favor of NCCPL and that NCCPL has taken up those obligations substituting original parties. Thus, it substitutes the original contracting parties and assumes their obligations of delivery and payment. This process of substitution is known as a novation. Novation means that the central clearing agency has now substituted the original seller and original buyer and as a result, has become counter party for both seller and buyer.⁴⁴ Through processes like novation, central counterparties streamline settlement of stocks, enhance efficiency and mitigate counterparty risks. Once settlement of stocks obligations is discharged, ownership of the stocks is transferred to the buyer and the trade is considered complete.⁴⁵

Procedures and Risk Management," NCCPL Official Website, <<https://www.nccpl.com.pk/settlement-process>> (accessed 5 August 2024).

⁴³ National Clearing Company of Pakistan Limited Regulations, 2018, Chapter 3, s 3.16.1.

⁴⁴ Stehm J, "Clearance and Settlement Systems for Securities: Critical Design Choices in Emerging Market Economies", *World Bank Discussion Papers*, no.321 (1996).

⁴⁵ Simmons, Michael, *Securities Operations: A Guide to Trade and Position Management*, (New York: Wiley, 2011), 45.

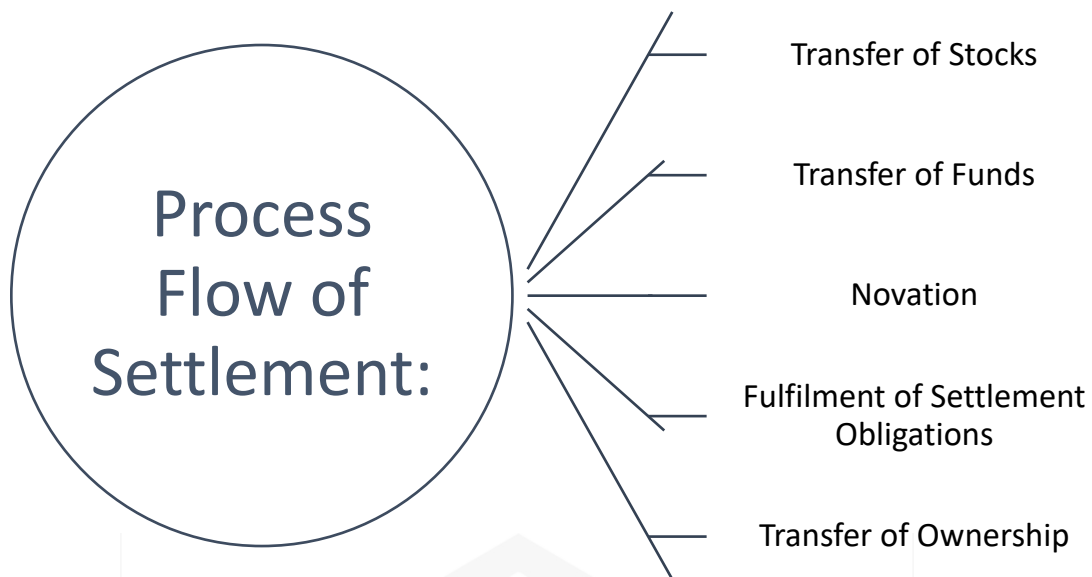


Figure 5.3: Process Flow of Settlement

The diagram for the process flow of settlement illustrates the key steps involved in the settlement of stocks, applicable to the regular market, leveraged market and futures market. It begins with the execution of a trade agreement on the stock exchange. The seller transfers the stocks to the buyer, while the buyer transfers funds to the seller. Central counterparties, such as the NCCPL, play a crucial role in this process by assuming the position of the buyer to every seller and the seller to every buyer, ensuring the efficient transfer of stocks and funds. This process of substitution, known as novation, allows the central counterparty to mitigate risks and streamline the entire transaction. Once both stock delivery and payment obligations are met, ownership is transferred to the buyer, completing the trade.

5.1.3 Custody of Stocks

Custody of stocks is an essential aspect of post stock trading, ensuring the safekeeping and administration of stock investors' holdings and involves storing and managing

stocks securely, typically in electronic or dematerialized form.⁴⁶ It may be defined as safekeeping and management of securities, such as stocks, on behalf of a stock investor by a financial institution or custodian.⁴⁷

Custody of stocks facilitates the transfer of ownership and streamline administrative processes related to dividend payments, corporate actions and proxy voting. Through comprehensive record-keeping and reporting capabilities, custodians ensure transparency and accountability, enabling stock investors to monitor and manage their portfolios with confidence.⁴⁸

Custody of stocks in Pakistan is operated by CDC which acts as a central depository.⁴⁹ CDC operates custody of stocks through an efficient depository system known as Central depository system (CDS).⁵⁰ It is an electronic system for custody and transfer of book entry of stocks. It changes the ownership of stocks without any physical movement or endorsement of instruments. It increases both in efficiency and safety through the immobilization of stocks and their safe storage in the depository, as contrasted with the old arrangements in which the scrip was actually held by the stock investor. Another benefit usually relates to the issue of stocks in a dematerialized or book-entry form. It also facilitates equity, debt-based securities and other financial instruments traded at PSX. It manages ordinary and preference stocks, TFCs, WAPDA bonds, *sukūk*, open-end and closed-end funds and *muḍārabah* certificates. It allows retail stock investors to directly open and maintain accounts with CDC for secure and

⁴⁶ Hazen Thomas Lee, *The Law of Securities Regulation*, (West Academic Publishing, 2020), 32.

⁴⁷ Urie Sandra K., "Best Practices for Custody of Stocks in Investment Management", *Journal of Investment Compliance*, vol. 7, no.2 (2006): 45-58.

⁴⁸ Cox, James D., Hillman, Robert W. and Langevoort, Donald C., *Securities Regulation: Cases and Materials*, (Wolters Kluwer, 2021), 25.

⁴⁹ Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, March 2019, 32. [extension://mjdgcagmikhbjnilkmfjjeamfikk/https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf](https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf) (accessed on 23 August 2023)

⁵⁰ Central Depositories Act 1997, s 4. <https://www.secp.gov.pk/document/central-depositories-act-1997/> (accessed on 19 October 2023)

safe custody of stocks. Stock investors have direct access to their stocks through stock investor accounts. They are safe and secure as they are directly maintained by CDC and are operated on the written or online instructions of stock investors. Therefore, stock investors have direct and complete control over their book entry of their stocks.

Custody of stocks encompasses a series of steps aimed at safeguarding and administering stocks on behalf of stock investors. It ensures the secure storage, efficient management and reliable handling of stocks, contributing to stock investor's confidence and the integrity of the stock market. These steps are similarly applicable to regular market, leveraged market and futures market transactions

The first step in the custody of stocks is the initiation of the depository relationship. Stock investors entrust their stocks to a custodian authorized by the regulatory authorities to provide custodial services for stocks, which acts as a fiduciary responsible for safeguarding these stocks. The custody of stocks is carried out by the CDC which is authorized by the regulatory authorities to provide custodial services for stocks. It holds stocks in custody on behalf of their stock investors and settle trades with the clearing house. It plays a significant role in managing stock investors' portfolios and executing corporate actions, such as dividend payments and proxy voting.⁵¹ This step involves the physical delivery of stock certificates or electronic transfer of stocks to the CDC's custody account.

Once the stocks are deposited in the custody of CDC, it registers them in the stock investor's name and creates documentation to confirm ownership. This documentation includes account statements, transaction confirmations and legal

⁵¹ See, Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, March 2019, 28.

extension://mjdgcandcagmikhbjnilkmfjjeamfikk/https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf (accessed on 25 October 2023)

agreements outlining the terms of custody. This registration establishes a clear record of ownership and provides stock investors with tangible evidence of their holdings. The stocks of a stock investor in the custody of CDC are kept in two kinds of ownerships namely legal ownership and beneficial ownership.

Legal ownership refers to the registered ownership of property or assets, where the legal title is in the name of the owner. The legal owner has the authority to transfer ownership and control the asset as recognized by law.⁵²

Beneficial ownership refers to the person or entity that enjoys the benefits of ownership, even though the title is in another name. The beneficial owner has the right to receive the benefits of the property, such as income or proceeds from sale, without being the registered owner.⁵³

The legal ownership of transferred stocks is held by CDC while beneficial ownership of stocks rests with the stock investors, the holders of the stocks. This distinction between legal ownership and beneficial ownership has its legal implications. In the legal ownership, the ownership of the stocks transferred to custodian lies with custodian itself. It maintains the register of legal ownership and is officially recognized as the holder of those stocks according to the records of the company. In beneficial ownership the ownership of the stocks transferred to CDC lies with the stock investor that originally owned the stocks and transferred them to CDC for safekeeping and trading purposes. This stock investor retains the rights and benefits associated with ownership, such as receiving dividends and exercising voting rights.⁵⁴ However, instead

⁵² Blumberg Phillip I., *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality*, (New York: Oxford University Press, 1993), 78.

⁵³ OECD, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes*, (Paris: OECD Publishing, 2001), 17.

⁵⁴ DeFeo Philip J., "Understanding Custodial Responsibilities in Securities Markets", *Journal of Financial Regulation and Compliance*, vol. 13, no.4 (2005): 367-381.

of holding physical stock certificates, their ownership is represented electronically through CDC's records.

Following registration, the CDC assumes responsibility for the safekeeping of the stocks. Robust security measures are implemented to protect against theft, loss, or damage, ensuring that the assets remain secure throughout the custody of stocks period. Whether stored in physical vaults or electronic databases, the stocks are subject to stringent security protocols to maintain their integrity.

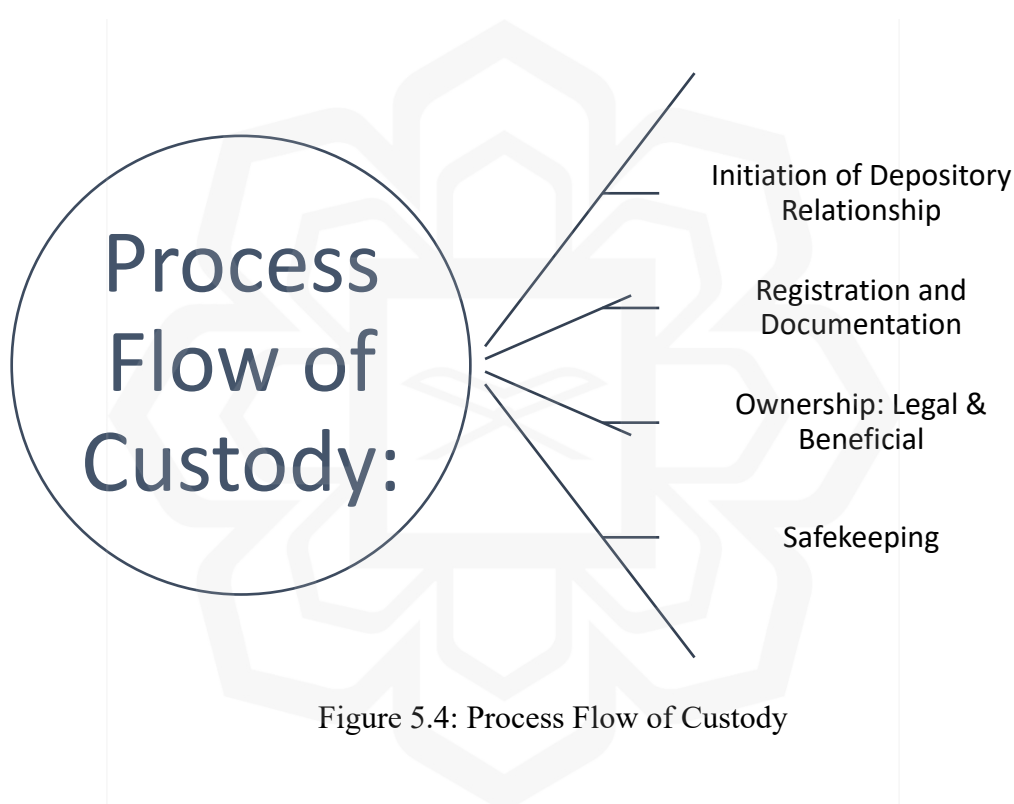


Figure 5.4: Process Flow of Custody

The diagram for the process flow of custody illustrates the steps involved in safeguarding and managing stocks on behalf of stock investors. The process begins with the initiation of a depository relationship, where stock investors transfer their stocks (via physical delivery or electronic transfer) to the CDC. Once in custody, the CDC registers the stocks under the stock investor's name, creating legal documentation to confirm ownership. The stocks are held with a distinction between legal ownership

(held by CDC) and beneficial ownership (retained by stock investors). The CDC then ensures safekeeping of the stocks, whether in physical or electronic form, implementing stringent security protocols throughout the custody period. This process applies to regular, leveraged and futures market transactions.

5.2 SHARĪ'AH ISSUES IN POST STOCK TRADING PRACTICES IN PSX

The *Sharī'ah* issues in post stock trading practices in PSX can be classified into the following categories: *Sharī'ah* issues pertaining to clearing of stocks, *Sharī'ah* issues pertaining to settlement of stocks and *Sharī'ah* issues pertaining to custody of stocks.

5.2.1 Sharī'ah Issues Pertaining to Clearing of Stocks

There are various *Sharī'ah* issues involved in post stock trading pertaining to clearing of stocks. These *Sharī'ah* issues include: i) status of clearing house and ii) mark to market profits and losses.

5.2.1.1 Status of Clearing House

An important *Sharī'ah* issue pertaining to clearing of stocks is on status of clearing house. In PSX, the trade is executed by the brokerage firm as an agent of its stock investor (buyer or seller). The stock investor appoints brokerage firm as its agent for the performance of number of acts including trading and its clearing. However, due to legal and regulatory restrictions, the brokerage firm generally delegates clearing work to a dedicated and designated institution which acts as national clearing house for all trades executed at PSX. Now the *Sharī'ah* issue is what is its position from *Sharī'ah* perspective? In other words, under which *fiqhi* contract or arrangement, clearing function of clearing house falls?

As mentioned above, the regulatory regime does not allow brokerage firm to undertake clearing work while the stock investor appoints brokerage firm its agent for all acts pertaining to stocks. Now when the brokerage firm assigns the task of clearing to the clearing house, it actually enters into a sub-agency contract with clearing house and pays fee to it for this service. All the cost born on clearing is virtually paid by the stock investor, the principal. Thus, clearing house is sub-agent and the contract is that of sub-agency. Here another question arises, is sub-agency allowed in Islamic law? Can a person who has been hired to perform certain work hire another person to perform that work? There are divergent opinions on the above issue in classical Islamic law.

The Muslim jurists differentiate between absolute *wakālah* and restricted *wakālah*. If the *wakālah* is restricted and the *wakīl* has been bound by the principal to perform the act by himself, then agent cannot hire another person to perform it i.e. to delegate its performance to another person. But if the *wakālah* is unrestricted and the principal has not demanded its performance from the agent specifically, then the agent is allowed to delegate it to some other as his agent. This view is held by the Ḥanafīs.⁵⁵ The Mālikīs do not allow sub-agency except in a situation when the work assigned to him, is below his status, yet he accepted it. In such case he can hire services of someone else to perform the act.⁵⁶ The view of Shafī'is and Ḥanbalis is that an agent is not allowed to make another person as his agent except when he is not capable to perform it alone. In such case he can appoint a sub-agent.⁵⁷ Māwardī, a Shaf'ī jurists writes that when a person hires services of an individual to perform certain act and requires him to

⁵⁵ 'Ala' al-Dīn 'Alī ibn 'Abd al-Karīm Kasānī, *Bada'i' al-Sana'i'*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 6:25.

⁵⁶ Muḥammad Dārdīr, *Al-Sharḥ al-Kabīr*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1999), 3:388.

⁵⁷ Muḥammad 'Alī Shīrbīnī, *Mughnī al-Muhtāj*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 2002), 2:226; 'Abdullah ibn 'Abd al-Raḥmān Ibn Qudāmāh, *Al-Mughnī*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 5:88.

perform it personally, he is not allowed to hire some other's services because the principal wants that the work be performed by the agent himself, not by someone else.⁵⁸ Ibn Qudāmah a Ḥanbali jurist writes that contract of hiring of persons is of two types, *ijārah* for a particular work by a particular person and *ijārah* on a described work (*ijārah mausufah fi al-zimmah*). When the *ijārah* is of second type then the agent is allowed to delegate work to someone else.⁵⁹

AAOIFI allows appointment of sub-agent with the permission of principal. It states that once a sub-agent is appointed, his termination does not spontaneously follow the termination of first agent, but the principal can terminate him.⁶⁰ It means that sub-agency is allowed with the consent of the principal and the appointment of sub-agent does not mean the dismissal of first agent. Both the first agency and sub-agency can work together. In the instant case when the stock investor appoints brokerage firm as its agent it requires from him the performance of numerous acts such as trading and clearing and other acts. He pays fee to the brokerage firm for the performance of his act. This implies that the stock investor has automatically allowed him to do whatever is necessary for the clearing of stocks. Thus, it is an implied consent by the stock investor to appoint sub-agent for the purpose of clearing of stocks. Thus, according to the verdict of AAOIFI, sub-agency is allowed in Islamic law. AAOIFI states that when a person is hired for doing a specific person, the employer has no right to hire out the services of such person to another person, unless the contract permits sub-hiring or this has been agreed by the two parties. If the hired services is specifically defined and has to be delivered in future the employer in this case has the right to hire out to someone

⁵⁸ Abū al-Ḥasan ‘Alī ibn Muḥammad Al-Mawardi, *Al-Hāwī*, (Beirut: Dār al-Kutub al-‘Ilmiyyah, 1999), 6:520.

⁵⁹ ‘Abdullah ibn ‘Abd al-Raḥmān Ibn Qudāmah, *Al-Mughnī*, (Beirut: Dār al-Kutub al-‘Ilmiyyah, 1997), 5:88.

⁶⁰ AAOIFI, *Sharī‘ah Standard No. 03: Agency and the Act of an Uncommissioned Agent*, Art 6/4.

else an identical service.⁶¹ If a person performed certain act in good faith and in the best interest of a certain person, while that person has not delegated him performance of that act, his act is treated permissible and acceptable by the Ḥanafis and Mālikis, provides the person for whom act has been done, subsequently ratifies that act. Such person is called *fuḍuli* (unauthorized or uncommissioned agent). From this it may be established that if acts of *fuḍuli* are recognized in *Sharī'ah*, the acts of sub-agent should also be acceptable in Islamic law.

The Permanent Committee for *Ifta* Saudi Arabia⁶² and contemporary *Sharī'ah* scholars such as Ibn 'Uthaimin,⁶³ al-Zuhaili,⁶⁴ al-Munjd,⁶⁵ Ibn Bāz,⁶⁶ allow sub-agency if the principal has not prevented his agent from delegating the task to some other person. If the principal has explicitly directed him to perform the act personally, then sub-agency is not allowed.⁶⁷ Ibn 'Uthaimin was asked if a person is hired to perform certain act such as he is asked to clean house or mosque for hundred riyal per month and he, on his own hires services of another person to perform cleaning work for fifty riyal per month, is it allowed? He replied it is permissible.⁶⁸

From the above discussion it maybe concluded that Islamic law allows sub agency if the agency is unrestricted, or it is an *ijārah* on a described work. In the case

⁶¹ Ibid, *Sharī'ah* Standard No. 34: *Hiring of Persons*, Art 5/1/3.

⁶² Permanent Committee for Islamic Research and Ifta (Saudi Arabia), *Fatwas of the Permanent Committee for Islamic Research and Ifta: Collection of Contemporary Legal Opinions*, (Riyadh: General Presidency of Scholarly Research and Ifta, 2000), 200-202.

⁶³ Ibn 'Uthaymīn, Muḥammad ibn Ṣālih, *The Concise Legacy of Shaykh Ibn 'Uthaymīn: Fatwas on Contemporary Islamic Issues*, trans. Muḥammad Saed Abdul-Rahman (New York: MSA Publication Limited, 2014), 110-112.

⁶⁴ Wahbah Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence: Fiqh al-Mu'amalat al-Maliyyah*, (Damascus: Dār al-Fikr, 2003), 2:320-322.

⁶⁵ Salih al-Munjd, Fatwa no. 368845,126722, <Islamweb.net.> (accessed 26 May 2024).

⁶⁶ See, <www.Ibnbaz.org.sa.fiqhi> (accessed 26 May 2024); Ibn Bāz 'Abd al-'Azīz ibn Bāz, *Selected Fatwas of Shaykh Ibn Bāz*, (Riyadh: Islamic University of Madinah Press, 1998), 150-152.

⁶⁷ Al-Zuhaili holds the view that a muḍārib can appoint sub-muḍārib for business provided the rabb al-māl, principal allows him to do it.⁶⁷ It is worthy to mention here that the muḍārib is the agent and sub-muḍārib is the sub-agent. See, Al-Zuhaili Wahbah, *Al-Fiqh al-Islamī wa Adillatuhū* (Beirut: Dār al-Fikr, 2015), 135.

⁶⁸ See, www.Islamqa.info (accessed 26 June 2024).

of sub-agency of the clearing house, we notice that the stock investor has entered into an unrestricted *wakālah* with the brokerage firm to perform the acts such as trading and clearing. It has not restricted the brokerage firm to do all acts by itself. This means that it has authorized him to delegate clearing work to the clearing house. Hence, it is allowed in both the classical and contemporary Islamic law.

5.2.1.2 Mark-to-Market Profits and Losses

Mark-to-market profits and losses is an important *Sharī'ah* issue pertaining to clearing of stocks. The concept of mark-to-market profits and losses is directly relevant to the clearing process of post stock trading. In the context of clearing, mark-to-market valuation determines the daily clearing of profits and losses for stock investors based on the current market value of their positions. This daily clearing is crucial for maintaining transparency and managing risks within the clearing system. However, from a *Sharī'ah* perspective, the issue arises regarding the fairness and legitimacy of this practice, as it involves transferring gains and losses between parties based on market fluctuations, which may not align with Islamic principles of justice and fair dealing. Thus, the discussion of mark-to-market profits and losses is intimately linked to the clearing process, highlighting the need for *Sharī'ah*-compliant alternatives in Islamic finance.

Mark-to-market is valuing the stocks at the current trading price. Therefore, it results in trader's daily clearing of profits and losses due to change in its market value.⁶⁹ This valuation is generally required in stock futures contracts. Mark-to-market profit means amount receivable by a clearing member at the end of each trade date on account of contracts executed on behalf of its stock investor in any stock from the NCCPL due

⁶⁹ See, <www.wallstreetmojo.com> (accessed 19 May 2022).

to the difference between trade price, on trade-to-trade basis, of the uncleared position in each stock. Mark-to-market loss means amount payable to the company by a clearing member at the end of each trade date on account of contracts executed on behalf of its stock investor in any stock from the NCCPL due to the difference between trade price, on trade-to-trade basis, of the uncleared position in each stock. For example, if a person has purchased one thousand stocks of OGDC at the rate of Rs. 50 per stock to be delivered after one month of the execution of trade. Now, mark-to-market profit and losses will come into play. The valuation of the stocks will be made every day and the difference between the trade price on a particular day and the contract price will be either receivable from NCCPL or payable to NCCPL. If the price of stock has gone up to rupees Rs. 55 the clearing member, the broker of stock investor will collect five rupees per stock from NCCPL. On the other hand, if the price goes down to Rs. 45 he will pay five rupees per stock to the NCCPL. The concept of mark-to-market profits and loss is alien to Islamic law. If credit price in a credit sale is fixed for certain commodity, the buyer is under obligation to pay that price regardless of whether the price of that commodity goes up or down. Thus, the mark-to-market profit is not a genuine profit earned by a party as a result of his act or any trade undertaken by him. This is a form of eating each other's properties wrongfully which is prohibited in the *Qur'ān*.⁷⁰ In the same way to hold the stock investor liable for compensating for a decrease in the value of stock is unjustifiable. There is no *Sharī'ah* justification or reason why he should bear this loss which has arisen from price fluctuation in the market. This goes without saying that the stock investor has no role in this price

⁷⁰ Al-Nisā': 29.

fluctuation. Why should one party compensate other party on trade-to-trade basis? As such this concept is not compatible with *Sharī'ah*.⁷¹

The alternative to mark-to-market profits and losses, maybe the principle of profit and loss sharing under *mushārah*. In *mushārah*, two or more parties contribute capital to a joint enterprise and share profits based on a pre-agreed ratio, while losses are shared in proportion to their capital contributions. This principle ensures fairness, as profits are derived from actual business activities, and any loss is tied to the invested capital, reflecting true risk-sharing. Unlike mark-to-market, where one party compensates the other based on price fluctuations unrelated to their actions, *mushārah* promotes ethical and just dealings aligned with Islamic principles.

5.2.2 Sharī'ah Issues Pertaining to Settlement of Stocks

There are various *Sharī'ah* issues involved in post stock trading practices pertaining to settlement of stocks. These issues include: i) status of substitution of original parties, ii) ready market settlement and iii) stock futures settlement.

5.2.2.1 Status of Substitution of Original Parties

An important *Sharī'ah* issue pertaining to settlement of stocks is on status of substitution of original parties. As stated earlier, that NCCPL substitutes original parties (buyer and seller) for the purpose of settlement of trade and assumes the position of central counter party for both buyer and seller. It becomes buyer for each seller and

⁷¹ The alternative to mark-to-market profits and losses, which is incompatible with *Sharī'ah*, should be the principle of profit and loss sharing under *mushārah*. In *mushārah*, two or more parties contribute capital to a joint enterprise and share profits based on a pre-agreed ratio, while losses are shared in proportion to their capital contributions. This principle ensures fairness, as profits are derived from actual business activities, and any loss is tied to the invested capital, reflecting true risk-sharing. Unlike mark-to-market, where one party compensates the other based on price fluctuations unrelated to their actions, *mushārah* promotes ethical and just dealings aligned with Islamic principles. See, Taqī 'Usmani, *An Introduction to Islamic Finance*, (Karachi: Idaratul Ma'arif, 2002), 45.

seller for each buyer. It assumes this status through novation arrangement. Now the *Sharī'ah* issue is: what is the *Sharī'ah* status of this substitution and novation? Does this substitution and novation fall under *hawālah* contract, in which a third party (*muhāl 'alayh*) substitutes the original party (*muhīl*) and takes up its rights and obligations and the original party (*muhīl*) is absolved of its obligation? The NCCPL, in this meaning, is *muhāl 'alāyh*, or a substituted debtor and obligor, who has to fulfil payment obligation towards the seller and delivery obligation towards the buyer. In Islamic law *hawālah* is defined as the shifting or assignment of debt from the liability of the original debtor to the liability of another person.⁷² Kasani defines *hawālah* as a transfer of debt, terminating the liability of the original debtor, to a third person.⁷³ This definition implies that after the conclusion of *hawālah* the principal debtor is relieved from the liability. According to *Majallah al-Ahkām al-Adliyyah*, a *hawālah* with the condition that *muhīl*, or transferor will remain under obligation to pay his debt or liability, is *kafālah* not *hawālah*.⁷⁴ If we look at novation in the light of *Sharī'ah* rules of *hawālah*, we observe that novation is not *hawālah* and NCCPL is not *muhāl 'alāy* (substituted debtor or obligor) because in case of novation, the original party is not absolved from its obligation. The buyer of stocks remains under obligation to make payment to the seller and seller remains under obligation to deliver stocks to buyer. Thus, novation of stock market does not fall under *hawālah* contract.

Another position of NCCPL could be that it is *wakīl* for both the parties for settlement of reciprocal obligations.⁷⁵ It is *wakīl* of seller to deliver stocks and *wakīl* of

⁷² 'Abd al-Hayy Zayla'i, *Tabyīn al-haqā'iq*, (Beirut: Dār al-Kitāb al-'Arabī, 1989), 4:1717.

⁷³ 'Alī ibn Muḥammad Kāsānī, *Badā'i' al-sanā'i'*, (Beirut: Dār al-Kitāb al-'Arabī, 1990), 6:17.

⁷⁴ *Majallah al-Ahkām al-Adliyyah*, (Istanbul: The Office of the Ministry of Justice, 1876), Art. 648.

⁷⁵ In a *wakālah* arrangement, the original contracting parties (buyer and seller) appoint NCCPL as their agent (*wakīl*) to facilitate the execution and settlement of their respective obligations. The buyer and seller remain the principals (*muwakkil*), while NCCPL, as the agent, ensures that stocks are delivered and payments are processed without assuming ownership of the stocks or financial liability beyond its agency function.

buyer to pay price to seller. Thus, the status of NCCPL is that of *wakīl*. As a *wakīl* of buyer, it buys stocks and then pays price. As *wakīl* of seller, it sells stocks on his behalf and after sale, makes delivery of stocks to buyer. Besides *wakīl*, it also assumes the role of *kafīl* (guarantor) for delivery as well as for payment of price.⁷⁶ This second position is much closer to the nature of novation and NCCPL.⁷⁷

The respondents of this study endorsed the second position. They held the view that status of NCCPL is that of *wakīl* and *kafīl*. In their opinion, it is not *hawālah*, because the original parties, even after the contract novation by NCCPL and its assuming role of central counter party, are not released from their obligations. They are obliged to deliver the stocks and pay the price. If they default, NCCPL imposes penalties on them. It calls a number of margins from them. This shows that the original position of the NCCPL is that of guarantor which guarantees the delivery of stocks to the buyer and payment of price to the seller. Different margins and collaterals are in fact *rahn* with the NCCPL to utilize it in case of default. It may assume the role of counter party i.e., buyer to seller and seller to buyer but this is just a temporary phase. Its actual status is that of *wakīl* and *kafīl*. It is not a real buyer or seller. The implications of novation are that original buyer and seller are separated from each other. NCCPL novates the old contract by creating two separate contracts, one with the buyer and the other with seller.

⁷⁶ In its role as *kafīl* (guarantor), NCCPL provides assurance that the stock delivery and payment obligations will be fulfilled. It guarantees that the seller will receive the payment and the buyer will receive the stocks. In case of default, NCCPL utilizes collected margins and collaterals (*rahn*) to ensure settlement, thus protecting market integrity and fulfilling the objective of *hifẓ al-māl* (preservation of wealth) in *Sharī'ah*.

⁷⁷ Unlike *hawālah*, where a debtor's obligation is transferred entirely to another party (*muhāl 'alayh*), NCCPL's role does not absolve the original buyer and seller from their obligations. Instead, it functions as an intermediary that temporarily assumes the role of counterparty while primarily acting as *wakīl* and *kafīl*. The novation process creates two separate contracts, but NCCPL does not become the actual buyer or seller.

The ultimate purpose novation arrangement is protection of the rights of both the parties and *hifẓ al-māl* which is an objective of *Sharī'ah*.⁷⁸

On the issue whether a single party can be *wakīl* for both buyer and seller, the respondents for this study, had divided opinions. The respondents from the category of *Sharī'ah* advisors were generally of the view that one party can be agent for both buyer and seller.⁷⁹ One *Sharī'ah* advisor held the view that one single party cannot be agent for buyer and seller.⁸⁰ The respondents from the category of market participants including stock investors and brokerage firms were of the view that clearing agency acts as central counter party. It is called novation of contract. It is a centralized risk management agency worldwide. There is no issue in being agent for both parties.⁸¹ NCCPL novates the contract and thus provides settlement guarantee. This is in the benefit of stock investors and enhances confidence of stock investors in the market and saves them from possible harm.⁸² The respondents from the category of law experts and academicians also endorsed this position.⁸³

5.2.2.2 Ready Market Settlement

Another *Sharī'ah* issue pertaining to settlement of stocks is on ready market settlement. This settlement generally takes place on T+2 cycle basis. A trade executed at certain day is settled after two days of the trade. This method of settlement may also cause problems. The price may become unfavorable for a party and he may refuse to discharge his obligation and this may lead to default. This is the reason why the International

⁷⁸ Respondents 105, 106.

⁷⁹ Respondents 102, 103, 104, 105, 106, 111.

⁸⁰ Respondent 101.

⁸¹ Respondents 114, 115, 116, 117, 118.

⁸² Respondent 107, 108, 109, 112, 113, 114.

⁸³ Respondents 108, 109.

Social Security Association (ISSA) 2000 has recommended the adoption of a trade date plus one settlement cycle in a form that does not increase operational risk. From *Shari'ah* perspective, generally delivery of two counter values cannot be deferred or postponed.⁸⁴ AAOIFI has however allowed deferment of two counter values in certain cases such as in supply contracts. This may provide a justification for deferment of counter values i.e. stocks and price or delivery and payment. However, there will be a real problem if the stocks represent gold, silver, currency and receivables. In that case the transaction must be simultaneous or hand to hand.⁸⁵ Such transaction falls under the rules of *ṣarf* (exchange of money for money) and *ribā al-faḍl*. The Prophet (S.A.W.) said: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt – like for like, equal for equal and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand”.⁸⁶ To address the practical problem which makes *Shari'ah* conscious stock investors to lag behind by two days, the SECP in collaboration with PSX introduced a mechanism for *Shari'ah* compliant stock trading namely *Shari'ah* compliant trading counter.⁸⁷ The *Shari'ah* compliant counter has been mandated to settle transactions in *Shari'ah* compliant stocks on the day of trade i.e. is on T+0 basis. However, still old system of T+2 is in practice at PSX.

⁸⁴ International Social Security Association (ISSA), *Social Security Guidelines on Investment in Public Markets*, (Geneva: ISSA, 2000).

⁸⁵ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Shari'ah Standards for Islamic Financial Institutions*, (Bahrain: AAOIFI, 2015), Standard No. 1, Articles 2.3 and 3.5, 250–251.

⁸⁶ Muḥammad ibn Isma'il Al-Bukhārī, *Saḥīḥ al-Bukhārī*, translated by Muḥammad Muḥsin Khan (Riyadh: Dārussalam, 1997), vol. 3, Book 34, ḥadīth 387.

⁸⁷ Securities and Exchange Commission of Pakistan (SECP), *Regulations for Trading at Pakistan Stock Exchange*, (Islamabad: SECP, 2017).

5.2.2.3 Stock Futures Settlement

Stock futures settlement is also a *Shari'ah* issue pertaining to settlement of stocks. Stock futures settlement refers to an arrangement to discharge mutual obligations of the parties under the contract by settling the difference between the value of stock at the time of the making of contract and at a specified future time.⁸⁸ For example, a stock investor (x) sold one futures contract of PSO stocks comprising 500 stocks for Rs. 10,000 to stock investor (y) on January 10 to be delivered on Feb 10, on the day of delivery and settlement the price of stocks increased to Rs. 15,000. Now y, instead of taking delivery will pay the difference between the contract amount i.e. Rs. 10,000 and the current market value i.e. Rs. 15,000. Thus, he will pay to x Rs. 5,000 and will settle the transaction. On the other hand, if the price decreases to Rs. 9,000 x will pay Rs. 1,000 to y and the transaction will come to an end.⁸⁹

Settlement of futures usually takes place without delivery. The parties exit from the transaction by settling the price differentials which is a type of cash settlement of stocks. The Muslim jurists pre-dominantly prohibit futures settlement of stocks. They consider it just a paper transaction which aims to make speculative profit. In settlement of futures, the contracting parties do not have any intention of taking delivery of the counter values. Thus, it is not a genuine sale. Instead, it is a speculative activity with the purpose of achieving maximum gains as a result of favorable price movement.⁹⁰

⁸⁸ Taqī Usmanī, *An Introduction to Islamic Finance*, (Karachi: Idaratul Ma'arif, 2002), 172-174.

⁸⁹ Ibid.

⁹⁰ Stock futures contracts were initially developed as financial instruments for hedging, allowing stock investors to manage risk by locking in prices for future transactions. Hedging involves mitigating potential losses from adverse price movements by taking an offsetting position in the futures market. Institutional investors and businesses use stock futures to protect their portfolios from volatility rather than for speculative gains. However, in practice, stock futures trading has increasingly been used for speculation, where stock investors engage in transactions with the primary goal of profiting from price fluctuations rather than securing their investments. This speculative aspect raises concerns in *Shari'ah* because it transforms futures contracts into a form of *qimār* (gambling) and *gharar* (uncertainty).

The International Islamic *Fiqh* Academy and Islamic *Fiqh* Academy of Muslim World League have ruled that futures settlement is not consistent with *Sharī'ah* because the ultimate goal from these contracts is to pay and receive price differences between sellers and buyers and therefore impermissible. By receiving price difference from the other party without giving or taking the delivery or possession of stocks and without taking any liability with respect to the ownership of the stocks, the parties actually eat up each other's properties wrongfully which is prohibited in *Sharī'ah*.⁹¹ The *Qur'ān* says: "You who believe, do not falsely eat up each other's properties among yourselves, but let there be trade among you with your mutual consent".⁹²

Prominent *Sharī'ah* scholar Zarqa says that any contract that includes false contract (*ṣuwari*) or fake does not intend to deliver item and price is void contract.⁹³ A genuine settlement of stocks like any other commodity in Islamic law requires that the counter values should be exchanged which means that seller should handover the stocks and the buyer should pay the price. In the current settlement of stocks this *Sharī'ah* requirement of settlement is not fulfilled.⁹⁴

From this, it may be concluded that the above mode of futures settlement is repugnant to *Sharī'ah* because it is mere a speculative activity and no genuine trade is intended by the parties. Transactions generally end in netting off the prices. This goes without saying that in futures trading the parties only settle their respective obligations by *muqāṣah* and neither party pays the actual cost of the stocks.

⁹¹ Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*, (Cambridge: Cambridge University Press, 2006), 110-112.

⁹² Al-Nisā':29.

⁹³ Ehab M. M. Injadat, "Futures and forwards contracts from perspective of Islamic Law", *Journal of Economics and Political Economy*, vol. 1, no.2 (2014): 241-252.

⁹⁴ Mahmood Ahmad Ghazi, "Mudārabah Financing: An appraisal" (paper presentation, Islamic Corporate Finance: *Sharī'ah* based Solutions, November. 21-22, 1998).

On the question whether settlement of stock futures without actual delivery, is permissible in *Sharī'ah*, all respondents agreed that cash settlement of stocks without actual delivery is not permissible in *Sharī'ah*. They, however, had divergent views on the grounds of impermissibility. Some were of the view that the reason for its impermissibility is that *salam* (futures sale contract) cannot be affected on stocks because stocks are not fungible commodity. They are identified thing. Thus, stocks cannot be subject matter of futures sale.⁹⁵ Other respondents were of the view that futures themselves are impermissible in *Sharī'ah* because of the incorporation of the elements of gambling and speculation in it. Thus, if futures are not valid, their settlement is also not permissible.⁹⁶

5.2.3 *Sharī'ah* Issues Pertaining to Custody of Stocks

There are various *Sharī'ah* issues involved in post stock trading practices pertaining to custody of stocks. These issues include: i) a change of *Sharī'ah* status of stocks from *Sharī'ah* compliant to *Sharī'ah* non-compliant stocks, ii) disinvestment of *Sharī'ah* non-compliant stocks, iii) income of non-*Sharī'ah* compliant stocks, iv) position of beneficial ownership of stocks, v) *zakāt* of stocks and vi) liability of stockholder.

5.2.3.1 *A change of Sharī'ah Status of Stocks from Sharī'ah Compliant to Sharī'ah non-Compliant Stocks*

An important *Sharī'ah* issue pertaining to custody of stocks is on a change of *Sharī'ah* status of stocks from *Sharī'ah* compliant to *Sharī'ah* non-compliant stocks because of change of *Sharī'ah* status of company. In certain cases, a company which was originally *Sharī'ah* compliant is declared *Sharī'ah* non-compliant which has implications on the

⁹⁵ Respondents 102, 103, 105, 112.

⁹⁶ Respondents 101, 103, 104, 106, 111, 115.

stocks. When a stock investor buys stocks of a company as a *Sharī'ah* compliant company, he keeps those stocks with CDC as stockholder. In the meantime, the company is excluded from the list of *Sharī'ah* compliant companies. Here the question is what are the *Sharī'ah* grounds for the change of status of a company?

The grounds for the change of status of a company from *Sharī'ah* compliant to *Sharī'ah* non-compliant can be classified into two broad categories. The first category is non-compliance of *Sharī'ah* screening criteria applicable in a particular jurisdiction. The second category is the change in external factors beyond *Sharī'ah* screening criteria. In the following these two categories of grounds for the change of status of a company from *Sharī'ah* compliant to *Sharī'ah* non-compliant are separately discussed in detail.

1- Non-Compliance of *Sharī'ah* Screening Criteria

The stock exchanges operating in different countries have prescribed different *Sharī'ah* screening criteria for the *Sharī'ah* compliant companies to turn into *Sharī'ah* non-compliant companies. If a company violates these criteria it changes from *Sharī'ah* compliant to *Sharī'ah* non-compliant company. In Pakistan the *Sharī'ah* screening criteria provides threshold for interest-based borrowing and lending which is 37% and 33% of the total assets of the company respectively, while the benchmark for illegitimate income is 5% of the total income of the company.⁹⁷ It is observable that in Pakistan, the tolerance benchmark is very lenient due to market needs which require a flexible criterion to encourage the companies to be included in KMI-All Shares Islamic

⁹⁷ Saadia Kamran, "Islamic Finance in Pakistan: *Shari'ah* Compliance and Operational Challenges", *Journal of Islamic Banking and Finance*, vol. 36, no.1 (2021): 89-105.

Index.⁹⁸ But since Pakistan is on its way to a complete transformation to an Islamic financial and economic system, as required in the FSC judgment delivered in 2022,⁹⁹ the ratios for interest-based borrowing or investing must be phased out gradually. For instance, thresholds or limits of 37% and 33% should be lowered to 25% in 2024, then to 15% in 2025, 5% in 2026 and to ban interest bearing borrowing and lending from the domestic market completely by the end of 2027.¹⁰⁰ Similarly, the ratio of *Shari'ah* non-compliant income may be phased out to zero and any company investing or getting money based on interest would not qualify to be *Shari'ah*-compliant company for the stock investors in stocks.¹⁰¹

In Malaysia the threshold provided by SAC of SC Malaysia for interest-based borrowing and lending is 33% of total market capitalization.¹⁰² The ratio of impermissible income set by these institutions is 5% of the total income of the company. Any income above this ratio has to be given in charity.¹⁰³ The SAC of SC Malaysia further provides that the core activity of the company should be permissible and the non-permissible element should be very small. Such impermissible element may be based on the matters such as *'umūm al balwā* (common plight and difficult to avoid) and the rights of non-Muslim community which are accepted by Islam.¹⁰⁴ *'Umūm al*

⁹⁸ Zahid Ahmad and Muhammad Saeed, "Flexibility in *Shari'ah* Screening Criteria: The Case of Pakistan", *International Journal of Islamic and Middle Eastern Finance and Management*, vol. 13, no.4 (2020): 701-715.

⁹⁹ Federal *Shari'at* Court of Pakistan, "Judgment on *Ribā* and Interest-based Transactions, 2022," available at: <https://www.federalshariatcourt.gov.pk/Judgments/Riba_Judgment_2022.pdf>

¹⁰⁰ Ayub Mansoori, "Islamization of Non-Banking Sector in Pakistan" (paper presentation, AAOIFI-SECP Islamic Capital Market Conference, Islamabad, May 29, 2023).

¹⁰¹ Shari'ah Advisory Council of Pakistan, "Recommendations for Gradual Elimination of Non-compliant Income", *Journal of Islamic Finance*, vol. 18, no.2 (2022): 45-58.

¹⁰² *Shari'ah Advisory Council, Securities Commission Malaysia*, "Guidelines on the Determination of Capital Market Products under the *Shari'ah* Principles (Securities Commission Malaysia)", <<https://www.sc.com.my/api/documentms/download.ashx?id=443a1236-8a0e-48bc-8d77-269081a5e72f>> (accessed 24 June 2024).

¹⁰³ Ibid.

¹⁰⁴ Ahmad Ibrahim, "Shari'ah Governance in Islamic Finance: Core Activities versus Minor Non-permissible Elements", *Journal of Islamic Banking and Finance*, vol. 15, no.3 (2019): 45-62.

balwā is the situation that effects most people and is difficult to avoid and it frequently occurs in people's life.¹⁰⁵ The SAC of SC Malaysia has suggested following three benchmarks of tolerance of mixed business: a) Five percent benchmark is applied to assess the level of mixed contributions from the activities that are clearly prohibited such as *ribā* (interest-based companies like conventional banks), gambling, liquor and pork.¹⁰⁶ b) Ten percent benchmark is applied to assess the level of mixed contributions from the activities that involve the element of *'umūm al balwā* which is a prohibited element affecting most people and difficult to avoid. For example, interest income from fixed deposits in conventional banks.¹⁰⁷ c) Twenty five percent benchmark is used to assess the level of mixed contributions from the activities that are generally permissible according to *Sharī'ah* and have an element of *maslahah* (public interest), but there are other elements that may affect the *Sharī'ah* status of these activities. For example, hotel and resort operations as these activities may also involve other activities that are deemed non permissible according to *Sharī'ah*. This benchmark suggests that if the impermissible component of mixed business exceed these benchmarks, then the status of such company will be changed from *Sharī'ah* compliant to *Sharī'ah* non-compliant company.¹⁰⁸

It is observable here that the Malaysian regulator has followed flexible approach in setting the tolerance benchmark.¹⁰⁹ This appears justifiable keeping in view the fact that a considerable part of Malaysian population is non-Muslim whose rights are

¹⁰⁵ *Shari'ah Advisory Council, Securities Commission Malaysia*, "Guidelines on the Determination of Capital Market Products under the *Shari'ah* Principles (Securities Commission Malaysia)", <<https://www.sc.com.my/api/documentms/download.ashx?id=443a1236-8a0e-48bc-8d77-269081a5e72f>> (accessed 24 June 2024).

¹⁰⁶ Securities Commission Malaysia, *Guidelines on the Assessment of Mixed Business Activities*, (Kuala Lumpur: Securities Commission Malaysia, 2024).

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

¹⁰⁹ Securities Commission Malaysia, *Annual Report 2023*, (Kuala Lumpur: Securities Commission Malaysia, 2023).

protected by Islam as well as the constitution.¹¹⁰ Thus, the occurrence of *'umūm al balwā* is most common in the Malaysian society.¹¹¹

The threshold suggested by AAOIFI for interest-based borrowing and lending is 30% of total market capitalization whereas the benchmark for the illegitimate income is 5% of total income of the company. Any income above that should be given in charity.¹¹²

2- Changes in External Factors Beyond *Sharī'ah* Screening Criteria

The external factors beyond *Sharī'ah* screening criteria are the factors which are actually independent, but they are having an impact on *Sharī'ah* screening criteria. These factors are as follows.

a) Changes in Core Operations

Changes in core operations of a company refers to significant shifts in the fundamental activities of a company. For instance, if a company expands its operations into sectors that are not compliant with *Sharī'ah* principles, such as alcohol, gambling, or conventional finance, it can jeopardize its compliance status.¹¹³ For example, a *Sharī'ah* compliant textile company deciding to diversify its business by entering the entertainment industry and producing movies. However, the entertainment industry often involves activities such as producing movies with content that may not align with

¹¹⁰ Abdul Razak and Aishah Myra, "Protection of Non-Muslim Rights in Malaysia: A Comparative Study", *Asian Journal of Comparative Law*, vol. 11, no.2 (2016): 321-340.

¹¹¹ Zaidi Zainuddin, "'Umūm al Balwa: Understanding its Prevalence in Malaysian Society", *Journal of Southeast Asian Studies*, vol. 48, no.1 (2017): 89-105.

¹¹² Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Sharī'ah Standards: Ijārah wa Ijārah Muntahiyah bil Tamlik*, (Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions, 2008).

¹¹³ Muḥammad Nejatullah Siddiqi, *Islamic Capital Markets: Principles and Practices*, (Leicester: The Islamic Foundation, 2000), 55-58.

Sharī'ah principles, like promoting gambling or indecent behavior. This expansion into a non-compliant sector could lead the company to lose its *Sharī'ah* compliant status.¹¹⁴

b) New Partnerships or Investments

New partnerships or investments refers to collaborating with or investing in businesses or ventures that do not adhere to *Sharī'ah* principles and can affect the overall compliance of the company. This might include forming partnerships with companies involved in interest-based finance or other non-compliant activities.¹¹⁵ For example, a *Sharī'ah* compliant real estate development company seeking investment from a conventional bank to fund a new project. By entering into an agreement with the conventional bank, the company may be involved in interest-based transactions, which are not permitted in *Sharī'ah*. Even if the project itself is *Sharī'ah* compliant, the involvement in interest-based financing could taint the overall compliance status of the company.¹¹⁶

c) Changes in Financial Transactions

Changes in financial transactions refers to engaging in financial transactions that are not in line with *Sharī'ah* principles, such as issuing debt-based instruments or taking on interest-bearing loans. Engaging into such transactions can impact on the company's compliance ratios. Even trading instruments that affect the balance sheet ratios unfavorably can pose a risk to compliance.¹¹⁷ For example, a *Sharī'ah* compliant

¹¹⁴ Maḥmūd A. El-Gamal, *Islamic Finance: Law, Economics and Practice*, (Cambridge: Cambridge University Press, 2006), 112-115.

¹¹⁵ Taqī 'Usmanī, *An Introduction to Islamic Finance*, (The Hague: Kluwer Law International, 2002), 78-80.

¹¹⁶ Muḥammad Ayub, *Understanding Islamic Finance*, (Chichester: Wiley, 2007), 95-98.

¹¹⁷ Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance: Religion, Risk and Return*, (The Hague: Kluwer Law International, 1998), 130-133.

manufacturing company decides to issue bonds to raise capital for expansion. However, the terms of the bonds include interest payments, which are not permissible under *Sharī'ah*. By engaging in this debt-based financing, the company violates *Sharī'ah* principles, risking its compliance status.¹¹⁸

d) Change in Ownership Structure

Change in ownership structure refers to a situation when a *Sharī'ah* compliant company undergoes a change in ownership, such as a merger or acquisition with a *Sharī'ah* non-compliant company, which can lead to a shift away from compliance.¹¹⁹ Similarly, if a *Sharī'ah* compliant company is acquired by a *Sharī'ah* non-compliant company, its compliance status may be compromised. For example, a *Sharī'ah* compliant food distribution company being acquired by a multinational company that also owns businesses involved in the production and sale of alcoholic beverages. As a result of the acquisition, the *Sharī'ah* compliant company becomes part of a group that engages in *Sharī'ah* non-compliant activities, potentially compromising its compliance status.¹²⁰

e) Inability to Rectify Non-Compliance

Inability to rectify non-compliance refers to situations when a *Sharī'ah* compliant company fails to address and rectify instances of non-compliance within a given buffer period and thus may result into losing its *Sharī'ah* compliant status.¹²¹ This inability to regain compliance can result in the company being classified as *Sharī'ah* non-compliant. For example, a *Sharī'ah* compliant investment company that specializes in

¹¹⁸ Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking: History, Performance and Prospects*, (New York: Palgrave Macmillan, 2005), 140-145.

¹¹⁹ Siddiqi, *Islamic Capital...* 60–62.

¹²⁰ El-Gamal, 120–123.

¹²¹ Usmanī. *An Introduction...* 85–88.

trading stocks in compliance with *Sharī'ah* and carefully screens potential investments to ensure they comply with *Sharī'ah* guidelines, avoiding businesses involved in activities such as alcohol, gambling, tobacco and other *Sharī'ah* non-compliant sectors. However, the investment company decides to purchase stocks of a company that manufactures consumer electronics because the company's products are popular and seem to offer promising returns. However, undiscovered to the investee company, that the manufacturing company also has a subsidiary that produces alcoholic beverages, which goes against *Sharī'ah* principles. After the purchase is made, it comes to light that a significant portion of the company's revenue comes from its alcoholic beverage subsidiary. This revelation means that a portion of the investment company's funds are indirectly supporting *Sharī'ah* non-compliant activities, thus violating *Sharī'ah* principles. Upon discovering this non-compliance, the investment company must take immediate action to divest from the company's stock, ensuring that its investments align with *Sharī'ah* principles. Failure to promptly rectify this *Sharī'ah* non-compliance could result in the investment company losing its *Sharī'ah* compliant status.¹²²

f) Matters Not Covered by *Sharī'ah* Screening Criteria

Matters not covered by *Sharī'ah* screening criteria include factors such as disregarding *Sharī'ah* audits or advice from *Sharī'ah* boards or violating *Sharī'ah* principles in the company's ongoing operations. Ignoring such guidance or engaging in activities contrary to *Sharī'ah* principles can lead to non-compliance.¹²³ For example, a *Sharī'ah* compliant investment company that focuses on trading stocks in compliance with *Sharī'ah* and diligently screens potential investments to ensure they align with *Sharī'ah*

¹²² Ayub, 105–108.

¹²³ Vogel, Frank E., and Samuel L. Hayes III. *Islamic Law and Finance: Religion, Risk, and Return*, (The Hague: Kluwer Law International, 1998), 140–143.

guidelines, avoiding businesses involved in activities such as alcohol, gambling and interest-based finance, decides to invest in a company that operates in the technology sector. The company has a strong track record of innovation and growth, making it an attractive investment opportunity. However, after the investment is made, it comes to light that the company has recently issued a bond to raise capital for expansion. While issuing bonds is a common practice in conventional sector, it involves paying interest, which is not permitted in *Sharī'ah* due to the *Sharī'ah* prohibition of *ribā*. The investment company's *Sharī'ah* board reviews the situation and advises divesting from the company's stocks due to its involvement in interest-based transactions. Despite the company's strong performance and potential for growth, the investment company prioritizes adherence to *Sharī'ah* principles and decides to sell its stocks in the company and maintains its *Sharī'ah* compliant status upholding its commitment to ethical and *Sharī'ah* compliant investing practices.¹²⁴ A solution to this issue could be ensuring continuous *Sharī'ah* compliance audits. The investment company could implement more frequent reviews of its portfolio, ensuring that any changes in the financial activities of invested companies are flagged promptly. Additionally, adopting a risk management strategy that includes criteria for timely divestment from non-compliant investments helps mitigate the financial and reputational risks while maintaining *Sharī'ah* adherence. Furthermore, the company could explore alternatives like *sukūk* as a more suitable investment vehicle that complies with *Sharī'ah* principles.

¹²⁴ Zubair Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects*, (New York: Palgrave Macmillan, 2005), 150.

5.2.3.2 Disinvestment of *Sharī'ah* Non-Compliant Stocks

Another important *Sharī'ah* issue pertaining to custody of stock is on disinvestment of *Sharī'ah* non-compliant stocks of a company that has been declared as *Sharī'ah* non-compliant company. The *Sharī'ah* Governance Regulations 2018 provides that such stocks should be disinvested in a period of one year.¹²⁵ The Regulations giving one year, appears to be motivated by business considerations. From the perspective of *Sharī'ah*, an individual stock investor, on becoming aware of the impermissibility of his stock, should immediately disinvest it. Continuation of the holding of *Sharī'ah* non-compliant stock is act of disobedience. It also amounts to cooperating in the acts of sin. If the stock investor delays disinvestment, till the value of his stock becomes at par with his investment or above it, then it means he prefers his monetary benefits over *Sharī'ah* requirements.¹²⁶ Taqī 'Usmani hold the view that a minority stockholder on becoming aware of company's interest-based borrowing and lending should record his protest on AGM (annual general meeting). By doing this, he is no longer responsible for these impermissible activities, nor does he bear any sin. The whole responsibility lies with the directors or policy makers in the company. And since he is not responsible for anything, he may not need to disinvest his stocks.¹²⁷

It is pertinent to mention here that this view has not been subscribed by any Muslim scholar in the world because this opinion implies that even after knowing that the company is involved in interest-based borrowing and lending, he is not required to disinvest. Some *Sharī'ah* scholars do not agree with this approach. In their opinion, when a stockholder becomes aware that the company is involved in interest-based

¹²⁵ *Sharī'ah* Governance Framework Regulations 2018, s 13.

¹²⁶ El-Gamal, 110-115.

¹²⁷ Taqī Usmanī, *Islam Aur Jadid Maeeshat Wa Tijarat*, (Islam and Modern Economics and Trade), (Karachi: *Idārat ul Ma'ārif*, 1996), 87.

borrowing and lending and does not discontinue his relationship with it, he becomes part of this impermissible act. So, he should give up his relationship with the company by disinvesting his stock. Disinvestment is an act of repentance (*tawbah*) from sin and to continue stockholding in the company is like insistence on the act of sin.¹²⁸

On the methodology of disposal of *Shari'ah* non-compliant stocks, the respondents were of the view that if a person invested in *Shari'ah* compliant stock and subsequently declared *Shari'ah* non-compliant, he should dispose it off.¹²⁹ They had, however, divergent views regarding the methodology and period of disinvestment of *Shari'ah* non-compliant stock. One respondent observed that the stock investor, who knew about *Shari'ah* non-compliance of stock, should disinvest it in shortest possible time. This time should not exceed ninety days. If value of his stock appeared to be more than his cost or equal to his cost, before this period then he should not wait even for ninety days. He should immediately disinvest it.¹³⁰ Another respondent said that the non-*Shari'ah*-compliant stock should be sold immediately. If the price is lower than cost price, then he may wait for maximum 90 days and profit or dividend of this period should be charitized.¹³¹ Few respondents observed that if the price of stock on the day of its declaration as *Shari'ah* non-compliant, is above the cost price, then the stock investor should immediately dispose it off. But if the disposal value current price is less than his cost price then he should hold it till it becomes equal to cost price. For calculating price, he can add to it dividends on it. But if he did not dispose it of while

¹²⁸ Ashraf Muḥammad Duwābah, *Al-Istithmār wā al-Mudārabah fī Ashūm al-Bunūk al-Taqlidiyyah wā al-Sharikāt al-Taqlidiyyah-Ru'yah Islāmiyyah* (Investment in Shares of Conventional Banks and Companies from *Shari'ah* Perspective), (paper presentation, Islamic Banking in Theory and Practice, Dubai, June 2, 2020).

¹²⁹ Respondents 101, 102, 103, 104, 105, 111.

¹³⁰ Respondent 102.

¹³¹ Respondent 104.

its current value is more than its cost price, then he has to give the capital gain on it as charity. He is not allowed to retain capital gain or dividends.¹³²

5.2.3.3 Income of Non-Sharī'ah Compliant Stocks

A significant *Sharī'ah* issues pertaining to custody of stocks is on income of non-*Sharī'ah* compliant stocks which needs to be purified when the company is *Sharī'ah* compliant, but it has generated some illegitimate income either from *ḥarām* business activity or interest-based lending. If the illegitimate income does not exceed the prescribed threshold which is five percent of the total income in case of Pakistan and five percent, ten percent and twenty five percent in case of Malaysia, then such income has to be purified. The methodology of purification of illegitimate income in PSX is to deduct the amount of *Sharī'ah* non-compliant income from the total income. *Sharī'ah* non-compliant income is treated as liability and credited into charity account.¹³³ It is necessary that this illegitimate income be purified before the distribution of dividends.

On this issue, all respondents endorsed the above position that illegitimate income must be purified before the distribution of dividends.¹³⁴

A question arises here regarding whether a stockholder can keep the profit when the *Sharī'ah* status of a company changes and consequently he disinvests his stocks. According to the *Sharī'ah* scholars, the stockholder can keep the profit proportional to the percentage of the business that was *Sharī'ah* compliant. The remaining profit must be purified. For example, if the value of stocks is Rs. 100 and the stockholder sells them

¹³² Respondent 114.

¹³³ Salman Ahmad Shaikh, "Analysis of Islamic Mutual Funds Operations in Pakistan," MPRA, July 1, 2012, <https://mpa.ub.uni-muenchen.de/42495/1/MPRA_paper_42495.pdf>; Kabir Hasan and Michael Mahlkecht, *Islamic Capital Markets: Products and Strategies*, (United Kingdom: John Wiley & Sons, 2011), 125.

¹³⁴ Respondents 1-18.

for Rs. 120, the profit is Rs. 20. If looking at financials of the company, it appears that 50 percent of the company was *Shari'ah* compliant, the stockholder is allowed to keep Rs. 10 of the profit. The remaining Rs. 10, which corresponds to the non-compliant portion, must be purified.¹³⁵

Another question is whether a stockholder can receive dividends if the *Shari'ah* status of a company changes to non-compliant and he does not disinvest his stocks for one year and in the meantime the company declares its dividends. Majority of *Shari'ah* scholars hold the same view that the stockholder can receive dividends corresponding to the *Shari'ah* compliant portion of the business and the remaining portion must be purified. For example, if a company distributes Rs. 200 as dividends and 60 percent of its business is *Shari'ah* compliant, the stockholder can keep Rs. 120. The remaining Rs. 80, corresponding to the non-compliant portion, must be purified.

The respondents generally agree this viewpoint. One respondent was of the view that profits of disinvestment after change of status, can be retained by the stockholder because he is not responsible for impermissible business.¹³⁶

5.2.3.4 Position of Beneficial Ownership of Stocks

Position of beneficial ownership of stocks is another important *Shari'ah* issue pertaining to custody of stocks. As stated earlier, the stocks, after the settlement of trade, are shifted to CDC. The CDC holds the legal ownership of stocks. In the company's register, the name of CDC is mentioned as an owner.¹³⁷ In other words, stocks are registered in CDC's name. The stockholders are treated as beneficial owners not the legal owners.

¹³⁵ Respondents 1-18, This opinion corresponds with a fatwa of Ibn Taymiyyah which states that if *haram māl* is mixed with *halal māl*, *haram* portion should be separated from the whole and remaining is *halal* for the owner. See, Ibn Taymiyyah, *Majmu' al-Fatawa*, (Beirut: Dār al-Ma'rifah, 2005), 29:73.

¹³⁶ Respondent no. 114.

¹³⁷ Usmanī, *An Introduction*... 181-182.

This distinction between legal ownership and beneficial ownership raises some questions: Does Islamic law recognize the concept of beneficial ownership? Does beneficial ownership qualify to be a real ownership in *Sharī'ah*?

To answer the above questions, we observe that the Ḥanafis use two terms to convey the meaning of beneficial ownership that are *milk al-manfa'ah* (ownership of usufruct) and *haqq al-intifa'* (right to benefit) in *ijārah* and *qard* contracts.¹³⁸ Zuhaili asserts that Ḥanafis use them as interchangeable terms.¹³⁹ According to Ḥanafis, *haqq al-intifa'* entitles the holder to benefit himself or make someone else owner of that benefit and usufruct. As such, the concept of beneficial ownership does exist in Hanafi school, though its connotation is narrow as compared to its use in the modern sense of the word where the owner holds all disposal rights except right to legal title. The Maliki definition of ownership also accommodates the concept of beneficial ownership. According to the Mālikis, ownership is a legal authority over corpus of a property and its benefit.¹⁴⁰ Thus, this definition of ownership covers beneficial ownership. The Shafi'is also cover in their definition of ownership, concept of beneficial ownership for its holder. In their opinion, ownership is a legal authority over a property that enables a person to benefit from it.¹⁴¹ Shafi'i jurist Suyuti opines that whoever holds *milk al-intifa'* (beneficial ownership) has the right to transfer this beneficial ownership to a third party".¹⁴² In other words he gives the owner certain rights. Ḥanbalis also endorse the Shafi'is view. Ibn al-Qayyim uses the term *tamlik al-manfa'ah* to signify the meaning of beneficial ownership. In his view the owner has the right to benefit himself or transfer

¹³⁸ Kasānī, 6:188.

¹³⁹ Zuhailī, *Al-Fiqh...* 4:60.

¹⁴⁰ Al-Qaraḥī, 30.

¹⁴¹ Al-Ramlī, *Nihayah al-Muhtāj*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1996), 4:255.

¹⁴² Jalāl al-Dīn Suyūṭī, *Al-Ashbah wā al-Nazā'ir*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1411 H), 326.

this benefit to someone else.¹⁴³ The above opinions of classical jurists establish that they recognize the concept of beneficial ownership. In their opinion, the owner of beneficial ownership holds certain ownership rights. It is however, worthy to note that classical connotation of beneficial ownership is not as wide as modern connotation of beneficial ownership, because the holder of beneficial ownership in classical law is not allowed to sell or gift the property in his control, while the beneficial owner in the modern usage, has all disposal rights except that he does not have its title. Thus, beneficial ownership of classical Islamic law may be termed as *milk al-nāqis* (incomplete and deficient ownership).

In recent times, many prominent *fiqh* bodies and institutions have examined the issue of beneficial ownership and have accorded their recognition to it. These institutions include *Sharī'ah* Board of State Bank of Pakistan (SBP), OIC Islamic *Fiqh* Academy, AAOIFI, *Sharī'ah* Advisory Council of Bank Negara Malaysia, *Sharī'ah* Committee of Rajhi Bank in the Kingdom of Saudi Arabia (KSA) and Islamic Financial Services Board (IFSB).¹⁴⁴ *Sharī'ah* Board of SBP holds the view that beneficial ownership is permissible with the condition that the beneficial ownership must result in all rights and liabilities attached to the purchase, albeit short of legal title.¹⁴⁵ According to OIC Islamic *Fiqh* Academy, beneficial ownership must be scrutinized according to *Sharī'ah* guidelines and the same process must be used for its recognition.¹⁴⁶ AAOIFI *Sharī'ah* board has acknowledged beneficial ownership in an implied and implicit manner that beneficial ownership is recognized from the *Sharī'ah*

¹⁴³ Ibn al-Qayyīm, *Badā'i' al-fawā'id*, (Beirut: Dār al-Kitāb Al-‘Arab, 1993), 3.

¹⁴⁴ Adawiah, E. R., Klopich, N., Elias, M. R. F., & Haron, M. N., “Application of the Concept of Beneficial Ownership in Sukūk Structures: An Islamic Legal Analysis”, *ISRA International Journal of Islamic Finance*, vol. 7, no.2 (2015): 105-133.

¹⁴⁵ SBP Circular No. 12.

¹⁴⁶ International Fiqh Academy, *Resolutions and Recommendations of the International Islamic Fiqh Academy*, (Sharjah: 1430 AH), 9th Session.

perspective.¹⁴⁷ SAC of Bank Negara Malaysia more specifically, discussed the beneficial ownership in the context of *ijārah* assets.¹⁴⁸ The SAC, resolved that the lessor is the owner of the leased asset although his name is not registered in the asset's title.¹⁴⁹ The resolution was based on the *Shari'ah* recognition of both legal title and beneficial ownership. The SAC recognized that in products based on *ijārah* the lessor has the beneficial ownership although the asset is not registered under his name. The council further stated that such beneficial ownership may be proven through the documentation of the *ijārah* agreement concluded between the lessor and the lessee and presumably the purchase agreement between the seller and lessor/purchaser.¹⁵⁰ As per IFSB, a mandatory feature of ownership is that the ownership right must be transferred to the original stock investor that is a stockholder in this case and the registration title may not necessarily be in the name of beneficial ownership.¹⁵¹

The modern *Shari'ah* scholars like Zarqa,¹⁵² Taqi 'Usmani,¹⁵³ Yousuf al-Shubaili,¹⁵⁴ Muḥammad 'Uthman Shabbir,¹⁵⁵ 'Abd al-Sattar Abu Ghuddah,¹⁵⁶ 'Abd Al-Razzaq Abd al-majid,¹⁵⁷ recognize the concept of beneficial ownership in the modern sense of the word. The recognition of beneficial ownership is clearly observable the

¹⁴⁷ Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Shari'ah Standards: Ijārah wa Ijārah Muntahiyah bil Tamlik*, (Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions, 2008).

¹⁴⁸ SAC, 2010, 6.

¹⁴⁹ Bank Negara Malaysia, *Sharī'ah Resolution in Islamic Finance*, (Kuala Lumpur: Bank Negara Malaysia, 2nd ed., 2010), 45.

¹⁵⁰ Ibid.

¹⁵¹ ISRA, *Islamic Capital Markets: Principles and Operation*, (Kuala Lumpur: International Sharī'ah Research for Islamic Finance, 2015), 25.

¹⁵² Zarqa, *Al-Madkhal ila Nazariyyah al-Iltizam Al-'Ammah*, (Damascus: Dār al-'Ilm, 1999), 45.

¹⁵³ Taqī 'Usmanī, *Buhuth fi Qadaya Fiqhiyyah Mu'asirah*, (Damascus, Dār al-Qalam, 2003), 84.

¹⁵⁴ Shubaili, *Haqq al-Intifa' al-'Iqari*, (Kuwait: Fourth Fiqh Conference of Islamic Financial Institutions, 2011).

¹⁵⁵ Shabbir, *Al-'Itiyād 'an Haqq al-Intifā' wā Tatbiqātuhū al-Mu'asirah fi al-Fiqh al-Islamī wā al-Qanūn al-wad'i*, (Kuwait: Second International Fiqh Conference for Islamic Financial Institutions, 2005), 9.

¹⁵⁶ Abū Ghuddah, *Haqq al-Intifa' al-'Iqari*, (paper presentation, Fourth Fiqh Conference for Islamic Financial Institutions, 2011).

¹⁵⁷ 'Abd al-Msjid, 'Abd Al-Azzaq, "Tatbiq al-Milkiyyah al-Qānūniyyah wā al-Milkiyyah al-Nāfi'yyah fi al-Tamwīl al-Islāmī", *Journal of Al-Shariqah University*, vol. 13, no.1 (2016): 12.

modern Islamic juristic literature in two fields which are beneficial ownership of stocks and beneficial ownership of *ṣukūk*.

From the above discussion, it may be concluded that Islamic law recognizes the concept of beneficial ownership. The respondents for this study also endorsed and validated the stance of modern *Sharī'ah* scholars and *fiqh* institutions that beneficial ownership of stocks is a valid ownership from the perspective of *Sharī'ah*.¹⁵⁸ Majority of them have held that *Sharī'ah* recognizes the beneficial ownership as there is no text or rule prohibiting it. The stockholder enjoys full authority to dispose of his stocks. This freedom of disposition in the stocks (*ḥuriyyat al-taṣarruf*) by the owner is a valid ground for validity and *Sharī'ah* permissibility of beneficial ownership. They held that the beneficial ownership is the real ownership when all the risks and rewards relating to the stock are transferred to the beneficial owner. There is no issue if the legal title remains with the CDC.¹⁵⁹

5.2.3.4 Payment of Zakāt of Stocks

Another important *Sharī'ah* issue pertaining to custody of stocks is on payment of *zakāt* of stocks. The issue of payment of *zakāt* of stocks, is subject to interpretation within Islamic jurisprudence. The generally accepted view in modern Islamic law is that stocks owned for investment purposes are generally subject to *zakāt*. These are stocks bought with the intention of holding them for the long term, with the aim of earning dividends and capital appreciation rather than for short-term trading. This is the view of International *Fiqh* Academy, Jeddah and Abu Zahrah. *Zakāt* is assessed at the end of

¹⁵⁸ Respondents 101-118.

¹⁵⁹ Respondents 101, 102, 103, 104, 105, 106, 107, 111, 112, 114 and 115.

the lunar year (*ḥawl*).¹⁶⁰ If the total value of the stocks, along with other *zakātable* assets, meets or exceeds the *nisāb* (minimum threshold), *zakāt* becomes obligatory. The *zakāt* rate is usually set at 2.5% of the total value of *zakātable* assets, including the market value of the stocks. In the opinion of Abu Zahrah, a stock is like tradeable assets (*‘urudh tijariyyah*), so it is *zakātable*.

Taqi ‘Usmani differentiates between *zakātable* assets of a company and non-*zakātable* assets. In his view, *zakātable* assets of a company includes liquid assets such as cash, receivables, raw material and manufactured goods. Non-*zakātable* assets are the fixed assets such as building and machinery. A stock represents both *zakātable* and non-*zakātable* assets. Thus, if the *zakātable* assets of the company are 60 percent of the total assets and non-*zakātable* assets are 40 percent of the total assets a stockholder will not pay on the total value of stock. Instead, he will pay *zakāt* on 60 percent of the total value of stock. If, for example, the current market value of stock is Rs. 100, he will pay *zakāt* on Rs 60, not on Rs 100 which is the total value of stock. This means that he will pay 2.5% of Rs 60 because remaining Rs 40 are not *zakātable*.¹⁶¹

However, this opinion does not seem to be practicable, because it is difficult to investigate how much assets of the company are liquid (*zakātable*) and how much are illiquid and fixed (non-*zakātable*). So, the preferred opinion is of Abu Zahrah that a stock is like *‘urudh tijariyyah* so *zakāt* will be paid on total market value of stocks.

In addition to it the dividends received from stocks are subject to *zakāt* if they meet the *nisab* and *ḥawl* criteria. There are differing opinions among scholars regarding whether dividends should be included in the total wealth calculation for *zakāt*. Taqī

¹⁶⁰ Abū Zahrah, Payment of Zakāt of Stocks in *Modern Islamic Law*, (Jeddah: International Fiqh Academy), 59.

¹⁶¹ Muḥammad Taqī Usmani, *An Introduction to Islamic Finance* (Karachi: Maktaba Ma‘arifur Qur’an, 1998).

‘Usmani and Muḥammad ibn Adam al-Kawthari argue that since dividends represent income generated by the stocks, they should be included,¹⁶² while Ibn Bāz and Ibn ‘Uthaimin suggest that *zakāt* should be paid only on the value of the stocks themselves.¹⁶³

Furthermore, the profit gained from selling stocks at the same time is subject to payment of *zakāt* if the profit, along with other assets, meets the *niṣāb* and *ḥawl* criteria. However, if the profit is reinvested immediately, some scholars argue that *zakāt* is not due until the end of the *ḥawl* period when the profit becomes part of the total *zakātable* assets.¹⁶⁴

There are different methods for calculating *zakāt* on stocks and related earnings. Al-Qaradawi recommends using the market value of the stocks at the end of the lunar year to calculate *zakāt*. This involves determining the total value of all *zakātable* assets, including the market value of the stocks, at the end of the *ḥawl* period.¹⁶⁵ The Islamic *Fiqh* Academy suggests using the average market value of the stocks throughout the year for calculation purposes. This method involves averaging out the market value of the stocks over the entire lunar year.¹⁶⁶

¹⁶² Taqī ‘Usmanī and Muḥammad ibn Adam al-Kawthari generally hold the view that dividends should be included in the total wealth calculation for *zakāt*, considering them as part of one's wealth subject to *zakāt* if they meet the *niṣāb* and *ḥawl* criteria. See, Taqī ‘Usmanī, *Contemporary Issues in Islamic Finance*, (Karachi: Maktaba Ma‘āriful Qur‘ān, 2001), 132-135; Muḥammad ibn Adam al-Kawtharī, *Islamic Guide to Zakat*, (London: White Thread Press, 2010), 87-89.

¹⁶³ ‘Abdul-‘Aziz Ibn Bāz and Ibn ‘Uthāimin have held the view that dividends should not be included in the *zakāt* calculation. Their stance was often conservative and adhered closely to traditional interpretations of Islamic law. See, Ibn Bāz, ‘Abdul-‘Aziz, *Fatāwa Ibn Bāz*, (Riyadh: Dārussalam, 1996), 112-115; Ibn Uthaimin, *Majmoo‘ Fatāwa Ibn ‘Uthāimin*, (Riyadh: Dār Al-Watan, 2003), 243-245.

¹⁶⁴ Nizam Yaquby and Monzer Kahf hold the view that profit from selling stocks should be treated similarly to other forms of wealth and *zakāt* would be applicable if the profit, along with other assets, meets the *niṣāb* and *ḥawl* criteria.

¹⁶⁵ Yusūf al-Qaradawi has expressed opinion favoring the use of the market value of stocks at the end of the lunar year for *zakāt* calculation purposes. See, Yusūf Al-Qaradawi, *Islamic Finance: The Principles of Zakah*, (Cairo: Dār Al-Qalam, 2002), 76-82.

¹⁶⁶ Islamic *Fiqh* Academy has favored a more conservative approach to *zakāt* calculation and have argued for a simpler method of calculation, favoring a straightforward assessment of assets without considering fluctuations in market value. See, Islamic *Fiqh* Academy, "Guidelines on Zakāt Calculation", <<https://www.islamicfiqhacademy.org/guidelines-zakat-calculation>>, (accessed 3 July 2024).

The preferred opinion on the payment of *zakāt* on stocks, is the first view that suggests that stocks should be treated like tradeable assets and *zakāt* should be paid on the total market value of the stocks at the end of the lunar year if the total value meets or exceeds the *niṣāb* (minimum threshold). This approach simplifies the calculation process and ensures that *zakāt* is paid on the full value of the investment, aligning with the principle of *zakāt* as a means of wealth purification and redistribution.

5.2.3.5 Liability of Stockholder

Liability of stockholder is another important *Sharī'ah* issue pertaining to custody of stocks. Limited liability of stockholder in the modern business law means that liability of a stockholder towards the debts owed by the company, is limited to the extent of his capital share only and does not include his personal assets. Here a question arises: From the perspective of *Sharī'ah*, is a stockholder's liability in a company limited to their shares, or does it extend to their personal assets? In other words, is the liability limited or unlimited?

AAOIFI, International *Fiqh* Academy and Modern *Sharī'ah* scholars such as Taqi 'Usmani,¹⁶⁷ Wahbah Zuhaili¹⁶⁸ and Abdul Aziz Khayyat,¹⁶⁹ recognize concept of limited liability. AAOIFI states that it is permissible to restrict the liability of a company to its paid-up capital if this is made public, in order to make the customers of the company aware of the financial position of the company without uncertainty or lack of transparency.¹⁷⁰ International *Fiqh* Academy endorses the position of limited liability of the stockholders stating that there is no objection in *Sharī'ah* for setting up a company

¹⁶⁷ 'Usmanī, *An Introduction*...224.

¹⁶⁸ Zuhailī, *Al-Fiqh al-Islāmī*... 4:881.

¹⁶⁹ Khayyat, *Al-Sharikat fī Al-Sharī'ah al-Islāmīyyah wa Al-Qanun al-Wad'i*, (Amman: Dār Albashir, 1994), 89.

¹⁷⁰ AAOIFI, *Sharī'ah* Standard no. 12, Art. 4.1.2.9.

whose liability is limited to its capital because that is known to the company stock investor and such awareness on their part precludes deception.¹⁷¹

Taqi ‘Usmani draws analogy between the liability of *rabb al-māl* in *muḍarabah* and liability of stockholder. He maintains that in *muḍarabah*, liability of *rabb al-māl* is restricted to his capital. A *muḍarib* is not allowed to raise financial liability of *rabb al-māl* by buying on credit beyond the capital of *muḍarabah* and raising loans on account of *muḍarabah*. This is known as *istidānah* in Islamic law and *istidānah* is not allowed for *muḍarib*. If he enhances financial liability of *rabb al-māl*, then he alone is liable for that. Similarly, stockholder is liable only to the extent of his capital amount.¹⁷²

In modern Islamic finance, the concept of limited liability is generally accepted and practiced. This means that stockholders' liability is limited to the amount of their investment in the company. In other words, if a company goes bankrupt or faces legal claims, stockholders are only liable to lose the amount of capital they have invested in the company and their personal assets are generally protected. This concept aligns with the broader principles of fairness and risk-sharing in Islamic finance.¹⁷³

However, according to *Dār al-Iftā*, *Jamī‘ah al-‘Ulūm Islamiyyah*,¹⁷⁴ and Nyazee¹⁷⁵ the Islamic law does not acknowledge limited liability of stockholder. *Dār al-Iftā*, in its *fatwā* against prevailing Islamic banking practices in Pakistan, criticized the concept of limited liability on which banking companies are built. In the opinion of authors of *fatwā* Islamic law of partnership provides for unlimited liability of partners.¹⁷⁶ Nyazee argues that *Sharī‘ah* principles establish the idea of liability through

¹⁷¹ *Resolutions and Recommendations of International Fiqh Academy*, (Jeddah, 2000), 130.

¹⁷² ‘Usmanī, *Islam aour Jadid...*, 81.

¹⁷³ Anas Zarqa, *Islamic Economics: An Approach to Human Welfare*, (New York: Palgrave Macmillan, 2015), 102-104.

¹⁷⁴ Jamī‘ah al-‘ulūm Islamiyyah, *Current Islamic Banking: Sharī‘ah Analysis, Fiqhi Evaluation*, (Karachi, *Dār ul Iftā, Maktaba Bayyinah*, 2009), 130.

¹⁷⁵ Aḥsan Nyazee, *Islamic Law of Business Organization Partnerships*, (Islamabad: IRI, 1998), 90.

¹⁷⁶ Jamia al-‘Uloom al-Islāmīyyah, 130.

the general principle of *al-kharāj bi-al-ḍamān*. This principle suggests that a person's entitlement to profit from an investment is directly linked to his liability for any losses or liabilities incurred from the business venture. Therefore, if someone's liability is limited, their profits should also be limited proportionately. Stockholder shouldn't benefit from profits stemming from credit or debt for which they aren't liable. Consequently, a stockholder's liability in Islamic business organizations is considered unlimited across all lawful transactions.¹⁷⁷

Despite the acceptance of limited liability in modern Islamic finance, there are ongoing debates and discussions about the ethical implications. Critics argue that limited liability can lead to moral hazard, where stockholders may engage in risky behaviour knowing that their personal assets are protected. Proponents, however, contend that limited liability encourages investment and entrepreneurship, which are essential for economic development.¹⁷⁸

While comparing both the positions the preferred view, is that limited liability is allowed in Islamic law. The concept of limited liability has gained a great degree of acceptability and recognition in the modern Islamic jurisprudence. AAOIFI, International *Fiqh* Academy and majority of *Sharī'ah* scholars uphold this position. While comparing both the opinions the researcher is of the view that limited liability of the stockholder is acceptable in Islam and there is consensus of all international *fiqh* bodies on this and this is close to fairness and it protects the rights of stock investors and encourages investments.

¹⁷⁷ ‘Usmān Nawāz, “Liability of Shareholder from *Shari’ah* Perspective: A critical Appraisal”, *Journal of Managerial Sciences*, vol. 14, no.4 (2020): 25.

¹⁷⁸ ISRA, *Islamic Capital Markets: Principles and Operation*, (Kuala Lumpur: International *Sharī'ah* Research for Islamic Finance, 2015), 38.

5.3 LEGAL ISSUES IN POST STOCK TRADING PRACTICES IN PSX

The legal issues in post stock trading practices in PSX can be classified into the following categories: legal issue pertaining to clearing of stocks, legal issue pertaining to settlement of stocks and legal issue pertaining to custody of stocks.

5.3.1 Legal Issues Pertaining to Clearing of Stocks

The legal issues involved in post stock trading practices pertaining to clearing of stocks include: i) non-transfer of stocks to CDC account and ii) unauthorized use and movement of stock investors' stocks.

5.3.1.1 Non-Transfer of Stocks to CDC Account

A significant legal issue pertaining to clearing of stocks is on non-transfer of stocks to CDC account. Under the prevailing regulatory regime, a brokerage firm is required to transfer the stocks purchased by it for its stock investors to CDC account.¹⁷⁹ This is an important condition and requirement of clearing of stocks. It is found that many brokerage firms are found in breach of this requirement. They keep those stocks in their account and use them for proprietary trading or for pledging with financial institutions to obtain loan or some financing facilities. On the complaint of stock investor, the CDC and SECP initiated legal proceedings against such brokerage firms and took judicial action against them.

In *SECP v. F.M Stocks (Private) Limited*,¹⁸⁰ proceedings were initiated through show cause notice dated January 9, 2015, issued to F.M Stocks (Private) Limited (the

¹⁷⁹ Hussain, Tariq, "Ensuring Regulatory Compliance in Pakistan's Stock Market", *Journal of Financial Regulation and Compliance*, vol. 19, no.2 (2018): 95-99.

¹⁸⁰ *SECP v F.M Stocks (Private) Limited* [2015] CLD 30.

respondent) under section 22 of the Stocks and Exchange Ordinance 1969 read with rule 8 of the Brokers and Agents Registration Rules 2001.

The SECP received a complaint from Mr. Murtaza Maqsood Lari (the complainant) alleging that he bought 1,000 stocks of DG Khan Cement Limited and 1,000 stocks of Jahangir Siddiqi Company Limited in the year 2010 through the respondent and subsequently sold-these stocks on November 6, 2014. However, during the period of four years, his aforesaid stocks have never been transferred in his CDC sub-account No. 1362. In this regard the complainant provided the ledger statements dated August 5, 2010, August 2010 and November 6, 2014, issued by the respondent which confirmed that the complainant bought the aforesaid stocks. Furthermore, the account activity report of the sub-account of the complainant maintained under the participant ID of the respondent ascertained from CDC has shown that no such holding has ever been transferred into the CDC sub-account of the complainant.

The respondent vide letter dated December 18, 2014, was asked to clarify its position as to why the said stocks were not kept into the complainant's CDC account. However, the respondent failed to provide any cogent reason in this regard. In accordance with regulation 41(1)(b) of the General Regulations of the LSE, the respondent was required to keep the stocks bought for the complainant in his CDC sub-account maintained under the participant ID of the respondent. Moreover, condition 7(a) of the special terms and conditions of the Standardized Account Opening Form (SAOF) annexed in the regulations provides that the respondent was responsible to ensure the delivery of CDC eligible stocks in the CDC account of the complainant subject to full payment by the complainant. Therefore, the show cause notice was issued to the respondent under section 22 of the ordinance read with rule 8 of the Broker Rules for prima facie contravention of the regulations and condition 7 of the SAOF.

Hearing in the matter of aforesaid show cause notice was scheduled for January 23, 2015, at the Commission Office, Islamabad which was attended by Mr. Fakhar Mirza, Chief Executive Officer (CEO) of the respondent. During the course of hearing, the CEO of the respondent submitted that the complainant purchased the stocks four years ago. At that time, they hired a new employee and he mistakenly transferred the stocks in another stock investor's account. Since the complainant has not done any other transaction in his account during the past four years and the quantity of stocks was very negligible, therefore, the said matter got unnoticed and overlooked. He further submitted that the moment said mistake was pointed out by the complainant, they rectified it immediately and resolved all the issues with the complainant. He further, apprised that necessary changes have been made in their system to ensure that accounts of other stock investors are being maintained in accordance with requirements of the law. In the end, he admitted his mistake and prayed that the said mistake was unintentional, therefore, a lenient view may kindly be taken.

After hearing the respondent and examining the facts, evidences and documents on record, in addition to written and verbal submissions made by the respondent, the SECP held the view that the respondent has not acted in accordance with the regulations by not transferring the stocks in the CDC account of the complainant. However, considering the arguments submitted by the respondent and the fact that the said complaint has already been settled by the respondent, it took a lenient view and a penalty of Rs. 10, 000 was imposed on the respondent. Moreover, the respondent was directed to be vigilant while discharging its responsibilities as brokerage firm. The respondent is further directed to ensure full compliance with the ordinance, rules, regulations and directives of the commission and stock exchange.

The above legal case establish that brokerage firm was in breach of regulatory requirement of transfer of stock investor's stocks to the CDC, which is an integral part of clearance function. It is observable in the above case that the concerned brokerage firm kept the purchased stocks in its sub-account and did not transfer to CDC account. In this case, the respondent brokerage firm failed to satisfy CDC tribunal as to why it did not transfer stocks to CDC account. It is worthy to mention that transfer of stocks in CDC account is the only proof of ownership of stockholder, thus, non-transfer has serious implications for the owner. Besides, it badly shatters the confidence of stock investors in the integrity and efficiency of stock market.

5.3.1.2 Unauthorized Movement of Stock Investor Stocks

Another important legal issue of the clearing of stocks is on an unauthorized movement of stock investor stocks by brokerage firms. This practice includes using stock investor stocks for proprietary trading, pledging them for loans, or transferring them without the stock investor's approval. Such actions constitute a serious breach of trust and regulatory compliance, posing significant risks to the financial system.

The regulatory framework aims to protect stock investors' assets by stipulating that brokerage firms must obtain explicit authorization before transferring stock investor stocks. This requirement is detailed in regulation 6.7.2 of the CDC regulations and rule 12 of the Brokers and Agents Registration Rules 2001. These provisions are designed to ensure that stock investors maintain control over their assets and are informed of any actions taken by the brokerage firms.

In some cases, brokerage firms are found guilty of the unauthorized movement of stock investor stocks in CDC account of their customers which invoked legal proceeding against the brokerage firms. In *CDC v. M/s. First National Equities*

Limited,¹⁸¹ SECP received a complaint against First National Equities Limited regarding handling stock investors' stocks without approval from his CDC account. It was alleged by the complainant that respondent failed to resolve the matter despite of several reminders. On April 5, 2013, the respondent conveyed in writing to the complainant his willingness to pay the sale returns against disinvestment of stocks. The statement made by the respondent hence proved that the complainant's stocks were handled without his due approval. Therefore, several provisions of CDC Act 1997 and Brokers and Agents Registration Rules 2001 are applied to this matter. The Brokers and Agents Registration Rules 2001 provides that if a brokerage firm doesn't follow the rules laid out in their code of conduct, they can get their registration suspended.¹⁸² It also provides that brokerage firm holding a certificate of registration under the rules shall abide by the code of conduct specified in the third schedule.¹⁸³

The CDC Act 1997 regarding handling book-entry stocks without authority provides that a participant shall not handle or authorize or permit any handling of book-entry stocks entered in the sub-accounts maintained under his account without authority of the sub-account holder. It also provides that a participant shall not, except with the authority of his stock investors, handle or authorize or permit any handling of book-entry stocks beneficially owned by such stock investors and entered in his account.¹⁸⁴

It is apparent from the abovesaid facts that the respondent has infringed rule 8 (iv) and rule 12 of the Brokers and Agents Registration Rules 2001 read with the section 24 of the CDC Act, 1997. Therefore, the commission called the respondent to appear in person or by attorney on October 23, 2013, and also submit a written answer explaining

¹⁸¹ *CDC v M/s. First National Equities Limited* [2014] PLJ 8.

¹⁸² Brokers and Agents Registration Rules 2001, Rule 8 (iv).

¹⁸³ *Ibid*, Rule 12.

¹⁸⁴ CDC Act 1997, s 24.

the cause by October 21, 2013. The commission therefore declared the respondent guilty for using complainant's stock without his prior approval and fined the respondent for an amount of 500,000 to be furnished in the commission's account within the time period of 30 days.

Another notable case is *DJM Stocks v. CDC*,¹⁸⁵ in which CDC tribunal gave verdict against the DJM Stocks, a brokerage firm, for unauthorized movement of stocks from its sub-account maintained with the above brokerage firm.

The CDC conducted an inspection of records maintained by the appellant for the period from June 01, 2012, to May 31, 2013. As per the inspection report, the appellant was found failure to obtain written authorization in 23 instances, from a sub-account holder, for pledging of stocks with financial institutions, in contravention of provision of regulation 6.7.2 of the CDC Regulations. The chief executive officer of CDC, in exercise of power vested under regulation 14.3.1 (b) of the CDC Regulations, on account of aforesaid non-compliances/violations of CDC Regulations, imposed penalty of Rs. 260,000 on the appellant vide notice dated July 24, 2013.

The appellant challenged the aforesaid notice before CDC tribunal, which, after providing hearing opportunity to both parties upheld the decision of the CEO of CDC and directed to the appellant to pay the penalty of Rs. 260,000/- for regularizing of the non-compliances, within 15 days of the receipt of impugned order.

The appellant filed appeal against the impugned order, to SECP under regulation 14.7.2 of CDC regulations on the grounds that the order of the CDC tribunal is bad in law and wrong on fact of the case. The appellant stated that the learned CDC tribunal has erred in law, on facts of the case a wrongly inferred that the appellant failed to

¹⁸⁵ *DJM Stocks v CDC* [2015] PLJ 9.

provide any written authorization from the sub-account holder for executing pledged transaction with financial institution as well as evidence of sending account balance statements. The appellant also stated that the documentary evidence submitted by them was not considered by the CDC tribunal. He added that as per his understanding/ interpretation of regulation only single general authorization was required to be taken from the relevant sub-account holder for pledging of stocks. He added that all the pledge transactions pointed out by CDC team from-where the stocks were pledged belongs to one of his own family members. She is wife of his brother. We perceived that authorization form is necessary for ordinary sub-account holder. He further stated that she was abroad; therefore, it was not possible to obtain such authorization for 23 times. There was no unauthorized movement except this account. He assured that no such non-compliances will be repeated in future.

In response, the authorized representative of the respondent rebutted the arguments advanced by the appellant and stated that the documents submitted by the appellant were duly considered. In fact, the appellant has misconceived the provision of the CDC Regulations. He added that the appellant admitted that written authorization had not been obtained for each transaction and his assertion was that a general authorization was sufficient to meet the requirement of law. While, according to regulation 6.7.2 of the CDC Regulations, the participant requires a specific prior written authorization from the relevant sub-account holders in favor of the participants for each transaction. Therefore, a prior single authorization is insufficient, as the appellant had made various stock pledges without obtaining the written authorization for each of the transactions.

After hearing arguments of both the parties the commission held that the primary objective of the regulation 6.7.2 and regulation 6.2 A-1 of the CDC Regulations is to

protect the interest and assets of the stock investors. The stock investor must be aware as and when his/her stocks are used by a brokerage firm for pledging purpose. Similarly, it may be recalled that in consequence of stock market crisis 2008, number of brokerage firms were defaulted and investigation of brokerage firms' record disclosed that most of stocks of stock investors were moved from their respective CDC-sub-accounts by the brokerage firms without intimation/prior permission. In some cases, stock investors' stocks were transferred to house account of brokerage firm for pledging with banks for heavy financing and in some cases transferred to *benami* accounts for misappropriation. Therefore, keeping in view the misuse of the stock investors' stocks which may lead to the default of brokerage firms/systematic risks of the market, the regulators inserted specific regulations 6.7.2 and 6.2A.1 in CDC Regulations on August 05, 2009 and made its compliance mandatory.

As such, the commission upheld the order of CDC tribunal and directed the appellant to deposit penalty amount in the relevant account.

In *Mr. Sohail Ahmad v. M/S Harvest Smartened Stocks (Private) Limited*,¹⁸⁶ Mr. Sohail Ahmad, a stock investor of MHSSPL filed a complaint against the brokerage firm regarding unauthorized movement of stocks. It was discovered from the CDC's record that the stocks of said complainant were moved from CDC's sub-account without the prior approval of customer. Hence the commission served a hearing notice to the respondent under rule 8 of the Brokers and Agents Registration Rules 2001 and section 28 of the Central Depositories Act 1997. The respondent was summoned by the commission to appear personally or by attorney by February 20, 2014 and also furnish a written explanation regarding the above-mentioned violations by February 18, 2014. Accordingly, the respondent submitted its written response to the commission and

¹⁸⁶ *Mr. Sohail Ahmad v M/S Harvest Smartened Stocks (Private) Limited* [2014] PLJ 20.

stated that the complaint of the stock investor has been resolved and an amount of Rs. 68,000 due has been paid to him as settlement amount through cheque no. 1821673. Furthermore, the respondent argued verbally regarding the transfer of complainant's stocks without his approval that the respondent faced heavy losses in year 2008 due to stock market crisis and that all the complaints of stockholders have been resolved. But the commission held that the respondent failed to satisfy the commission with a solid reasoning as to why he transferred the stocks of complainant without his prior approval which is a clear violation of the CDC Act 1997.¹⁸⁷ Therefore, the commission declared the respondent as guilty of above-mentioned serious violation and imposed a fine of Rs. 20,0000 to be furnished before the expiry of a period of 30 days.

The unauthorized movement of stock investor stocks violate several key regulations, including regulation 6.7.2 and rule 12 of the Brokers and Agents Registration Rules 2001. These violations result in significant legal consequences, including fines and legal proceedings. More importantly, they undermine the trust stock investors place in brokerage firms and the financial system as a whole.¹⁸⁸

Unauthorized movement of stock investor stocks jeopardize the stock investors' financial interests, leading to potential losses and legal disputes. They also pose a broader risk to the financial market's stability by eroding stock investors' confidence. The regulatory actions taken in these cases reflect the need for stringent enforcement to protect stock investors and maintain the integrity of the financial system.¹⁸⁹

The issues of unauthorized movement of stock investor stocks by brokerage firms represent significant legal challenges in the stock clearing process and highlight

¹⁸⁷ CDC Act 1997, s 24.

¹⁸⁸ 'Aamir Khan, *Stock Market Regulation in Pakistan: SECP and CDC's Role in Legal Enforcement*, (Karachi: National Institute of Management, 2019), 85-88.

¹⁸⁹ Lewis, Mervyn K., *Handbook of Islamic Banking*, (Cheltenham: Edward Elgar Publishing, 2007), 115-118.

the importance of regulatory compliance to maintain market integrity and protect stock investors' interests. It has been proven in some cases that brokerage firms moved stock investors' stocks without his authorization and used them for pledging with financial institutions to obtain financing facilities. In one instance, a court held that stock investors' stocks were transferred to the house account of a brokerage firm for pledging with banks for heavy financing and in other cases, these stocks were transferred to *benami* accounts for misappropriation.¹⁹⁰ The regulatory framework, enforced by the SECP and CDC, aims to ensure that brokerage firms adhere to strict standards, thereby safeguarding the financial market and enhancing stock investors' confidence. Through legal proceedings and penalties, these regulatory bodies work to address breaches and uphold the principles of transparency and accountability in the financial sector.

5.3.2 Legal Issues Pertaining to Settlement of Stocks

There are various legal issues involved in post stock trading practices pertaining to settlement of stocks that include: i) validity of novation in stock settlements and ii) legality of the central counterparty system.

5.3.2.1 Validity of Novation in Stock Settlements

An important legal issue in the settlement of stocks is on validity of novation in stock settlements. In the stock market, all trades executed on an exchange are reported to the NCCPL for settlement. The NCCPL acts as a central counterparty by substituting the original counterparties i.e. the buyer and seller. In this role, the NCCPL becomes the

¹⁹⁰ Khalid Shahid, *Regulation of the Pakistan Stock Market: Legal and Ethical Issues*, (Lahore: Punjab University Press, 2020), 130-135.

buyer to every seller and the seller to every buyer, ensuring that trades are settled efficiently.¹⁹¹

The concept of novation in the stock market raises several legal questions. Firstly, does the novation practiced in the stock market align with the traditional concept of novation as defined in the Contract Act 1872? According to traditional contract law, novation involves an agreement to substitute a new party for one of the original parties in a contract, with the consent of all parties involved.¹⁹² This creates a new contract and releases the original parties from their obligations. However, in the stock market, the original parties are not fully released from their obligations and all claims relating to delivery and payment are addressed to the original parties.

Furthermore, there is a question of whether the buyer and seller, or their respective brokerage firms, have ever entered into a novation agreement with the NCCPL. Does the assignment of settlement duties to the NCCPL amount to a legal substitution of the original counterparties? Additionally, are the original parties absolved of their obligations to each other after the novation and the creation of a central counterparty?

In order to investigate these issues, it seems pertinent to understand the concept of novation in contract law in common law system.¹⁹³ Novation is an agreement to change a contract by substituting a third party for one of the original two parties.¹⁹⁴ It may also be described as the replacement of one of the parties, with the agreement of all three parties involved.¹⁹⁵

¹⁹¹ Tariq Ahmad, *Modern Financial Markets and Instruments*, (Lahore: Finance Publications, 2019), 88-90.

¹⁹² Contract Act 1872, s 62.

¹⁹³ Janson, Nils and et al., *Financial Markets and Legal Novation: An Analytical Perspective*, (New York: Legal Books Publishing, 2015), 128.

¹⁹⁴ Russell Jane, *Dictionary of Banking and Finance*, (London, A & C Black, 1991), 45.

¹⁹⁵ See, <[Investopedia.com/terms/n/novation](https://www.investopedia.com/terms/n/novation)> (accessed 23 June 2024).

It is pertinent to mention here that novation as applied in financial markets, is not the same as conceived in the contract law in common law system. Under the law of the novation, the original party agrees to forgo or surrender any rights offered to it by the original contract. In other words, the parties agree to extinguish the original contract and replace it with an entirely new contract and with a new party. This provides an exit to the original contracting party. On the other hand, the novation as applied in financial markets does not deprive the original contracting parties of their rights nor does it release them of their obligations. All claims relating to delivery and payment are addressed to the original parties.¹⁹⁶

To ensure legal clarity, regulatory adjustments or explicit contractual provisions are required to bridge the gap between traditional novation and its financial market application. One approach could be to adopt a qualified novation framework, where the law formally recognizes the intermediary's role as a central counterparty without fully extinguishing the original contractual relationships. This could be achieved through specific amendments in SECP regulations governing stock trading and clearing processes.

Additionally, market participants and regulators could enhance legal certainty by explicitly defining the scope and limits of novation in financial transactions. This may include recognizing NCCPL's role as a risk mitigator rather than as a party that assumes complete contractual obligations. Further, harmonizing contractual documentation used in financial markets with common law novation principles by clearly delineating the rights and obligations retained by the original parties could help align financial practice with traditional contract law.

¹⁹⁶ NCCPL Regulations 2018, s 7.

By adopting such measures, the legal ambiguity surrounding novation in stock trading can be minimized, ensuring greater consistency in financial transactions while preserving the integrity of traditional contract law principles.

5.3.2.2 Legality of the Central Counterparty System

Another significant legal issue in settlement of stocks is on legality of the central counterparty system operated by the NCCPL. The NCCPL, by interposing itself between the buyer and the seller, becomes the buyer to every seller and the seller to every buyer, effectively mitigating counterparty risk. However, this arrangement presents unique legal challenges.

One such challenge is that in traditional contract law, a contract requires two distinct parties. The NCCPL, acting as both the buyer and seller of the same stock at the same time, creates a scenario where it is not a two-party contract but rather a single entity fulfilling both roles.¹⁹⁷ This raises questions about the validity of such contracts under traditional contract law principles.

Additionally, in stock markets, transactions are often faceless, meaning that the buyer and seller remain unidentified to each other when the trade is executed.¹⁹⁸ The NCCPL addresses this by assuming the obligations of the original parties, but this leads to legal uncertainty regarding the validity of these transactions. To better understand these challenges, relevant case laws can be looked into concerning the duality of contracts and dual agency.

¹⁹⁷ Contract Act 1872, s 10.

¹⁹⁸ Squire Richard and Steven L. Schwarcz, "Central Clearing and Systemic Risk Regulation", *Journal of Financial Regulation*, vol. 1, no.1 (2015): 16-34.

In *Fauji Foundation v. Shamimur Rehman*,¹⁹⁹ the Supreme Court of Pakistan addressed the principle of agency and emphasized that an agent cannot represent conflicting interests in the same transaction without explicit consent from both parties. This case holds relevance to the CCP system because the NCCPL effectively acts as an intermediary, representing both buyer and seller. The decision stresses the importance of consent and clarity when one entity assumes multiple roles in a transaction.

In *English v. Dedham Vale Properties Ltd*,²⁰⁰ the court held that an agent could not represent both parties in a transaction without the express consent of both. This principle emphasizes on the importance of clear consent and disclosure when one entity takes on dual roles in a transaction. Applying this to the central counter party, it becomes evident that all participants must be fully aware and have consented to the central counter party's dual role to ensure the validity of the contracts.

Furthermore, the case of *R v. David John Arkwright*²⁰¹ highlights the necessity for transparency and the management of potential conflicts of interest when an agent represents both parties. The central counter party must ensure transparency in its operations to maintain the validity of the contracts it facilitates.

Moreover, in *Ghulam Rasool v. Abdul Hamid*,²⁰² the court discussed the concept of mutual mistake in contract law, where contracts can be rendered void if both parties are fundamentally mistaken about the subject matter of the contract. This case is pertinent to the CCP system, as misunderstandings about the NCCPL's role and the nature of the contracts being formed could raise issues regarding the validity of the transactions facilitated by the CCP.

¹⁹⁹ *Fauji Foundation v Shamimur Rehman* PLD [1983] SC 457.

²⁰⁰ *English v Dedham Vale Properties Ltd* [1978] 1 WLR 93.

²⁰¹ *R v David John Arkwright* [1994] 4 All ER 464.

²⁰² *Ghulam Rasool v Abdul Hamid* PLD [1964] SC 72.

Another issue arises when laws and regulations governing the central counter party, its rules, procedures, contractual arrangements and the timing of counterparty substitution are not clearly stated, internally coherent and readily accessible to participants. The current counterparty substitution system primarily functions as a financial risk management tool, guaranteeing settlement but not assuming bilateral rights and obligations. This lack of clarity can lead to legal complications and challenges in enforcing the settlement agreements.²⁰³

Clear and well-defined contracts between brokerage firms and the NCCPL are essential to mitigate these legal risks. By ensuring that all parties understand their rights and obligations, the legal framework can support the effective operation of the central counter party system, thus maintaining market confidence and stability.²⁰⁴

5.3.3 Legal Issues Pertaining to Custody of Stocks

The legal issues involved in post stock trading practices pertaining to custody of stocks include: i) legal and beneficial ownership of stocks and ii) treatment of stocks in insolvency proceedings against CDC.

²⁰³ Pirrong Craig, "The Economics of Central Clearing: Theory and Practice", *ISDA Discussion Papers Series*, no.1 (2011): 8-15.

²⁰⁴ Norman Peter, *The Risk Controllers: Central Counterparty Clearing in Globalised Financial Markets*, (Chichester, UK: John Wiley & Sons, 2011), 56-61.

5.3.3.1 Legal and Beneficial Ownership of Stocks

The legal issue pertaining to custody of stocks is on legal and beneficial ownership of stocks. When the stocks are bought by an individual or corporation, they are kept in trust with CDC. Similarly, when stocks are held by a pledgee authorized by the CDC, these stocks are held in trust by the pledgee. The pledgee is generally a bank or any other financial institution which provided financing for the purchase of stocks. Stocks are registered in the name of pledgee as legal owner. Now the issue is what are potential legal issues which may arise from a distinction between legal ownership and beneficial ownership? And what are the legal implications of the distinction between legal ownership and beneficial ownership?

According to prevailing regulatory regime, when the buyer of stock transfers the stock to the custody of CDC in trust, the CDC assumes its legal title. In the register of company, the name of CDC appears as its legal owner for legal purposes such as litigation and adjudication of disputes. The CDC is required to provide list of its real owner. The real owner holds beneficial ownership for corporate entitlements such as distribution of bonuses and dividends by the company.²⁰⁵ This distinction between legal ownership and beneficial ownership has some legal implications. It sometime gives rise to disputes. For this reason, clear rules are required for beneficial ownership, whose breach should invoke legal action.

The distinction between legal ownership and beneficial ownership has been explored and clarified through various notable legal cases. In *Lloyds & Scottish Finance Ltd v. Williamson*,²⁰⁶ a husband held stocks in his name, but the beneficial ownership belonged to his wife. When the husband was declared bankrupt, the issue arose as to

²⁰⁵ Sa'eed Ahmed, "The Role of Central Depositories in Modern Financial Markets: A Case Study of Pakistan", *Journal of Financial Regulation and Compliance*, vol. 22, no.1 (2022): 55-60.

²⁰⁶ *Lloyds & Scottish Finance Ltd v Williamson* [1991] BCLC 168.

whether the stocks should be considered part of his estate. The court held that despite the husband being the legal owner of the stocks, the beneficial interest resided with his wife. Consequently, the stocks were not part of the husband's bankrupt estate. This decision underscores the principle that beneficial ownership can override legal ownership, particularly in determining the true nature of asset ownership in bankruptcy cases.

Another significant case is *Prest v. Petrodel Resources Ltd.*²⁰⁷ This case involved a divorce settlement where the wife sought a stock of assets held by companies controlled by her husband. The husband contended that these assets were legally owned by the companies and not by him personally. The UK Supreme Court found that the companies were effectively holding the assets on behalf of the husband, who was the beneficial owner. Thus, the assets were deemed available for the divorce settlement. This case is pivotal in both family law and corporate law, illustrating that courts can penetrate corporate structures to identify the true beneficial owner, especially in cases of asset concealment.

Moreover, in *Agip (Africa) Ltd v. Jackson*,²⁰⁸ Agip (Africa) Ltd was defrauded and the fraudsters transferred funds to various bank accounts. The issue was whether the recipients of the funds could be pursued for the return of the money based on beneficial ownership. The court held that the recipients were not the beneficial owners of the funds, as they received them in a fiduciary capacity. Therefore, Agip could trace the funds and claim them back. This case is significant in demonstrating how beneficial ownership can affect the tracing of assets and the recovery of misappropriated funds.

²⁰⁷ *Prest v Petrodel Resources Ltd* [2013] UKSC 34.

²⁰⁸ *Agip (Africa) Ltd v Jackson* [1990] Ch 265.

Furthermore, the case of *Re Polly Peck International Plc*,²⁰⁹ involved the collapse of Polly Peck International and the administrators' attempt to recover assets from subsidiaries. The issue was whether the parent company had a beneficial interest in the assets of the subsidiaries. The court concluded that the parent company did not have a beneficial interest in the assets of the subsidiaries, which were distinct legal entities. This case highlights the importance of corporate structure and the distinction between legal and beneficial ownership in the context of group companies.

Additionally, the *Mareva Compania Naviera SA v. International Bulkcarriers*,²¹⁰ addressed the freezing of assets. The plaintiff sought to freeze assets held in the name of third parties, arguing they were beneficially owned by the defendant. The court established the principle that assets could be frozen if there was evidence that the defendant was the beneficial owner, despite the assets being held in another's name. This case is foundational in the development of the Mareva injunction (freezing order), illustrating how beneficial ownership can be leveraged to secure assets in legal disputes.

These cases show the challenges in distinguishing between legal and beneficial ownership. *Lloyds & Scottish Finance Ltd v. Williamson* upheld a spouse's ownership rights despite the formal legal ownership being held by the husband. *Prest v. Petrodel Resources Ltd* illustrated the courts' ability to look beyond corporate structures to ensure fair asset division in divorce cases. *Agip (Africa) Ltd v. Jackson* clarified ownership in relationships of trust, while *Re Polly Peck International Plc* emphasized the separate legal identities of corporate entities. *Mareva Compania Naviera SA v. International Bulkcarriers SA* showed how identifying beneficial ownership can be practically applied in legal disputes.

²⁰⁹ *Re Polly Peck International Plc* [1998] 3 All ER 812.

²¹⁰ *Mareva Compania Naviera SA v International Bulkcarriers* [1980] 1 All ER 213.

These cases suggest that legal ownership alone may not always reflect the true ownership rights. It is essential for researchers and legal practitioners alike to recognize the significance of beneficial interests, particularly in cases involving fraud, trusts and complex corporate arrangements. Understanding these distinctions can help navigate legal disputes effectively and ensure fair and just outcomes.

This difference in legal and beneficial ownership raises many sub-legal issues. Some potential legal issues are as follows.²¹¹

a) Identification of Beneficial Owners

An important legal issue is identification of beneficial owners which refers to determining the beneficial owners of stocks held with CDC, which can sometimes be challenged, especially in cases where stocks are held through intermediaries or in trust arrangements. This can raise concerns regarding transparency and compliance with regulatory requirements, particularly regarding anti-money laundering (AML) and know your customer (KYC) regulations. Identification of beneficial owner becomes more severe in transactions known as *benami* transactions. *Benami* is a transaction or an arrangement where a property or assets like stocks are transferred to or are held by a person, but the consideration of such property has been provided or paid by another person. In other words, the holder of the asset (frontman) is not its true beneficial owner. Such person in whose name stocks are transferred and holds stocks as frontman, while his source of income is not disclosed, is called in Pakistani law as *benamidar*.²¹²

This arrangement means that the property is purchased in the name of someone other than the person financing it, with the intention of concealing the identity of the

²¹¹ Financial Industry Regulatory Authority (FINRA), “Understanding Beneficial Ownership”, <<https://www.finra.org/rules-guidance/key-topics/beneficial-ownership>> (accessed 24 June 2024).

²¹² Benami Transaction (Prohibition) Act 2017, s 2.

real owner, often for avoiding taxation or circumventing property ownership restrictions. For example, a businessman, A, buys stocks in the name of B, his driver and the source of income of B is not disclosed by Mr. A, then the stocks become *benami* property and his driver becomes the *benamidar*.²¹³ In Pakistan, *Benami* Transaction (Prohibition) Act 2017 was enacted to provide for prohibition of holding property in *benami* and restrict the right to recover or transfer property held *benami* and provide mechanism and procedure for confiscation of property held *benami*.²¹⁴

There are many laws in Pakistan that require reporting and disclosure of beneficial ownership such as Companies Ordinance 1984, Securities Act 2015, Companies Act 2017 and *Benami* Act 2017.

Under the Companies Ordinance 1984, companies are required to maintain proper records of stockholders and their respective stockholdings. This requirement ensured that the actual owners behind the companies were identifiable, thereby promoting transparency in corporate ownership.²¹⁵

The Securities Act 2015 requires companies listed on stock exchanges to disclose information about individuals who owned substantial stocks, typically defined as owning more than 5% of a company's stocks. This act is instrumental in preventing market manipulation and insider trading by making the identities of significant stockholders known to the public and regulatory authorities.²¹⁶

The Companies Act 2017 introduced stricter requirements for the disclosure of beneficial ownership. Companies are now required to maintain a register of beneficial owners, which includes information about individuals who, directly or indirectly, have

²¹³ Ibid.

²¹⁴ Government of Pakistan, Companies Ordinance 1984; Companies Act 2017; Stocks Act 2015; Benami Act 2017.

²¹⁵ Companies Ordinance 1984, s 214A.

²¹⁶ Securities Act 2015, s 101.

significant control over the company. This act also mandates regular updates to ensure the accuracy of the information. By requiring detailed disclosure of ownership, the Companies Act 2017 aims to prevent the misuse of corporate entities for illegal activities such as money laundering and tax evasion.²¹⁷

The *Benami* Transactions (Prohibition) Act 2017 requires the disclosure of beneficial ownership of such properties. It prohibits *benami* transactions and prescribes penalties for those who engage in them. The law is designed to uncover hidden wealth and bring it within the tax net, thereby reducing corruption and increasing government revenue. The Act 2017 tackles the issue of *benami* properties – assets that are held in the name of one person, but the real ownership lies with another.²¹⁸ According to this law, *benamidar* is not the real owner of property. The real owner is the beneficial owner who is actual beneficiary of the property (stocks in this case). From this it may be established that under prevailing legal regime, CDC and *benamidar* are not the real owners of stocks, the real owner is the beneficial owner.²¹⁹

When stocks are held through intermediaries like CDC, identifying the true beneficial owners can be challenging, complicating compliance with disclosure and transparency obligations. This issue raises concerns regarding regulatory requirements, particularly AML and KYC regulations.

To address this legal issue, regulatory frameworks can be strengthened to require more rigorous identification and verification processes for beneficial owners. This includes enhancing AML and KYC regulations to ensure that intermediaries and custodians like the CDC have robust mechanisms to trace the true ownership of stocks.

²¹⁷ Companies Act 2017, s 452.

²¹⁸ Benami Transactions (Prohibition) Act 2017, s 2(10) & 3.

²¹⁹ Securities and Exchange Commission of Pakistan (SECP), *Regulations on Beneficial Ownership*, (Islamabad: SECP, 2020), <<https://www.secp.gov.pk/document/regulations-on-beneficial-ownership/>> (accessed 24 June 2024).

Additionally, enforcing laws like the *Benami* Transaction (Prohibition) Act 2017 in Pakistan helps prevent and address the misuse of *benami* transactions by prohibiting the holding of property in another's name and providing mechanisms for the confiscation of such properties.

b) Voting Right

A significant legal issue concerns voting right when stocks are held by intermediaries like the CDC on behalf of stock investors. This situation may result in a separation between the legal owners (the CDC) and the beneficial owners (the stock investors). This separation can raise questions about how voting rights are exercised, as the legal owner might hold the voting rights, but the beneficial owners have the economic interest. Ensuring proper corporate governance and alignment of interests between legal and beneficial owners is crucial to avoid conflicts and ensure fair representation.²²⁰ A related legal challenge involves proxy voting, which ensures that beneficial owners have the right to exercise their voting rights in stockholder meetings and participate in corporate governance processes. Proxy voting allows stockholders to vote on corporate matters without physically attending meetings. When stocks are held by CDC, it may hold the voting rights, but individual stock investors may want to exercise their voting rights on specific issues. Ensuring that beneficial owners have a mechanism to participate in proxy voting through the CDC is important to avoid legal disputes regarding voting rights and corporate decision-making.²²¹

²²⁰ Financial Stability Board, *Principles for Effective Risk Data Aggregation and Risk Reporting*, (Basel: Financial Stability Board, 2013), 24.

²²¹ *Institutional Shareholder Services (ISS)*, “Proxy Voting Guidelines”, <<https://www.issgovernance.com/file/policy/2024proxy-voting-guidelines.pdf>> (accessed 24 June 2024).

When stocks are held by intermediaries like CDC, the separation between legal ownership and beneficial ownership can complicate the exercise of voting rights. This issue raises concerns about ensuring that beneficial owners can participate in corporate governance processes through proxy voting.

To address this legal issue, regulations can be implemented to ensure that beneficial owners have a clear and effective mechanism to exercise their voting rights. This includes establishing procedures for proxy voting that allow beneficial owners to participate in corporate governance without physically attending meetings. Strengthening corporate governance frameworks and aligning the interests of legal and beneficial owners can help avoid conflicts and ensure fair representation in corporate decision-making.

c) Transfer of Ownership:

The issue of transfer of ownership of stocks also poses legal concerns, particularly when transferring ownership of stocks held by CDC. This may involve additional steps compared to transferring physical stock certificates, such as documentation of beneficial ownership transfer,²²² verification of ownership rights²²³ and coordination with CDC for the update of records.²²⁴ If these steps are missing, legal issues may arise, including disputes over ownership rights and improper documentation of the transfer.²²⁵

²²² Proper legal documentation must be completed to reflect the change in beneficial ownership. This ensures that all relevant details are accurately recorded and legally recognized. See, *Central Depository Company of Pakistan Limited*, "Transfer of Shares Process", <<https://www.cdcpakistan.com/services/transfer-of-shares/>> (accessed 29 September 2024).

²²³ The new beneficial owner's rights must be verified to ensure they are entitled to the stocks. This step involves confirming the authenticity and legality of the transfer. See, *Ibid*.

²²⁴ The CDC must be notified and their records updated to reflect the new ownership. This step ensures that the transfer is officially recognized and recorded in the centralized system. See, *Ibid*.

²²⁵ *Securities and Exchange Commission of Pakistan (SECP)*, "Transfer of Ownership Regulations", <<https://www.secp.gov.pk/document/transfer-of-ownership-regulations/>> (accessed 24 June 2024).

When stocks are held by intermediaries like CDC, transferring ownership requires meticulous documentation and verification processes. This ensures that the transfer is legally recognized and properly recorded.

To address this legal issue, regulatory frameworks can be established to streamline the process of transferring ownership of stocks held by the CDC. This includes implementing standardized procedures for documenting beneficial ownership transfer, verifying ownership rights and coordinating with the CDC for record updates. Enhancing the transparency and efficiency of these processes can help prevent legal disputes over ownership rights and ensure proper documentation of transfers.

d) Dispute Resolution

Dispute resolution is another critical legal issue, arising when disputes regarding ownership rights, entitlements, or the interpretation of agreements related to beneficial ownership occur. Disputes may also arise between legal owners and beneficial owners, especially concerning the exercise of rights and the alignment of interests. Clear legal frameworks and mechanisms for dispute resolution are essential to address such issues effectively, ensuring that both legal and beneficial owners' rights are protected and conflicts are resolved fairly and efficiently.²²⁶

When stocks are held by intermediaries like CDC, disputes can arise over ownership rights and entitlements. These disputes may involve both legal owners and beneficial owners, necessitating clear legal frameworks and mechanisms for resolution.

To address this legal issue, it is essential to establish robust legal frameworks and dispute resolution mechanisms. This includes creating clear guidelines for

²²⁶ Brown, H. Lowell, *Legal Issues in Securities and Financial Markets*, (New York: Oxford University Press, 2019), 112-115.

ownership rights, entitlements and the interpretation of agreements related to beneficial ownership. Providing accessible and efficient dispute resolution channels, such as arbitration or mediation, can help resolve conflicts fairly and protect the rights of both legal and beneficial owners.

e) Dividend Distribution

Dividend distribution presents another legal complication, as it pertains to the proper distribution of dividends to beneficial owners. Legal issues may arise if there are discrepancies or delays in disbursing dividends to the rightful owners of stocks held with CDC.²²⁷ Discrepancies in dividend distribution include errors in identifying the rightful beneficiaries or incorrect calculations of dividend amounts. Delays occur due to administrative inefficiencies or issues in coordinating between CDC records and dividend payments. These problems can lead to disputes and financial losses for the rightful owners.

When stocks are held by intermediaries like CDC, ensuring accurate and timely dividend distribution to beneficial owners is crucial. Discrepancies and delays can lead to disputes and financial losses.

To address this legal issue, regulatory frameworks can establish strict guidelines for dividend distribution processes. This includes improving administrative efficiency, ensuring accurate record-keeping and implementing robust verification mechanisms to identify rightful beneficiaries. Regular audits and oversight can help prevent errors and ensure timely disbursement of dividends to beneficial owners.

²²⁷ Ibid.

f) Disclosure Requirements

Disclosure requirements also constitute a legal issue. Stocks regulations often require companies to disclose information to their stockholders.²²⁸ However, when stocks are held through a CDC, the company might not have direct access to the identities of all beneficial owners. This can complicate compliance with disclosure requirements and transparency obligations, leading to potential legal issues if disclosure lapses occur.²²⁹

When stocks are held by intermediaries like CDC, companies may struggle to access the identities of all beneficial owners, complicating compliance with disclosure requirements and transparency obligations.

To address this legal issue, regulatory frameworks can mandate intermediaries like the CDC to maintain and provide up-to-date information about beneficial owners to companies. This includes establishing clear procedures for data sharing and ensuring compliance with disclosure requirements. Enhancing transparency and communication between companies and intermediaries can help prevent lapses in disclosure and ensure regulatory compliance.

5.3.3.2 Treatment of Stocks in Insolvency against CDC

An important issue pertaining to the custody of stocks is on treatment of stocks in insolvency proceedings against CDC. Here the question arises how the stocks of stockholders will be legally treated in the event of insolvency proceedings against CDC? The following principles and rules outline the treatment of stocks held by the CDC on behalf of beneficial owners.

²²⁸ *Securities and Exchange Commission of Pakistan (SECP)*, “Regulations on Beneficial Ownership”, <<https://www.secp.gov.pk/document/regulations-on-beneficial-ownership/>> (accessed 24 June 2024).

²²⁹ Corporate Governance Code 2016, s 12.

First and foremost is the segregation of stocks. Stocks held by the CDC on behalf of beneficial owners are usually segregated from the CDC's own stocks. This segregation ensures that beneficial owners' assets are not treated as part of the CDC's estate in insolvency proceedings.²³⁰ This principle is critical to protect stock investors' holdings from being used to satisfy the CDC's debts.²³¹

In *KASB Securities v. SECP*,²³² the issue of asset protection and the role of custodians in insolvency was raised in the context of brokerage firm insolvency. The court examined the regulatory framework designed to protect stock investors and emphasized that beneficial owners' stocks should be safeguarded from claims by creditors of brokerage firms or custodians like CDC in case of insolvency.

The case of *Re Lehman Brothers International (Europe)*,²³³ dealt with the treatment of stock investor assets in the insolvency of a financial services firm. The court of appeal emphasized the need to protect stock investor assets and ensure their return to beneficial owners ahead of other creditors. This case set out principles for the ring-fencing of stock investor assets and the priority of claims, highlighting the legal framework designed to protect stock investors in the event of insolvency.

In addition to segregation, beneficial ownership protection is paramount. Since the beneficial owners are the true owners of the assets, these assets should not be used to satisfy the debts of the CDC.²³⁴ The beneficial owners retain their ownership rights and the assets should be returned to them or transferred to another depository or

²³⁰ Kanda Hideki, "The Role of Custodians in Securities Markets", *Law and Financial Markets Review*, vol. 5, no.2 (2011): 112-113.

²³¹ Gullifer Louise and Payne Jennifer, *Corporate Finance Law: Principles and Policy*, (Oxford: Hart Publishing, 2011), 401.

²³² *KASB Securities v SECP* [2017] CLD 158.

²³³ *Re Lehman Brothers International (Europe)* [2012] EWCA Civ 1628.

²³⁴ Goode Roy, *Principles of Corporate Insolvency Law*, (London: Sweet & Maxwell, 4th ed., 2011), 685.

custodian as directed by the regulatory authorities or the court overseeing the insolvency proceedings.²³⁵

In *Re MF Global UK Ltd*,²³⁶ the court of appeal dealt with the distribution of stock investor assets and the priority of claims in the insolvency of a brokerage firm. This case reinforced the legal principles concerning the segregation and protection of stock investor assets, ensuring that these assets are not used to satisfy the firm's debts.

The custodial arrangements also play a significant role. The legal framework governing CDC often includes provisions that protect the interests of beneficial owners in the event of insolvency. This may involve the appointment of a trustee or receiver to manage and protect the assets until they can be transferred safely to the beneficial owners or another custodian.²³⁷ These arrangements ensure that the assets remain secure and are not caught up in the financial distress of the CDC.

In the case of *Re Danka Business Systems Plc*,²³⁸ the court addressed the application of insolvency principles to assets held by a custodian. Specifically, the court examined the fiduciary duties of custodians to safeguard the assets of beneficial owners during insolvency proceedings. The case underscored the necessity for custodians to maintain a clear distinction between their own assets and those held on behalf of stock investors. It highlighted that custodians have an obligation to ensure that the assets of beneficial owners are protected and not used to satisfy the custodian's own debts in the event of insolvency. The court emphasized that the legal protections afforded to beneficial owners must be robust enough to ensure that their assets are returned to them, reflecting their true ownership and are not entangled in the custodian's financial

²³⁵ Hideki, 114.

²³⁶ *Re MF Global UK Ltd* [2013] EWCA Civ 1310.

²³⁷ Gullifer Louise and Payne Jennifer, 412.

²³⁸ *Re Danka Business Systems Plc* [2005] EWCA Civ 636.

difficulties. This ruling reinforced the importance of fiduciary responsibility and the legal mechanisms in place to protect beneficial owners' interests in insolvency scenarios.

Regulatory safeguards further strengthen the protection of stock investors' assets. Regulatory authorities typically have rules in place to ensure the protection of stock investors' assets. These rules might include the requirement for CDCs to maintain detailed records of beneficial ownership and to conduct regular audits to confirm the segregation and integrity of these assets.²³⁹ Such measures ensure transparency and accountability, safeguarding stock investors' interests.

Insolvency proceedings represent a significant legal challenge. In the event of insolvency or bankruptcy involving CDC or any other party involved in the custody chain, legal issues may arise concerning the treatment of assets held on behalf of beneficial owners and the priority of their claims. One key legal issue is whether the assets held by the custodian are properly segregated from the custodian's own assets. Segregation ensures that the assets held on behalf of beneficial owners are not commingled with the custodian's own assets and can be readily identified and returned to their rightful owners in the event of insolvency. Competing claims to the assets held by the custodian may arise in such events, including claims by creditors of the custodian, claims by beneficial owners and claims by other parties.

During insolvency proceedings, beneficial owners may need to submit claims and recovery to recover their assets.²⁴⁰ The process for this will depend on the jurisdiction's insolvency laws and the specific regulations governing the CDC. The

²³⁹ Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Basel: Financial Stability Board, 2011), 10-11.

²⁴⁰ Wood Philip R., *Principles of International Insolvency*, (London: Sweet & Maxwell, 2nd ed., 2007), 523.

beneficial owners' claims are usually given priority over the general creditors of the CDC.²⁴¹ This prioritization reflects the legal recognition of the beneficial owners' rights to their assets.

The legal precedents established in these cases significantly influence the treatment of assets held by CDCs in the event of insolvency and underscore the importance of robust regulatory frameworks, including the segregation of stock investor assets, regulatory oversight and legal protections for beneficial owners. These precedents ensure that stock investor assets are protected and returned to them in accordance with legal principles, maintaining market confidence and stability even in times of financial distress.

The treatment of stocks in insolvency proceedings against CDC centres on safeguarding the assets held for beneficial owners. Segregation of these stocks from the CDC's own assets is crucial to ensure that they are not used to satisfy the CDC's debts. This principle has been reinforced by legal precedents such as *Re Lehman Brothers International (Europe)* and *Re MF Global UK Ltd*, which emphasize the priority of returning stock investor assets to their rightful owners over other creditors. The fiduciary duties of custodians, highlighted in *Re Danka Business Systems Plc*, further underscore the importance of maintaining a clear separation between custodial and personal assets. Regulatory safeguards, including detailed record-keeping and regular audits, support these protections, ensuring that beneficial owners' claims are prioritized and their assets remain secure during insolvency. These principles and legal frameworks collectively maintain market confidence and protect stock investors' rights, even amidst financial instability.

²⁴¹ Goode Roy, 712.

5.4 CONCLUSION

There are many *Sharī'ah* and legal issues pertaining to post stock trading at PSX at three important stages which are clearing, settlement and custody of stocks. The findings of *Sharī'ah* issues pertaining to clearing of stocks are as follows. With regard to status of clearing house, it is found that clearing house is sub-agent for the stock investor and that the sub-agency is allowed in both classical and modern Islamic law. Regarding mark to market profits and losses and valuating stocks on current market price on daily basis and binding stock investor to pay fictitious loss, it has been found that the concept does not have any grounds in *Sharī'ah*. The findings of *Sharī'ah* issues pertaining to settlement of stocks are as follows. With regard to status of substitution of original parties by NCCPL, it has been concluded that the status of NCCPL is that of *wakīl*. As a *wakīl* of buyer, it buys stocks and then pays price. As *wakīl* of seller, it sells stocks on his behalf and after sale, makes delivery of stocks to buyer. Besides *wakīl*, it also assumes the role of *kafīl* (guarantor) for delivery as well as for payment of price. With regard to ready market settlement, it has been found that the *Sharī'ah* issue with the T+2 settlement cycle for stocks is that it defers the delivery of counter values, which is generally not permissible in *Sharī'ah* except in certain cases. The AAOIFI allows deferment in specific instances, but for stocks representing gold, silver, currency and receivables, simultaneous transaction is mandatory to avoid falling under the rules of *ṣarf* and *ribā al-faḍl*. To address this, the SECP and PSX introduced a *Sharī'ah*-compliant trading counter that mandates same-day settlement (T+0) for *Sharī'ah*-compliant stocks, although the old T+2 system is still in practice at PSX. This mechanism ensures that *Sharī'ah*-conscious stock investors can settle transactions on the day of trade, aligning with *Sharī'ah* principles. On the issue of stock futures settlement, that whether settlement of stock futures without actual delivery, is

permissible in *Sharī'ah*, it has been found that cash settlement of stocks without actual delivery is not permissible in *Sharī'ah*. The findings of *Sharī'ah* issues pertaining to custody of stocks are as follows. With regard to a change of status of stock from *Sharī'ah* compliant to *Sharī'ah* non-compliant stock, it is provided that change of status occurs for various reasons such as violation of *Sharī'ah* screening benchmarks and other external factors like change in core operations of company and expanding the business into *Sharī'ah* non-compliant sectors and changes in ownership structure of company through merger in any *Sharī'ah* non-compliant company. With regard to disinvestment of *Sharī'ah* non-compliant stocks, it has been found that as per *Sharī'ah* screening rules, such stocks have to be disinvested within a period of one year or when the market value of the stocks equals the cost of investment, whichever is earlier. This period of disinvestment is too long and it could be reduced to 90 days. However, the disinvestment should not inflict heavy loss to the stockholder. Regarding the income of *Sharī'ah* non-compliant stock, it is concluded that the stockholder can hold profit or income proportional to legitimate portion of business and remaining has to be given in charity. With regard to the position of beneficial ownership of stocks it is concluded that Islamic law recognizes concept of beneficial ownership provided all risks and reward are shifted to beneficial owner of stocks. The beneficial owner is real owner of stock even though the legal ownership rests with CDC. With regard to the issue of *zakāt* of stocks, it has been found that accepted view in modern Islamic law is that stocks owned for investment purposes are generally subject to *zakāt*. These are stocks bought with the intention of holding them for the long term, with the aim of earning dividends and capital appreciation rather than for short-term trading. With regard to treatment of *zakāt*, the view of Abu Zahrah has been upheld that a stock is like *'urudh tijāriyyah* and *zakāt* is payable on total market value of stocks. With regard to liability of stockholder

it has been found that limited liability of stockholder has gained a great degree of acceptability and recognition in modern Islamic jurisprudence and has been accepted by all prominent *fiqh* bodies and institutions. Thus, if limited liability is clearly specified in the prospectus and made public for those who deal with the company, then there is no *Shari'ah* issue in it.

The findings of legal issue pertaining to clearance of stocks are as follows. With regard to non-transfer of stocks to CDC account, it has been found that some brokerage firms are found committing non-transfer of stock investors' stocks to CDC account in violation of regulatory requirement, which has attracted judicial action against such firms. The courts adjudicating cases against such firms observed that brokerage firm used stock investor's stocks for pledging with financial institutions for obtaining some financing facility and in some cases transferred to *benami* accounts for misappropriation. It is noted that courts have generally taken lenient and moderate view in deciding cases. Such approach, in the opinion of researcher may not be helpful in curbing male practices. In some cases, meager fine of Rs. 10,000 has been imposed on the firm that has earned profits at the cost of stock investors. With regard to unauthorized use and movement of stock investors' stocks it has been found that the unauthorized use and movement of stock investor stocks by brokerage firms pose significant legal and financial risks. Violations of regulations, such as using stock investor stocks for proprietary trading or pledging without approval, result in serious legal consequences and undermine stock investor trust. The findings of legal issue pertaining to settlement of stocks are as follows. With regard to validity of novation in stock settlements, the issue that has been raised is whether the novation practiced in stock market is same as conceived by Contract Act 1872 in which, original party is substituted by a third party. As a result of novation, it is absolved from all obligations.

It has been found that the novation of NCCPL is just a form of guarantee to deliver counter values. The original parties, despite novation remain under obligation to deliver counter values. With regard to legality of the central counterparty system the finds that the central counterparty system operated by the NCCPL, while mitigating counterparty risk, presents unique legal challenges including questions about contract validity, given the NCCPL's dual role as buyer and seller and legal uncertainties due to faceless transactions and unclear regulations. Clear, well-defined contracts between brokerage firms and the NCCPL are essential to address these legal risks and ensure effective market operation. The findings of legal issues pertaining to custody of stocks are as follows. With regard to legal and beneficial ownership of stock, it has been found that this distinction involves many potential legal issues such as determining the beneficial owners of stocks held with CDC, voting right, proxy voting, transfer of ownership of stocks, dividend distribution, dispute resolution, segregation of stock investors' assets from custodians' own assets and disclosure requirements. With regard to treatment of stocks in insolvency proceedings against CDC it has been found that the assets of stockholders held by the CDC are protected through several key principles. These stocks are segregated from the CDC's own assets, ensuring they are not used to satisfy the CDC's debts. Beneficial owners retain their ownership rights and regulatory frameworks often involve appointing trustees or receivers to manage these stocks.

CHAPTER SIX

CONCLUSION AND RECOMMENDATIONS

6.0 INTRODUCTION

There are various *Sharī'ah* and legal issues of stock trading practices in Pakistan Stock Market (PSX). These issues depend on the stages of the trading whether it is pre-stock trading, actual stock trading and post-stock trading practiced in regular market, leveraged market and futures market.

The chapter provides brief evaluations of the *Sharī'ah* and legal issues pertaining to stock trading practices at PSX as per determined in previous chapters and some recommendations and suggestions for the reformation of existing stock trading practices to be in line with the *Sharī'ah* and legal principles.

6.1 BRIEF EVALUATIONS OF THE *SHARĪ'AH* ISSUES

There are various *Sharī'ah* issues pertaining to pre-stock trading practices, actual stock trading practices and post-stock trading practices at PSX.

6.1.1 *Sharī'ah* Issues on Pre-Stock Trading

The *Sharī'ah* issues pertaining to pre-stock trading practices at PSX include position of a brokerage firm, conflict of interest, charging fee, commission, performance-based fee and incentive and stockholder's funds in the custody of brokerage firm. It is found that position of brokerage firm is a *wakīl* of stockholder resulting the rules of *wakālah* and agency apply to him. It has been concluded that *Sharī'ah* emphasizes on avoidance of conflict of interest. It has been established that charging normal fee, commission,

performance-based fee and incentives by the brokerage firm is consistent with *Sharī'ah*. Charging fee and commission falls under *wakālah* contract, whereas the performance-based fee and incentive conforms to the principles of *ju'ālah*. It has been concluded that the stockholder's funds in the custody of brokerage firm are *amānah* and trust. If any loss occurs in stockholder's funds without his negligence, the brokerage firm will not be liable.

6.1.2 *Sharī'ah* Issues on Actual-Stock Trading

There are *Sharī'ah* issues pertaining to actual stock trading practices at PSX in three different markets namely regular market, leveraged market and futures market.

The *Sharī'ah* issues in regular market include trading in conventional stocks, trading in preferred stocks, trading on T+2 basis, intraday trading, market manipulation and insider trading. After analyzing the above issues, it has been concluded that trading in conventional stocks is inconsistent with *Sharī'ah* because it contains many *Sharī'ah* prohibited elements such as elements of *ribā*, *gharar* and *qimār*. Preferred stocks as practiced in financial markets, are generally held impermissible because these stocks guarantee a fixed dividend, regardless of the company's profit or loss, which contradicts the *Sharī'ah* principle that profit must be linked to liability for loss. Trading on T+2 carries potential *Sharī'ah* issues. As per the *Sharī'ah* principles the effects of a sale contract should start immediately without any delay because the delay may lead to *gharar*. Intraday trading as per prevailing and dominant view, is not compatible with *Sharī'ah* since it is a sale without ownership and possession. Market manipulation falls under many *Sharī'ah* prohibitions such as *taghrir* (misrepresentation), *tanājush* (artificially raising price), *ghabn faḥish* (charging exorbitant price) and fraud and deception. In market manipulation, the colluding brokerage firms artificially raise price

of stocks to give false impression to innocent and less knowledgeable stockholder about high price of stocks. Insider trading raises many *Sharī'ah* issues such as it is a form of injustice because it infringes the rights of innocent stockholders who do not know that the price of stock declared in the market is not the real price, but it has been artificially inflated and raised through collusion by the shrewd brokerage firms and stockholder. It greatly harms his interest and it is in fact eating other's properties wrongfully which is considered injustice. Thus, insider trading is impermissible in *Sharī'ah* on account of incorporation of elements of fraud, deception and concealment of facts.

The *Sharī'ah* issues in leveraged market include issue of short selling and margin financing. After analyzing the above issues, it has been concluded that short selling is repugnant to *Sharī'ah* for the reasons such as selling without ownership prohibited by *Ḥadīth*, borrowing involving stocks and interest in loans. These practices involve *gharar*, deception and injustice, making them impermissible under Islamic law. Margin financing is also disallowed in *Sharī'ah* for the reasons such as interest-based lending, mark to market losses and issue of two contracts in one contract and element of speculation.

The *Sharī'ah* issues in futures market include sale of a non-existent thing (*bāy' ma'dūm*), sale of one debt for another debt, sale of a thing which is yet to be possessed by the seller and it is a form of *gharar* and *maysir*. After analyzing the above issues, it has been concluded that sale of a non-existent thing is not consistent with *Sharī'ah* because according to *Islamic* law at least one counter value must exist at the time of sale, except in the case of *salam* contracts. In a *salam* contract, the sale of a non-existent thing is allowed because it involves an advance payment for goods to be delivered in the future, thus providing certainty and eliminating *gharar*. Therefore, while the sale of a non-existent thing is typically prohibited, *salam* contracts are an exception where such

sales are permitted under specific conditions. The sale of debt for debt in futures trading raises several issues from the *Sharī'ah* perspective, including the potential for *ribā*, *gharar*, delays in delivery and payment and excessive speculation. With regard to sale of a thing which is yet to be possessed by the seller all the leading classical jurists agreed that selling of an item prior to taking possession is prohibited. With regard to form of *gharar* and *maysir* it has been found that futures contracts are a form of prohibited *gharar* and *maysir*. Futures contracts are generally considered as just paper transaction for the purpose of making speculative profit and not a genuine sale.

6.1.3 *Sharī'ah* Issues on Post-Stock Trading

There are *Sharī'ah* issues pertaining to post-stock trading practices at PSX at three important stages which are clearing, settlement and custody of stocks.

The *Sharī'ah* issues pertaining to clearing of stocks include status of clearing house and mark to market profits and losses. The findings of these *Sharī'ah* issues are that clearing house is sub-agent for the stockholder and that the sub-agency is allowed in both classical and modern Islamic law. Regarding mark to market profits and losses it has been found that the concept does not have any grounds in *Sharī'ah*.

The *Sharī'ah* issues pertaining to settlement of stocks include status of substitution of original parties by NCCPL, ready market settlement and stock futures settlement. The findings of these *Sharī'ah* issues are that with regard to status of substitution of original parties by NCCPL, it has been concluded that the status of NCCPL is that of *wakīl*. As a *wakīl* of buyer, it buys stocks and then pays price. As *wakīl* of seller, it sells stocks on his behalf and after sale, makes delivery of stocks to buyer. Besides *wakīl*, it also assumes the role of *kafil* (guarantor) for delivery as well as for payment of price. With regard to ready market settlement, it has been found that the

Sharī'ah issue with the T+2 settlement cycle for stocks is that it defers the delivery of counter values, which is generally not permissible in *Sharī'ah* except in certain cases. The AAOIFI allows deferment in specific instances, but for stocks representing gold, silver, currency and receivables, simultaneous transaction is mandatory to avoid falling under the rules of *ṣarf* and *ribā al-faḍl*. On the issue of stock futures settlement, that whether settlement of stock futures without actual delivery, is permissible in *Sharī'ah*, it has been found that cash settlement of stocks without actual delivery is not permissible in *Sharī'ah*.

The *Sharī'ah* issues pertaining to custody of stocks include a change of status of stock from *Sharī'ah* compliant to *Sharī'ah* non-compliant stock, disinvestment of *Sharī'ah* non-compliant stocks, income of *Sharī'ah* non-compliant stock, position of beneficial ownership of stocks, *zakāt* of stocks and liability of stockholder. The findings of these *Sharī'ah* issues are that with regard to a change of status of stock from *Sharī'ah* compliant to *Sharī'ah* non-compliant stock, it has been provided that change of status occurs for various reasons such as violation of *Sharī'ah* screening benchmarks and other external factors like change in core operations of company and expanding the business into *Sharī'ah* non-compliant sectors and changes in ownership structure of company through merger in any *Sharī'ah* non-compliant company. With regard to disinvestment of *Sharī'ah* non-compliant stocks, it has been found that as per *Sharī'ah* screening rules in Pakistan, such stocks have to be disinvested within a period of one year or when the market value of the stocks equals the cost of investment, whichever is earlier. Regarding the income of *Sharī'ah* non-compliant stock, it has been concluded that the stockholder can hold profit or income proportional to legitimate portion of business and remaining has to be given in charity. With regard to the position of beneficial ownership of stocks it has been concluded that Islamic law recognizes concept of beneficial ownership

provided all risks and reward are shifted to beneficial owner of stocks. The beneficial owner is real owner of stock even though the legal ownership rests with CDC. With regard to the issue of *zakāt* of stocks, it has been found that accepted view in modern Islamic law is that stocks owned for investment purposes are generally subject to *zakāt*. These are stocks bought with the intention of holding them for the long term, with the aim of earning dividends and capital appreciation rather than for short-term trading. With regard to treatment of *zakāt*, it has been found that a stock is like '*urudh tijariyyah* and *zakāt* is payable on total market value of stocks. With regard to liability of stockholder it has been found that limited liability of stockholder has been accepted by all prominent *Fiqh* bodies and institutions. Thus, if limited liability is clearly specified in the prospectus and made public for those who deal with the company, then there is no *Sharī'ah* issue in it.

6.2 BRIEF EVALUATIONS OF THE LEGAL ISSUES

There are various legal issues pertaining to pre-stock trading practices, actual stock trading practices and post-stock trading practices at PSX.

6.2.1 Legal Issues on Pre-Stock Trading

The legal issues pertaining to pre-stock trading practices at PSX include practices of conflict of interest, misuse of stockholder's funds and non-segregation of accounts. It has been concluded that these practices violate the prevailing legal regime prescribed for the brokerage firm. The brokerage firm in Pakistan is generally involved in the practices of conflict of interest and giving its interest priority over the interest of stockholder. With regard to misuse of stockholder's funds it has been found that the brokerage firm cannot use stockholder's money for its own business, nor can it use it

for pledging and obtaining financing facility from the banks. With regard to non-segregation of accounts it has been found that the non-segregation of accounts constitutes a serious legal issue, reflecting misconduct by brokerage firm and shattering stockholder confidence.

6.2.2 Legal Issues on Actual-Stock Trading

There are legal issues pertaining to actual stock trading practices at PSX in three different markets namely regular market, leveraged market and futures market.

The legal issues in regular market include legal nature of preference stocks contract, market manipulation and insider trading. After analyzing the above issues, it has been concluded that with regard to the legal nature of preference stocks contract, it has been found that they are generally perceived as having priority over common stocks in terms of dividends and claims on assets upon liquidation. However, they do not typically share in surplus assets unless explicitly stated in a company's regulations or articles of association. Courts have often ruled that preference stockholders are entitled to fixed dividends and return of capital but not to surplus profits, thereby resembling fixed loan securities more than equity instruments. Consequently, preference stocks are predominantly viewed as debt instruments due to their fixed returns and limited potential for capital appreciation. With regard to the market manipulation, it has been found that it is deemed illegal under Securities Act 2015, the Competition Act 2010, Securities Brokers (Licensing and Operations) Regulations 2016 and the Securities and Exchange Ordinance 1969. Both criminal and civil penalties are imposed for such misconduct, including imprisonment, hefty fines and injunctions, reflecting the severity of the offense and the regulator's commitment to maintaining market integrity and protecting stockholders. With regard to the insider trading, it has been found that it is

illegal under the Securities Act 2015 and the Securities and Exchange Ordinance 1969, because of the fraudulent conduct that effects market fairness and stockholder's trust. The laws surrounding insider trading prescribe both civil and criminal penalties for the offenders.

The legal issues in the leveraged market include blank sale and short and distort. After analyzing the above issues, it has been concluded that the blank sale involves selling stocks without borrowing them or ensuring their availability, which is considered illegal and can lead to market manipulation, increased volatility and systemic risks, as evidenced by major market crises and legal cases involving regulatory enforcement against brokerage firms and individuals engaging in blank sale. With regard to short and distort it has been found that the short and distort practices, involving short selling of stocks coupled with spreading false or misleading information to manipulate prices, are considered illegal and may constitute securities fraud and market manipulation.

The legal issue in the futures market is sale without ownership. After analyzing the above issue, it has been concluded that sale without ownership in futures trading is illegal as per contract law principles, requiring parties to have legal ownership or authority over the underlying assets.

6.2.3 Legal Issues on Post-Stock Trading

There are legal issues pertaining to post-stock trading practices at PSX at three important stages which are clearing, settlement and custody of stocks.

The legal issues pertaining to clearing of stocks is non-transfer of stocks to CDC account and unauthorized movement of stockholders' stocks. The findings of legal issues pertaining to clearance of stocks are that with regard to non-transfer of stocks to

CDC account, it has been found that some brokerage firms are found committing non-transfer of stockholders' stocks to CDC account in violation of regulatory requirement, which has attracted judicial action against such firms. The courts adjudicating cases against such firms observed that brokerage firm used stockholder's stocks for pledging with financial institutions for obtaining some financing facility and in some cases transferred to *benami* accounts for misappropriation. It has been noted that courts have generally taken lenient and moderate view in deciding cases. Such approach, in the opinion of researcher may not be helpful in curbing male practices. In some cases, meager fine of Rs. 10,000 has been imposed on the firm that has earned profits at the cost of stockholders. With regard to unauthorized movement of stockholders' stocks it has been found that the unauthorized movement of stockholder stocks by brokerage firms pose significant legal and financial risks and undermine stockholder trust.

The legal issues pertaining to settlement of stocks is validity of novation in stock settlements and legality of the central counterparty system. The findings of legal issue pertaining to settlement of stocks are that with regard to issue in the operations of novation and central counterparty system, the issue that has been raised is whether the novation practiced in stock market is same as conceived by Contract Act 1872 in which, original party is substituted by a third party. As a result of novation, it is absolved from all obligations. It has been found that the novation of NCCPL is just a form of guarantee to deliver counter values. The original parties, despite novation remain under obligation to deliver counter values. With regard to legality of the central counterparty system it has been found that the central counterparty system operated by the NCCPL, while mitigating counterparty risk, presents unique legal challenges including questions about contract validity, given the NCCPL's dual role as buyer and seller and legal uncertainties due to faceless transactions and unclear regulations. Clear, well-defined contracts

between brokerage firms and the NCCPL are essential to address these legal risks and ensure effective market operation.

The legal issues pertaining to custody of stocks is legal and beneficial ownership of stocks and treatment of stocks in insolvency proceedings against CDC. The findings of legal issues pertaining to custody of stocks are that with regard to legal and beneficial ownership of stock, it has been found that this distinction involves many potential legal issues such as determining the beneficial owners of stocks held with CDC, corporate governance, proxy voting, transfer of ownership of stocks, dividend distribution, dispute resolution, insolvency proceedings, segregation of stockholders' assets from custodians' own assets and disclosure requirements. With regard to treatment of stocks in insolvency proceedings against CDC the study finds that the assets of stockholders held by the CDC are protected through several key principles. These stocks are segregated from the CDC's own assets, ensuring they are not used to satisfy the CDC's debts. Beneficial owners retain their ownership rights and regulatory frameworks often involve appointing trustees or receivers to manage these stocks.

6.3 RECOMMENDATIONS ON *SHARĪ'AH* ISSUES

In line with the research objectives and research questions and based on the findings of the research, the following recommendations are made on *Sharī'ah* issues pertaining to pre-stock trading practices, actual stock trading practices and post-stock trading practices at PSX.

6.3.1 Recommendations on *Sharī'ah* Issues of Pre-Stock Trading

There are various recommendations made on *Sharī'ah* issues pertaining to pre-stock trading practices. The recommendations pertaining to pre-stock trading are as follows.

- (a) Since the position of brokerage firm is that of a *wakīl* of stockholder and the rules of *wakalah* apply to it, therefore the firm should be held liable for the loss occurring to the stockholder as a result of firm's negligence, misconduct and misrepresentation. It has been suggested that the brokerage agreement signed between the stockholder and the firm should clearly specify the situations of negligence, misconduct and misrepresentation that make the firm liable for the loss to the stockholder.
- (b) As stated above, that *Shari'ah* emphasizes on avoidance of conflict of interest for a *wakīl*. Under Islamic law of *wakalah*, a *wakīl*, has to prefer the interest of his principal on his own interest. It has been suggested that if any situation of conflict of interest arises, the firm should be made bound to disclose it to the stockholder. It has further been suggested that the current code of conduct for brokerage firms, should be further improved in the light of Islamic law of agency and the Islamic injunctions on avoidance of conflict of interest be incorporated in the code of conduct for brokerage firms. In other words, an Islamic code of conduct for brokerage firms be developed in which the issues such as conflict of interest are addressed in the light of *Shari'ah*.
- (c) It has been observed that brokerage firms heavily and excessively trade for the stockholder just in order to earn commission, regardless of whether trading is suitable for stockholder or not. It is recommended that PSX should monitor cases of unusual trading, in order to ensure that such trading was not motivated by mere charging commissions.
- (d) It has been observed that a common person or layman does not know about stock trading, yet he wants to invest his surplus funds in stocks. For this

purpose, he mainly relies on the knowledge and expertise of brokerage firm. On the other hand, it has been revealed, that brokerage firms were found involved in unethical market practices. They used stockholders' funds in proprietary trading, pledging their stocks for seeking financing from the banks for their own needs, non-segregation of stockholders' funds from their own funds, price manipulation and similar other unethical practices. Thus, it is imperative that SECP should launch awareness campaign for the common stockholders acquainting them with trading operations of stocks and the legal and regulatory framework governing the capital market. They should also be educated on the prevalent abusive practices of the market so that they are safeguarded and protected from the losses caused by such practices. The SECP should also arrange orientation sessions for the market operator and brokerage firms to equip them with the required code of conduct and other relevant rules and regulations.

Moreover, as the stock market is a specialized field of financial system and the *Sharī'ah* advisors and the *Sharī'ah* scholars generally do not have required knowledge and expertise of this field, it is necessary that SECP should conduct orientation sessions for *Sharī'ah* advisors and the *Sharī'ah* scholars as well on stock trading practices, its legal and operational framework, risk management system in stock market and clearing and settlement system and similar other issues that are necessary to know for a mufti issuing *fatwa* in this field.

Additionally, under the current brokerage regime, a brokerage firm deals with both the *Sharī'ah* compliant and *Sharī'ah* non-compliant securities. In order to develop Islamic capital market, it is preferred that there should be well trained, dedicated brokerage firms that deal only in *Sharī'ah* compliant stocks and securities. They should

have proper knowledge of *Sharī'ah* compliant trading, *Sharī'ah* compliant clearance and settlement, *Sharī'ah* screening, disposal of *Sharī'ah* non-compliant stock, purification methodology and similar other areas which a brokerage firm desiring to trade in *Sharī'ah* compliant manner, is required to know. For this purpose, special orientation sessions should be conducted for brokerage firm by the SECP.

6.3.2 Recommendations on *Sharī'ah* Issues of Actual-Stock Trading

There are various recommendations made on *Sharī'ah* issues pertaining to actual-stock trading practices at PSX in three different markets namely regular market, leveraged market and futures market.

The recommendations made on the *Sharī'ah* issues in the regular market are as follows.

- (a) With regard to trading in conventional stocks, it has been suggested that the SECP, as regulator instruct the brokerage firms and the PSX to gradually reduce volume of trading in conventional stocks and increase the volume of *Sharī'ah* compliant trading.
- (b) With regard to trading in preferred stocks, it has been suggested that, keeping in view the need of market, some *Sharī'ah* compliant alternatives need to be developed. In this regard, benefit may be taken from the concepts of *tanāzul* (forfeiture of right) and *hibah* (gift), imbedded in Malaysian model of preferred stocks.
- (c) Trading on T+2 carries potential *Sharī'ah* issues. To solve this issue, it has been suggested that *Sharī'ah* compliant counter on T+0 basis should be activated. For this purpose, SECP and PSX should take all stakeholders on board and persuade them to trade on same day delivery and payment basis.

The brokerage firms should ensure that they have sufficient funds available in the account of stockholder for payment on the same day instead of arranging funds after two days.

- (d) Intraday trading is generally a speculative activity. Brokerage firms persuade stockholders to engage in intraday trading which, in many cases result in loss to the stockholder. It has been suggested that in order to protect stockholders, that SECP should discourage it by limiting the size of intraday trades, for instance, a certain percentage of total trades. The brokerage firms should not be allowed to cross that limit.
- (e) Market manipulation is in conflict with *Sharī'ah* and legal principles, as it is against the fundamental ethics of fairness and transparency required in financial transactions. In case of market manipulation, an innocent stockholder trades on a bad price which is not truly reflective of the worth of the company. By looking at judicial actions in cases of market manipulation, it has been observed that the court has not taken stern actions against the brokerage firms involved in the abusive market practices that inflicted harm on stockholders. The SECP should take strict enforcement action to curb such practices and educate market participants on the importance of adhering to ethical standards. This approach will not only enhance the confidence of stockholders in the market but also ensure compliance with *Sharī'ah* principles.
- (f) An insider trader trades on the basis of non-public price sensitive information and thus makes undue gains or averts loss. It has been observed that due to deficiency of evidence in support of insider trading allegations and weak enforcement mechanism, very few cases of insider trading come

to light. The penalties imposed on insiders are generally in form of fines paid largely to SECP for contravention of regulatory regime. It has been suggested that enforcement mechanism should be strengthened, criminal liability beside civil liability against insider traders should also be invoked and insiders be held liable to compensate loss of the victim. In Pakistan, generally criminal penalties have not been imposed on the insiders.

The recommendations made on the *Shari'ah* issues in the leveraged market are as follows.

- i Short selling is generally held impermissible in *Shari'ah*. In order to make it *Shari'ah* compliant activity, it has been suggested that the regulator may develop some *Shari'ah* compliant alternatives for short selling. It may also consider ISSBNT as one of the alternatives to the current practice of short selling.
Additionally, the stakeholders need proper awareness and training regarding this model to ensure they fully understand its structure and compliance with *Shari'ah* principles.
- ii Margin financing is disallowed in *Shari'ah*. Its *Shari'ah* compliant alternative is *Murabahah Shares Financing* (MSF). In *MSF*, the brokerage firm, instead of providing interest-based financing, buys stocks from its own funds and sells them on *murahabah* basis to the customer. It has been suggested that Islamic banks and other Islamic financial institutions should register themselves with NCCPL as financiers and finance the needs of stockholders who, currently resort to conventional banks for margin financing. MSF cannot succeed without the help and patronage of Islamic banks. It has further been suggested that volume of margin financing be

gradually reduced so that it is phased out by the end of 31 December 2027, which is deadline for transformation of financial system to *Shari'ah* based system.

Moreover, the leveraged market transactions such as margin financing, margin trading, borrowing and lending of shares contained in Leveraged Market and Pledging Rules 2011 contain many *Shari'ah* issues that have been discussed. It has been suggested that Chapter 7B, 7C of NCCPL Regulations 2018 may be replaced with MSF Regulations. A time framework maybe given after which the above regulations will be discontinued and the MSF Regulations will be fully implemented.

The recommendations made on the *Shari'ah* issues in the futures market are as follows.

- i Futures contracts are largely impermissible in *Shari'ah* because they have number of *Shari'ah* issues such as sale of a non-existent thing, sale of one debt for another debt, sale of a thing which is yet to be possessed by the seller and it is a form of *gharar* and *maysir*. Cash settled futures, stock index futures, are especially in conflict with *Shari'ah* principles. It has been suggested that *Shari'ah* compliant alternatives may be developed for futures for genuine market needs. In this regard, benefit may be taken from Malaysian model of single stock futures with delivery of countervalues.
- ii The laws and regulations governing futures trading especially the Futures Market Act 2016 and Pakistan Stock Exchange Regulations 2018 contain some provisions which are contradictory to *Shari'ah*. Such provisions need to be reviewed by SECP *Shari'ah* Advisory Committee so that these laws and regulations are brought in conformity with *Shari'ah*.

- iii Futures Market Act 2016, contains many provisions that do not conform to *Sharī'ah*. The whole law needs to be examined by the Council of Islamic Ideology Pakistan (CII) and the *Sharī'ah* Board of SECP to determine its compatibility with *Sharī'ah* or otherwise and to suggest *Sharī'ah* compliant solutions for futures trading.
- iv Education and awareness programs should be conducted for market participants, including brokerage firms, stock investors and regulatory bodies, to ensure they understand the *Sharī'ah* issues associated with conventional futures contracts and the importance of developing and adhering to *Sharī'ah*-compliant alternatives. These programs should also emphasize the ethical and legal implications of non-compliance with *Sharī'ah* principles in futures trading, thereby promoting a more informed and compliant financial environment.

6.3.3 Recommendations on *Sharī'ah* Issues of Post-Stock Trading

There are various recommendations made on *Sharī'ah* issues pertaining to post-stock trading practices at PSX at three important stages which are clearing, settlement and custody of stocks.

The recommendations made on *Sharī'ah* issues in the clearing of stocks are as follows.

- i With regard to status of clearing house it has been recommended that the PSX should adopt AAOIFI standards allowing sub-agency with the principal's consent. Brokerage firms should ensure that stockholder agreements explicitly permit delegation of tasks, such as clearing, to a designated clearing house. This approach aligns with *Sharī'ah* principles,

ensures regulatory compliance and maintains transparency and trust with stockholders. Regular *Sharī'ah* compliance audits and stockholder education on sub-agency concepts are also suggested to uphold ongoing adherence to Islamic law.

- ii With regard to the practice of calculating mark to market profits and losses and valuating stocks on current market price on daily basis and binding stockholder to pay fictitious loss, it has been suggested that the financier in margin financing or MSF, may take some collateral from the stockholder, the financer to secure his debt, instead of demanding the stockholder, the financer to compensate a loss which has not actually occurred. Such loss is known and determined only with regard to price of stock on the day of settlement, not before.

The recommendations made on *Sharī'ah* issues in the settlement of stocks are as follows.

- i It has been recommended to recognize the role of NCCPL in the substitution of original parties in stock settlements as primarily as that of a *wakīl* and *kafīl*, rather than under a *hawālah* contract. This is because, under Islamic law, novation as practiced by NCCPL does not absolve the original parties of their obligations, unlike *hawālah*. NCCPL's function aligns more closely with acting as an agent for both buyer and seller, facilitating transactions and ensuring delivery and payment through a guaranteed mechanism. This dual role as *wakīl* and *kafīl* enhances market confidence and stockholder protection, consistent with *Sharī'ah* principles of *hifz al-māl* (protection of wealth).

- ii In T+2 settlement cycle for stocks the delivery of counter values, is deferred for two days. It involves *Shari'ah* issues and is generally not permissible in *Shari'ah*. It specially creates problem when stocks representing gold, silver, currency and receivables, are subject matter of trading. It has been suggested that T+0 system be implemented. This system will enable a *Shari'ah*-conscious stockholders to settle transactions on the day of trade, aligning with *Shari'ah* principles.
- iii On the issue of stock futures settlement, without actual delivery, it has been suggested that cash settlement of stocks without delivery should be discouraged and relevant regulations should be amended to align them with the principles of *Shari'ah*.

The recommendations made on *Shari'ah* issues in the custody of stocks are as follows.

- i With regard to change of status of company on account of violation of screening criteria, it has been observed that in Pakistan, the tolerance benchmark is very lenient due to market needs which require a flexible criterion to encourage the companies to be included in KMI-All Shares Islamic Index. But since Pakistan is on its way to a complete transformation to an Islamic financial and economic system, as required in the FSC judgment delivered in 2022, the ratios for interest-based borrowing or investing must be phased out gradually. For instance, thresholds or limits of 37% and 33% should be lowered to 25% in 2024, then to 15% in 2025, 5% in 2026 and to ban interest bearing borrowing and lending from the domestic market completely by the end of 2027. Similarly, the ratio of *Shari'ah* non-compliant income may be phased out to zero and any

company investing or getting money based on interest would not qualify to be *Sharī'ah*-compliant company for the stockholders in stocks.

Additionally, *Sharī'ah* Governance Regulations 2018 which has set financial ratios at 30% for interest-based borrowing and lending, should be implemented. The financial ratios should be further made strict.

- ii With regard to disinvestment of *Sharī'ah* non-compliant stocks as a result of change of status of company, the rule specifies a period of one year for disinvestment. This period of disinvestment is too long. It has been suggested that this period should be reduced to 90 days. In cases where disinvestment in 90 days involves loss to the stockholder, SECP may give him some relaxation in it. Such issues may be decided on individual merit of case. However, the disinvestment should not inflict heavy loss to the stockholder.
- iii It has been recommended that income of non-*Sharī'ah* compliant stocks be purified before dividend distribution by deducting the non-compliant income and crediting it to a charity account. This ensures compliance with *Sharī'ah* principles, which all respondents endorsed. If a stockholder disinvests after the company's *Sharī'ah* status changes, they may retain profit proportional to the compliant business percentage, purifying the remainder. Similarly, if dividends are declared while the stockholder retains stocks, they may keep the portion corresponding to the compliant business and purify the rest. This approach maintains adherence to *Sharī'ah* principles while addressing the nuances of stockholder income from non-compliant sources.

- iv With regard to the position of beneficial ownership of stocks it has been suggested that regulations clearly specify beneficial owner will carry all risks and rewards of stocks and that he will be regarded real owner only with this condition.
- v With regard to the issue of *zakāt* of stocks, it has been suggested that *zakāt* should be made payable on total market value of stocks.
- vi With regard to liability of stockholder it has been suggested that it should be clearly disclosed in the prospectus of the company that it is with limited liability and that the liability of stockholder is limited only to its capital. A limited liability should be recognized only with this condition. It should also be clarified in the prospectus that limited liability does not cover cases of fraud and misrepresentation by the directors of the company.

6.4 RECOMMENDATIONS ON LEGAL ISSUES

In line with the research objectives and research questions and based on the findings of the research, the following recommendations are made on legal issues pertaining to pre-stock trading practices, actual stock trading practices and post-stock trading practices at PSX.

6.4.1 Recommendations on Legal Issues of Pre-Stock Trading

There are various recommendations made on legal issues pertaining to pre-stock trading practices.

- i A major legal issue pertaining to pre-stock trading stage, is conflict of interest. It has been suggested that the regulations should clearly specify situations of conflict of interest, instead of leaving to the courts to decide

which case falls under conflict of interest and which does not. As a fiduciary, brokerage firm is under obligation to prefer the interest of stockholder over firm's interest. It has been observed that the profit earned by the brokerage firms on its own business, has been much higher than the profits from the business for its stockholders. SECP should monitor and take notice of such profit pattern and discrepancy between the profit of firm and profit of stockholders, because this shows that the firm has selected good investments for itself and bad investment for the stockholder. Further, the brokerage firms should be made bound to make clear and complete disclosures and take measures to ensure independence, objectivity and accountability in the investment decision making process in order to protect stockholder's interest.

- ii A brokerage firm is custodian of stockholder's assets and funds. It has been observed that brokerage firms do not segregate stockholder's assets from its own funds. It has been suggested that the firm in its agreement with the stockholder should clearly identify stockholder's assets and its separate account opened with a bank in the name of stockholder.
- iii Non-segregation of accounts constitutes a serious legal issue, reflecting misconduct by brokerage firm and shattering stockholder confidence. It has been suggested that merely imposing financial penalties may not suffice to address these malpractices; regulators must take strict regulatory actions proportional to the magnitude of such practices to curb such misconduct and restore stockholder's trust in the market.

6.4.2 Recommendations on Legal Issues of Actual-Stock Trading

There are various recommendations made on legal issues pertaining to actual-stock trading practices at PSX in three different markets namely regular market, leveraged market and futures market.

The recommendations made on the legal issues in the regular market are as follows.

- i With regard to preferred stocks contract, it has been suggested the current regulations on preferred stocks may be amended to align it with *Shari'ah* rules and principles.
- ii With regard to the market manipulation it has been recommended that stringent enforcement of existing regulations to combat market manipulation in PSX. Market manipulation, involving deceptive practices by brokerage firms, violates fiduciary duties as outlined in the Securities Act 2015, Competition Act 2010, Securities and Exchange Ordinance 1969, Securities Brokers (Licensing and Operations) Regulations 2016 and Brokers and Agents Registration Rules 2001. These acts prescribe severe criminal and civil penalties, including imprisonment, fines, disgorgement of profits and injunctions to cease manipulative activities. Regulatory authorities should enhance monitoring and impose strict penalties to deter such misconduct, ensuring market integrity and stockholder protection.
- iii To effectively address insider trading within the PSX, it is recommended to strengthen the regulatory framework by incorporating clearer definitions and stricter provisions against insider trading in the Securities Act 2015 and the Securities and Exchange Ordinance 1969. Introducing criminal penalties in addition to civil liabilities will serve as a stronger deterrent.

Enhanced enforcement capabilities for the SECP, including better resources and training for detecting and prosecuting insider trading, are essential. Mandating rigorous disclosure requirements, implementing whistleblower protections, conducting public awareness campaigns and utilizing advanced monitoring technologies will promote transparency and deter unethical practices. Collaboration with international regulatory bodies and providing specialized training for judges on insider trading cases will further bolster enforcement. Regularly reviewing and updating insider trading laws to adapt to market and technological changes is crucial for maintaining market integrity and stockholder confidence.

The recommendations made on the legal issues in the leveraged market are as follows.

- i To mitigate the risks and address the challenges posed by blank sales (naked shorting) in the PSX, it has been recommended that the SECP enhance regulatory enforcement and increase penalties for non-compliance. Strengthening the Regulations for Short Selling under Ready Market 2002 by imposing stricter monitoring and reporting requirements on brokerage firms will help ensure adherence to these rules. Implementing advanced technological solutions for real-time monitoring of trades can aid in detecting and preventing blank sales. Additionally, increasing public awareness about the risks and legal implications of blank sales, along with encouraging a culture of compliance within brokerage firms, will help maintain market integrity and protect stockholders. Collaboration with international regulatory bodies to adopt best practices and continuous

review and updating of regulations to address evolving market dynamics are essential for a robust regulatory framework.

- ii To address the legal issue of short and distort practices in the PSX, it is essential to implement stronger regulatory measures and enhance enforcement mechanisms. The SECP should introduce stricter penalties for those found guilty of market manipulation, including substantial fines and potential criminal charges. Increasing transparency in short selling activities by requiring detailed disclosures from market participants can help in early detection of manipulative schemes. Educating stockholders about the risks and signs of short and distort schemes will empower them to make informed decisions. Additionally, the SECP should consider establishing a dedicated task force to monitor and investigate suspicious trading activities in real-time. Collaboration with international regulatory bodies to adopt best practices and continuous updating of regulations to address evolving market manipulation tactics is crucial. This comprehensive approach will help maintain market integrity and protect stockholders from fraudulent activities.

The recommendations made on the legal issue in the futures market are as follows.

- i To address the issue of sale without ownership in the futures market, it is crucial for the SECP to enhance regulatory oversight and enforcement. This can be achieved by strictly enforcing existing laws such as the Contract Act 1872 and the Transfer of Property Act 1882, which require parties in futures contracts to possess legal ownership or authority over the underlying assets. The SECP should implement stringent verification processes for asset

ownership before allowing futures transactions, impose penalties for non-compliance by brokerage firms and intermediaries and establish effective mechanisms for resolving disputes related to sales without ownership. Educating stockholders about their rights and responsibilities in futures trading and promoting transparency through real-time reporting systems will further safeguard market integrity and protect stakeholders from fraudulent practices.

6.4.3 Recommendations on Legal Issues of Post-Stock Trading

There are various recommendations made on legal issues pertaining to post-stock trading practices at PSX at three important stages which are clearing, settlement and custody of stocks.

The recommendations made on the legal issues of the clearing of stocks are as follows.

- i To address the issue of non-transfer of stocks to CDC accounts by brokerage firms, it is imperative for the SECP to enforce stringent regulatory measures and ensure strict compliance with existing laws and regulations. The SECP should implement robust monitoring mechanisms to oversee the transfer process from brokerage firms' accounts to CDC accounts, imposing significant penalties for non-compliance. Enhancing transparency and accountability in the transfer process, along with educating stockholders about their rights and monitoring their investments, will bolster market integrity and safeguard stockholder confidence. Additionally, conducting regular audits and inspections to verify compliance with CDC transfer requirements will help prevent misuse of stockholder assets by brokerage

firms for proprietary trading or other unauthorized purposes, thereby upholding the sanctity of stockholder rights and promoting a fair and trustworthy stock market environment.

- ii To mitigate the risks associated with the unauthorized movement of stockholder stocks by brokerage firms, it is imperative to enhance and rigorously enforce existing regulatory measures. This can be achieved by strengthening the oversight and auditing capabilities of regulatory bodies such as the SECP and CDC, ensuring that brokerage firms adhere strictly to regulations like Regulation 6.7.2 of the CDC Regulations and Rule 12 of the Brokers and Agents Registration Rules 2001. Additionally, introducing more severe penalties for violations and implementing regular, mandatory compliance training for brokerage firm employees can further deter such practices. Moreover, technological solutions such as blockchain can be explored to provide a more transparent and tamper-proof system for tracking the movement of stockholder stocks, thereby bolstering trust and integrity within the financial system.

Furthermore, currently stock market cases are decided by the SECP whereby, the aggrieved party lodges complaint against certain brokerage firm and the SECP, performing quasi-judicial functions, issues notices to both complainant and the accused party mentioning nature of offence in the notice. On date of hearing, both the parties in person or through their attorneys plead their case. The cases are rarely referred to ordinary civil courts. In Pakistan there are special courts to hear cases relating to banking matters. These are called special banking courts. On the pattern of banking courts, there should be special courts for adjudicating stock market disputes. There should be well trained judges, possessing profound knowledge of stock market

operations, relevant laws and regulations, code of conduct prescribed for brokerage firms, common abusive market practices, common offences committed in the capital market and similar other matters required to be known by a judge sitting in the special court. The lawyers have a significant role in the enforcement of rule of law. They assist their stockholder in the matter before the court. They should also be trained in capital market laws.

The recommendations made on the legal issues of the settlement of stocks are as follows.

- i To address the legal validity of novation in stock settlements, it is crucial to align the practice with traditional contract law principles while accommodating the unique needs of the financial markets. This can be achieved by developing a clear legal framework that explicitly defines the roles and obligations of all parties involved in the novation process, including the NCCPL, original buyers and sellers and their brokerage firms. This framework should ensure that all parties consent to the novation and understand their ongoing rights and obligations, thereby providing legal clarity and reducing potential disputes. Additionally, incorporating technological advancements like blockchain can enhance transparency and traceability in the novation process, ensuring that all transactions are verifiable and secure. Regular review and updates to this legal framework, in consultation with legal and financial experts, will ensure it remains relevant and effective in addressing the evolving dynamics of the stock market.
- ii To address the legality of the central counterparty system operated by the NCCPL, it is essential to develop a robust legal framework that clarifies the

roles, rights and obligations of all parties involved. This framework should ensure that the NCCPL's dual role as buyer and seller is legally recognized and that contracts are designed to accommodate this unique arrangement. Additionally, the anonymity of transactions must be reconciled with traditional contract law principles through innovative legal mechanisms that uphold the validity of faceless trades. Clear, comprehensive and accessible regulations governing the NCCPL's operations, including explicit procedures for counterparty substitution, are crucial. Regular audits, transparent rule-making processes and continuous engagement with market participants can further enhance legal certainty and support the effective and stable functioning of the central counterparty system.

Moreover, while discussing case law on pre-stock trading activities, actual trading practice at PSX and post-stock trading activities, it has been noted that many instances of violations of code of conduct by the brokerage firm and their involvement in abusive practices of blank selling, pledging of stockholder stocks, non-transfer of stocks in CDC account, price manipulations and insider trading. Such practices have badly shattered confidence of stockholders in the market. It has been observed that SECP, performing its quasi-judicial functions, generally took lenient action against the parties involved in abusive practices. In many cases SECP impose meagre amount as financial penalties or suspended trading terminals for few days or issue warning letters to the parties involved in mal practices. In very few cases, license of concerned brokerage firms was cancelled. It has been recommended that SECP take strict actions against the offenders. The number of financial penalties should be proportionate to the size of violations and the magnitude of loss suffered by the stockholders. If the case involved criminal action, the matter should be referred to super courts for adjudication.

It has been concluded that many regulatory provisions could not be enforced due to market considerations, as in case of *Shari'ah* Governance Regulations 2018 on *Shari'ah* screening criteria. Thus, it is imperative that the regulatory and enforcement regime should be made effective and efficient so that the market should function smoothly and achieve the best result as per international standards.

The recommendations made on the legal issues of the custody of stocks are as follows.

- i To address the legal complexities surrounding the distinction between legal and beneficial ownership of stocks, it is crucial to establish a comprehensive legal framework that ensures transparency, accountability and clarity in stock ownership and custody. This framework should mandate precise identification and disclosure of beneficial owners, especially in cases involving intermediaries or trust arrangements, to comply with anti-money laundering (AML) and know your customer (KYC) regulations. It should also enforce strict corporate governance practices that align voting rights with beneficial ownership to prevent conflicts of interest. The legal process for transferring ownership and exercising proxy voting rights must be streamlined and clearly documented to avoid disputes. Additionally, robust mechanisms for dispute resolution and clear guidelines on the segregation and protection of assets during insolvency proceedings are essential to safeguard the interests of beneficial owners. Regular audits and compliance checks can further ensure adherence to these regulations, thereby enhancing trust and stability in the financial system.
- ii To safeguard stocks in insolvency proceedings against CDC, it is essential to segregate stocks held on behalf of beneficial owners from CDC's assets,

ensuring they are not used to satisfy CDC's debts. Regulatory frameworks must protect beneficial ownership by prioritizing the return or transfer of these assets as directed by authorities. Legal precedents, like those established in *Re Lehman Brothers International (Europe)* and *Re MF Global UK Ltd*, should guide the protection and management of stockholder assets, maintaining market confidence and stability.

6.5 CONCLUSION

There are various recommendations proposed to improve both *Sharī'ah* and legal issues. It has been concluded that many trading practices and governing regulations need to be aligned with *Sharī'ah* principles. Beside an efficient enforcement mechanism needs to be developed and implemented to curb malpractices in the PSX. It is hoped that reforms concerning stock trading practices and regulatory framework, will enhance the efficiency of stock market beside providing faith sensitive stockholders an avenue to augment their wealth in *Sharī'ah* compliant manner. The recommendations aim to create a more ethical and legally sound environment at PSX, ensuring *Sharī'ah* compliance and robust regulatory standards to uphold stockholder trust and market fairness in Pakistan.

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ANNEXURE – A

QUESTIONS FOR INTERVIEWS WITH *SHARĪ'AH* ADVISORS, ACADEMICIANS IN *SHARĪ'AH* DISCIPLINE, LAW EXPERTS AND MARKET PARTICIPANTS

Part 1: Questions Relating to Pre-Stock Trading Activity

Required Disclosures by the Issuer Company

- Do you think that omitting some necessary information in an IPO involves a legal issue? Is it a form of fraud and misrepresentation?

Brokerage Practices

- Do you think that stock-related practices by brokers violate the code of conduct prescribed for brokers? For instance, selling shares on behalf of clients that are not in the clients' best interest just to earn commission, placing shares as pledge, or giving them on credit for short selling?

Underwriting Fee/Commission

- Is charging a fee for underwriting permissible in *Sharī'ah*? If not, what should be the form of charging a fee or commission for underwriting in light of *Sharī'ah* principles?

SECP's *Sharī'ah* Screening Criteria

- Currently, a company is considered *Sharī'ah* compliant when its interest-based borrowing does not exceed 37% and interest-based lending does not exceed 33% of its market capitalization. Do you think this has sound *Sharī'ah* justification, especially now when Islamic investment modes are abundant, and banks have excess *Sharī'ah*-compliant liquidity?
- Would there be any issues if the investment and borrowing ratios were changed as per AAOIFI's criteria (30% borrowing and 30% lending)?
- If a stock/share is declared *Sharī'ah* non-compliant, how should it be disposed of? What steps should be taken for its disposal?

Part 2: Stock Trading Practices at Stock Exchange

Intra-Day Trading/Day Trading

- Do you think that the practice of buying and selling shares on the same day (intra-day trading) is permissible in *Sharī'ah*? What *Sharī'ah* issues are involved in it?

Preference Shares

- What is the *Sharī'ah* position on preferred stocks (preference shares)?

Short Selling

- Is short selling contradictory to *Sharī'ah*, considering the famous hadith in this context?
- What are the efficiency-related and legal issues in short selling, if any?
- In short selling, a trader borrows shares from a broker for selling and receiving proceeds. Can a broker lend shares that he practically does not have?

Margin Financing

- Does margin financing involve *Sharī'ah* issues?
- Can Murabahah financing be an effective *Sharī'ah*-compliant alternative for margin financing?

Stock Futures Contract

- Is there any *Sharī'ah*-compliant alternative for stock futures?
- Can a stock future be structured under *Sharī'ah* on a Muwa'adah (promise from both sides) basis, with the actual sale taking place on the settlement date and actual delivery of stocks?

Insider Trading

- What is the *Sharī'ah* and legal status of insider trading?

Part 3: Post-Stock Trading Activities

Settlement Issues

- Is cash settlement of futures stocks without actual delivery permissible in *Sharī'ah*? What *Sharī'ah* issues does this type of settlement involve?
- In the ready market, trading is settled on T+2, whereby the counter-values are delayed for two working days. Is it permissible to delay both counter-values in

a sale contract? Is it permissible to make a contract effective from a future date, say after two days?

- If the contract involves shares or stocks that represent gold or silver, what would be the permissible way of trading?
- NCCPL acts as an agent for both the seller and the buyer. Can it act as an agent for two parties under *Sharī'ah*?



ANNEXURE – B

QUESTIONS FOR INTERVIEWS WITH LAW EXPERTS AND MARKET PARTICIPANTS

Brokerage Practices

- Do you think that stock-related practices by brokers violate the code of conduct prescribed for brokers? For instance, selling shares on behalf of clients that are not in the clients' best interest just to earn commission, placing shares as pledge, or giving them on credit for short selling?

Part 2: Stock Trading Practices at Stock Exchange

Intra-Day Trading/Day Trading

- Do you think that the practice of buying and selling shares on the same day (intra-day trading) is a legal activity?

Short Selling

- Is short selling a legal trading practice in your view?
- What are the efficiency-related and legal issues in short selling, if any?
- In short selling, a trader borrows shares from a broker for selling and receiving proceeds. Can a broker lend shares that he practically does not have?

Insider Trading

- What is the legal status of insider trading?

Part 3: Post-Stock Trading Activities

Settlement Issues

- Is cash settlement of futures stocks without actual delivery a lawful activity? What legal issues are involved in such settlements?
- In the ready market, trading is settled on T+2, whereby the counter-values are delayed for two working days. Is it lawful to delay both counter-values in a sale contract? Is it permissible to make a contract effective from a future date, such as after two days?

- NCCPL acts as an agent for both the seller and the buyer. Can it act as an agent for two parties under the law?

