



***Sharī'ah* Challenges in Stock Custody:**

A Case Study of PSX

پاکستان اسٹاک ایکسچینج میں اسٹاک کسٹڈی کے شرعی چیلنجز: ایک مطالعاتی جائزہ

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Abstract:

The custody of stocks is a fundamental aspect of stock trading operations in financial markets, ensuring the safekeeping, administration, and efficient transfer of ownership. In the Pakistan Stock Exchange (PSX), the Central Depository Company (CDC) oversees this process through its Central Depository System (CDS), which facilitates electronic record-keeping and ownership transfers. While this system enhances security and operational efficiency, it also presents several *Sharī'ah* concerns that warrant critical examination. One key issue is the distinction between beneficial and legal ownership in the depository system. While investors hold stocks in their names, the actual control and management of these stocks often rest with the Central Depository Company (CDC), raising concerns about the investor's true ownership rights under *Sharī'ah*. Additionally, stocks that are *Sharī'ah*-compliant at the time of purchase may later become non-compliant due to changes in a company's financial activities, such as increased interest-based earnings or impermissible business engagements. This raises questions about the investor's responsibility upon such transitions, including whether they must sell these stocks immediately and how they should handle any dividends or capital gains earned during the non-compliant period. Another significant issue is the *Zakāt* obligation on stocks, particularly whether stocks should be classified as trade assets (subject to annual *Zakāt*) or long-term investments (potentially subject to *Zakāt* only on dividends). Lastly, issue of stockholder liability whether it remains limited to their investment or extends to personal assets. While AAOIFI and the International Fiqh Academy support limited liability for transparency and investment facilitation, some scholars argue for unlimited liability based on the principle of *al-kharāj bi-al-ḍamān*. By analyzing these aspects in light of Islamic jurisprudence, this paper identifies gaps in current custody practices and explores possible *Sharī'ah*-compliant solutions. The study aims to contribute to the ongoing discourse on ethical stock trading in Pakistan by ensuring that custody mechanisms align with Islamic financial principles, ultimately fostering greater confidence among *Sharī'ah*-conscious investors.

Keywords: Custody of stocks, *Sharī'ah* compliance, Pakistan Stock Exchange, Central Depository Company.

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Introduction

The custody of stocks plays a pivotal role in financial market operations by ensuring the safekeeping, administration, and seamless transfer of ownership. In the Pakistan Stock Exchange (PSX), this function is primarily managed by the Central Depository Company (CDC) through the Central Depository System (CDS), which provides an efficient electronic platform for recording and transferring stock ownership. The introduction of electronic custody has significantly improved transaction efficiency, reduced settlement risks, and enhanced investor confidence. However, despite these advancements, the system presents several *Sharī'ah* concerns that require careful scrutiny from an Islamic financial perspective.

One of the key issues pertains to the nature of stock ownership under the CDS framework. While stock investors hold shares in their names, the actual legal control often rests with the CDC. This distinction between beneficial and legal ownership raises important *Sharī'ah* questions regarding the investor's true rights over their stocks. From an Islamic legal standpoint, ownership entails full control, authority, and liability over an asset, making it essential to determine whether current custodial practices comply with these principles.

Another critical concern is the transition of stocks from *Sharī'ah*-compliant to non-compliant status. Given that companies' financial activities fluctuate over time, a stock that is initially permissible for investment under Islamic law may later become non-compliant due to factors such as an increase in interest-based earnings or engagement in impermissible business activities. This raises significant *Sharī'ah* questions regarding the stockholder's obligations upon such transitions, particularly in terms of divestment, the treatment of capital gains, and the purification of income derived from non-compliant stocks. Determining the appropriate course of action for *Sharī'ah*-conscious investors in such scenarios is vital to maintaining ethical stock trading practices.

Furthermore, the issue of *Zakāt* (obligatory almsgiving) on stocks remains an area of debate. Scholars differ on whether stocks should be categorized as trade assets, which are subject to annual *Zakāt* based on market value, or as long-term investments, where *Zakāt* may only apply to dividends. This classification has significant financial implications for stock investors, particularly those seeking to comply with Islamic obligations while engaging in equity investments.

Another fundamental aspect of stock custody is the liability of stockholders in the case of corporate debts and financial obligations. The modern legal framework operates on the principle of limited liability, where a stockholder's responsibility is confined to the extent of their investment, and their personal assets remain protected. While institutions such as AAOIFI and the International Fiqh Academy have endorsed this concept for its role in promoting investment and transparency, some scholars challenge its validity under Islamic law. They argue that *Sharī'ah* principles, particularly the doctrine of *al-kharāj bi-al-ḍamān*, establish a direct link between financial liability and entitlement to profits, thereby questioning the permissibility of limited liability in its conventional form. Addressing this issue is crucial for determining the alignment of modern corporate structures with *Sharī'ah* principles.

Given the increasing focus on Islamic finance in Pakistan, it is imperative to critically analyze these issues to ensure that stock trading remains *Sharī'ah*-compliant. This paper explores the custody of stocks in PSX from an Islamic legal perspective, identifying key areas where existing practices may require modification or clarification. By addressing concerns related to ownership rights, compliance transitions, *Zakāt*, and liability, this study aims to

contribute to the ongoing discourse on ethical stock trading and enhance the confidence of *Shari'ah*-conscious investors in the financial system.

Concept and Mechanism of Stock Custody

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.² 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.³

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.⁴

Custody of stocks in Pakistan is operated by CDC which acts as a central depository.⁵ CDC operates custody of stocks through an efficient depository system known as Central depository system (CDS).⁶ 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 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

² Hazen, Thomas Lee. *The Law of Securities Regulation*. (West Academic Publishing, 2020), 32.

³ Urie, Sandra K. "Best Practices for Custody of Stocks in Investment Management." *Journal of Investment Compliance* 7, no. 2 (2006): 45-58.

⁴ Cox, James D., Hillman, Robert W. and Langevoort, Donald C. *Securities Regulation: Cases and Materials*. (Wolters Kluwer, 2021), 25.

⁵ See, Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, March 2019, 32.

⁶ See, Central Depositories Act, 1997, s 4.

role in managing stock investors' portfolios and executing corporate actions, such as dividend payments and proxy voting.⁷ 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 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.⁸

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.⁹

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.¹⁰ However, instead 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.

⁷ See, Securities and Exchange Commission of Pakistan, *Savings and Capital Markets*, March 2019, 28.

⁸ Blumberg, Phillip I. *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality*. (New York: Oxford University Press, 1993) 78.

⁹ OECD. *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes*. (Paris: OECD Publishing, 2001) 17.

¹⁰ DeFeo, Philip J. "Understanding Custodial Responsibilities in Securities Markets". *Journal of Financial Regulation and Compliance* 13, no. 4 (2005): 367-381.

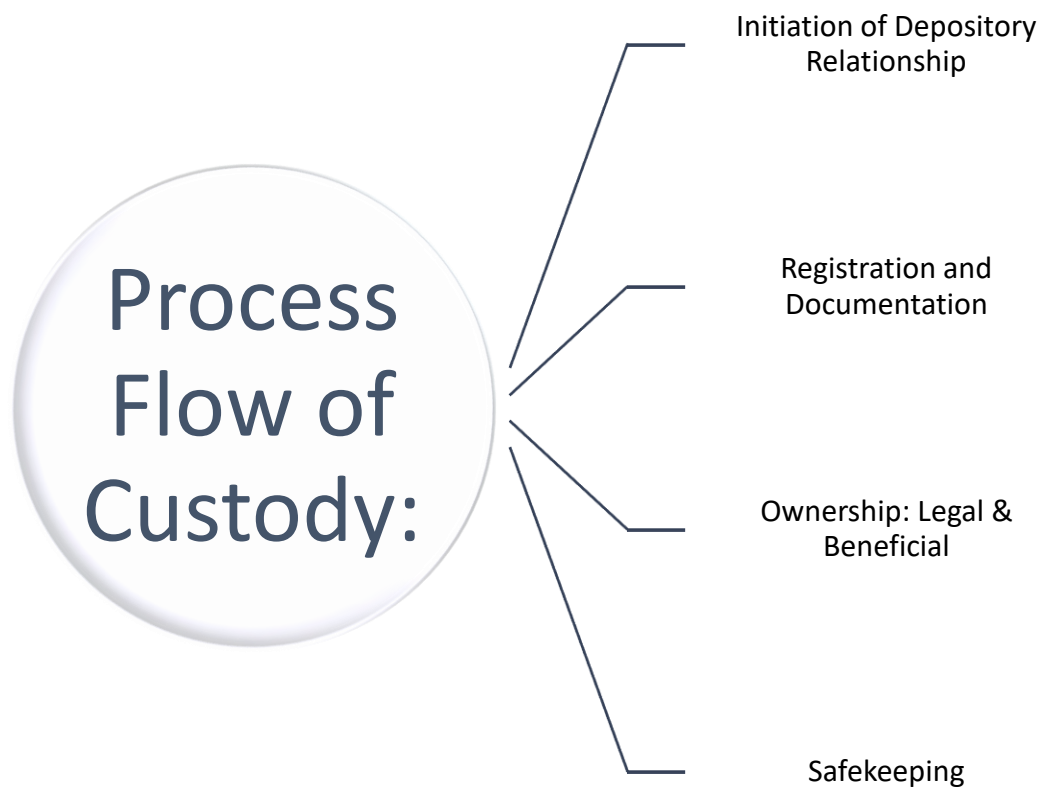


Figure 1: Process Flow of Custody

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.

***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.

i) A change of *Sharī'ah* Status of Stocks from *Sharī'ah* Complaint 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* complaint 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 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.¹¹ 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 Index.¹² 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 2022,¹³ the ratios for interest-based borrowing or investing must be phased out gradually.¹⁴ 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 2027.¹⁵ Similarly, the ratio of *Sharī'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 stock investors in stocks.¹⁶

¹¹ Kamran, Saadia. "Islamic Finance in Pakistan: *Sharī'ah* Compliance and Operational Challenges." *Journal of Islamic Banking and Finance* 36, no. 1 (2021): 89-105.

¹² Aḥmad, Zahid and Muhammad Saeed. "Flexibility in *Sharī'ah* Screening Criteria: The Case of Pakistan." *International Journal of Islamic and Middle Eastern Finance and Management* 13, no. 4 (2020): 701-715.

¹³ Federal *Sharī'ah* at Court of Pakistan. "Judgment on Ribā and Interest-based Transactions, 2022." Available at: <https://www.federalshariatcourt.gov.pk/Judgments/Riba_Judgment_2022.pdf>

¹⁴ Recent amendments in SECP regulations (2023) emphasize the adoption of AAOIFI standards, ensuring greater transparency in stock transactions. Additionally, IFSB guidelines have introduced stricter criteria for identifying non-*Sharī'ah*-compliant stocks.

¹⁵ Mansoori, Ayub, Paper titled: "*Islamization of Non-Banking Sector in Pakistan*" presented to AAOIFI-SECP Islamic Capital Market Conference held on 29th May, 2023 in Islamabad.

¹⁶ *Sharī'ah* Advisory Council of Pakistan. "Recommendations for Gradual Elimination of Non-compliant Income." *Journal of Islamic Finance* 18, no. 2 (2022): 45-58.

In Malaysia the threshold provided by SAC of SC Malaysia for interest-based borrowing and lending is 33% of total market capitalization.¹⁷ 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.¹⁸ 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.¹⁹ *'Umūm al balwā* is the situation that effects most people and is difficult to avoid and it frequently occurs in people's life.²⁰ 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.²¹ 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.²² 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.²³

It is observable here that the Malaysian regulator has followed flexible approach in setting the tolerance benchmark.²⁴ This appears justifiable keeping in view the fact that a considerable part of Malaysian population is non-Muslim whose rights are protected by Islam as well as the constitution.²⁵ Thus, the occurrence of *'umūm al balwā* is most common in the Malaysian society.²⁶

¹⁷ *Sharī'ah* Advisory Council, Securities Commission Malaysia. "Guidelines on the Determination of Capital Market Products under the *Sharī'ah* Principles (Securities Commission Malaysia)." <https://www.sc.com.my/api/documentms/download.ashx?id=443a1236-8a0e-48bc-8d77-269081a5e72f> (accessed June 24, 2024).

¹⁸ Ibid.

¹⁹ Ibrahim, Ahmad. " *Sharī'ah* Governance in Islamic Finance: Core Activities versus Minor Non-permissible Elements." *Journal of Islamic Banking and Finance* 15, no. 3 (2019): 45-62.

²⁰ *Sharī'ah* Advisory Council, Securities Commission Malaysia. "Guidelines on the Determination of Capital Market Products under the *Sharī'ah* Principles (Securities Commission Malaysia)." <https://www.sc.com.my/api/documentms/download.ashx?id=443a1236-8a0e-48bc-8d77-269081a5e72f> (accessed June 24, 2024).

²¹ Securities Commission Malaysia. "Guidelines on the Assessment of Mixed Business Activities." Kuala Lumpur: Securities Commission Malaysia, 2024.

²² Ibid.

²³ Ibid.

²⁴ Securities Commission Malaysia. "Annual Report 2023." Kuala Lumpur: Securities Commission Malaysia, 2023.

²⁵ Abdul Razak, Aishah Myra. "Protection of Non-Muslim Rights in Malaysia: A Comparative Study." *Asian Journal of Comparative Law* 11, no. 2 (2016): 321-340.

²⁶ Zainuddin, Zaidi. "'Umūm al Balwa: Understanding its Prevalence in Malaysian Society." *Journal of Southeast Asian Studies* 48, no. 1 (2017): 89-105.

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.²⁷

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.²⁸ 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 *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.²⁹

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.³⁰ 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.³¹

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.³² For example, a *Sharī'ah* compliant manufacturing company

²⁷ 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).

²⁸ Siddiqi, Muhammad Nejatullah, *Islamic Capital Markets: Principles and Practices* (Leicester: The Islamic Foundation, 2000), 55-58.

²⁹ Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge: Cambridge University Press, 2006), 112-115.

³⁰ 'Usmanī, Taqī, *An Introduction to Islamic Finance* (The Hague: Kluwer Law International, 2002), 78-80.

³¹ Ayub, Muhammad, *Understanding Islamic Finance* (Chichester: Wiley, 2007), 95-98.

³² Vogel, Frank E. and Hayes, Samuel L. *Islamic Law and Finance: Religion, Risk and Return* (The Hague: Kluwer Law International, 1998), 130-133.

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.³³

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.³⁴ 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.³⁵

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.³⁶ 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 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.³⁷

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

³³ Iqbal, Munawar and Molyneux, Philip. *Thirty Years of Islamic Banking: History, Performance and Prospects* (New York: Palgrave Macmillan, 2005), 140-145.

³⁴ Siddiqi, Muhammad Nejatullah. *Islamic Capital Markets*. (Jeddah: Islamic Research and Training Institute, 2006), 60-62.

³⁵ El-Gamal, Mahmoud A. *Islamic Finance: Law, Economics, and Practice*. (Cambridge: Cambridge University Press, 2006), 120-123.

³⁶ Usmani, Taqī. *An Introduction to Islamic Finance*. (Karachi: Idara Isha'at-e-Deeniyat, 2002), 85-88.

³⁷ Ayub, A. *Understanding Islamic Finance*. (Chichester: Wiley Finance, 2007), 105-108.

Sharī'ah principles can lead to non-compliance.³⁸ 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* 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.³⁹ 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.

ii) 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 provide that such stocks should be disinvested in a period of one year.⁴⁰ 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.⁴¹ Taqi '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.⁴²

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

³⁸ Vogel, Frank E., and Samuel L. Hayes III. *Islamic Law and Finance: Religion, Risk, and Return*. (The Hague: Kluwer Law International, 1998), 140–143.

³⁹ Iqbal, Zubair, and Philip Molyneux. *Thirty Years of Islamic Banking: History, Performance and Prospects*. (New York: Palgrave Macmillan, 2005), 150.

⁴⁰ *Sharī'ah* Governance Framework Regulations 2018, s 13.

⁴¹ El-Gamal, Mahmoud A. "Islamic Finance and Economics: A Critical Analysis." *Islamic Finance*, 2010, 110-115.

⁴² Usmanī, Taqī, *Islam Aur Jadid Maeeshat Wa Tijarat* (Islam and Modern Economics and Trade), (Karachi: Idārat ul Ma'ārif, 1996), 87.

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 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.⁴³

On the methodology of disposal of *Sharī'ah* non-compliant stocks, the respondents were of the view that if a person invested in *Sharī'ah* compliant stock and subsequently declared *Sharī'ah* non-compliant, he should dispose it of.⁴⁴ They had, however, divergent views regarding the methodology and period of disinvestment of *Sharī'ah* non-compliant stock. One respondent observed that the stock investor, who knew about *Sharī'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.⁴⁵ Another respondent said that the non-*Sharī'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.⁴⁶ Few respondents observed that if the price of stock on the day of its declaration as *Sharī'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 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.⁴⁷

iii) *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.⁴⁸ It is necessary that this illegitimate income be purified before the distribution of dividends.⁴⁹

⁴³ Muhammad Duwābah, Ashraf. *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 *Sharī'ah* Perspective) Paper presented in Conference on Islamic Banking in Theory and Practice, held in Dubai on June 2, 2020, 43.

⁴⁴ Respondents 101, 102, 103, 104, 105, 111.

⁴⁵ Respondent 102.

⁴⁶ Respondent 104.

⁴⁷ Respondent 114.

⁴⁸ Salman Ahmad Shaikh, Analysis of Islamic Mutual Funds Operations in Pakistan, MPRA, July 1, 2012, See, <https://mpa.ub.uni-muenchen.de/42495/1/MPRA_paper_42495.pdf>; Hasan, Kabir & Michael, Mählknecht. *Islamic Capital Markets: Products and Strategies*, (United Kingdom: John Wiley & Sons, 2011), 125.

⁴⁹ AAOIFI and SECP suggest that income from non-*Sharī'ah* compliant stocks should be donated to charity as a form of purification. Some scholars also recommend assessing *Zakāh* based on the proportion of compliant vs. non-compliant holdings in a stock portfolio.

On this issue, all respondents endorsed the above position that illegitimate income must be purified before the distribution of dividends.⁵⁰

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 for Rs. 120, the profit is Rs. 20. If looking at financials of the company, it appears that 50 percent of the company was *Sharī'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.⁵¹

Another question is whether a stockholder can receive dividends if the *Sharī'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 *Sharī'ah* scholars hold the same view that the stockholder can receive dividends corresponding to the *Sharī'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 *Sharī'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.⁵²

iv) Position of Beneficial Ownership of Stocks

Position of beneficial ownership of stocks is another important *Sharī'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.⁵³ In other words, stocks are registered in CDC's name. The stockholders are treated as beneficial owners not the legal owners. 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 Ḥanafīs 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.⁵⁴ Zuhaili asserts that Ḥanafīs use them as interchangeable terms.⁵⁵ According to Ḥanafīs, *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 Ḥanafī 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

⁵⁰ Respondents 1-18.

⁵¹ 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*. Vol. 29. (Beirut: Dār al-Ma'rifah, 2005), 73.

⁵² Respondent no. 114.

⁵³ Usmanī, Taqī. *An Introduction to Islamic Finance*. (Karachi: Idaratul Ma'arif, 2002), 181-182.

⁵⁴ Kasānī, *Bādā'i' al-Sānā'i'*, vol. 6. (Beirut: Dār al-Kutub al-'Ilmiyyah, 1997), 188.

⁵⁵ Zuhailī, Wahbah. *Al-Fiqh al-Islamī wā Adillatuhū*. vol. 4. (Damascus: Dār al-Fikr, 2006), 60.

ownership. According to the Mālikis, ownership is a legal authority over corpus of a property and its benefit.⁵⁶ 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.⁵⁷ 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".⁵⁸ In other words he gives the owner certain rights. Hanbalis 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 this benefit to someone else.⁵⁹ 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 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).⁶⁰ *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.⁶¹ 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.⁶² AAOIFI *Sharī'ah* board has acknowledged beneficial ownership in an implied and implicit manner that beneficial ownership is recognized from the *Sharī'ah* perspective.⁶³ SAC of Bank Negara Malaysia more specifically, discussed the beneficial ownership in the context of *ijārah* assets.⁶⁴ The SAC, resolved that the lessor is the owner of the leased asset although his name is not registered in the asset's title.⁶⁵ The resolution was based on the *Sharī'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

⁵⁶ Al-Qarafi. *Al-Furuq*. (Beirut: Dār al-Kutub al-'Ilmiyyah, 1995), 30.

⁵⁷ Al-Ramli. *Nihayah al-Muhtāj*. vol. 4. (Beirut: Dār al-Kutub al-'Ilmiyyah, 1996), 255.

⁵⁸ Suyūṭī, Jalāl al-Dīn, *Al-Ashbah wā al-Nazā'ir*, (Beirut: Dār al-Kutub al-'Ilmiyyah, 1411 H), 326.

⁵⁹ Ibn al-Qayyim, *Badā'i' al-fawā'id*, (Beirut: Dār al-Kitāb Al-'Arab, 1993), 3.

⁶⁰ Adawiah, E. R., Klopick, N., Elias, M. R. F., & Haron, M. N. Application of the concept of beneficial ownership in *shukūk* structures: an Islamic legal analysis. *ISRA International Journal of Islamic Finance*, vol. 7, No. 2, (2015): 105-133.

⁶¹ SBP Circular No. 12.

⁶² International Fiqh Academy. Resolutions and Recommendations of the International Islamic Fiqh Academy. 9th Session, Sharjah, Jumada al-Ula, 1430 AH.

⁶³ 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).

⁶⁴ SAC, 2010, 6.

⁶⁵ Bank Negara Malaysia. *Sharī'ah Resolution in Islamic Finance* (2nd Ed.). (Kuala Lumpur: Bank Negara Malaysia, 2010), 45.

the lessee and presumably the purchase agreement between the seller and lessor/purchaser.⁶⁶ 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.⁶⁷

The modern *Shari'ah* scholars like Zarqa,⁶⁸ Taqi 'Usmani,⁶⁹ Yousuf al-Shubaili,⁷⁰ Muhammad 'Uthman Shabbir,⁷¹ Abd al-Sattar Abu Ghuddah,⁷² 'Abd Al-Razzaq Abd al-majid,⁷³ recognize the concept of beneficial ownership in the modern sense of the word. The recognition of beneficial ownership is clearly observable the 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 *Shari'ah* scholars and *fiqh* institutions that beneficial ownership of stocks is a valid ownership from the perspective of *Shari'ah*.⁷⁴ Majority of them have held that *Shari'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 (*huriyyat al-taṣarruf*) by the owner is a valid ground for validity and *Shari'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.⁷⁵

v) *Payment of Zakāt of Stocks*

Another important *Shari'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 the lunar year (*ḥawl*).⁷⁶ 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,

⁶⁶ Ibid.

⁶⁷ ISRA. *Islamic Capital Markets: Principles and Operation*. (Kuala Lumpur: International *Shari'ah* Research for Islamic Finance, 2015), 25.

⁶⁸ Zarqa, *Al-Madkhal ila Nazariyyah al-Iltizam Al-'Ammah*, (Damascus: Dār al-'Ilm, 1999), 45.

⁶⁹ 'Usmani, Taqī, *Buhuth fi Qadaya Fiqhiyyah M'asirah*, (Damascus, Dār al-Qalam, 2003), 84.

⁷⁰ Shubaili, *Haqq al-Intifa' al-'Iqārī*, Fourth *Fiqh* Conference of Islamic Financial Institutions, Kuwait, 2011, 13.

⁷¹ Shabbir, *Al-'Itiyād 'an Haqq al-Intifa' wā Tatbīqātuhū al-Mu'āsirah fi al-Fiqh al-Islāmī wā al-Qanūn al-wad'i*, Second International *Fiqh* Conference for Islamic Financial Institutions, Kuwait, 2005, 9.

⁷² Abū Ghuddah, Paper titled: *Haqq al-Intifa' al-'Iqārī*, presented in Fourth *Fiqh* Conference for Islamic Financial Institutions, 2011.

⁷³ Abd al-Msjid, 'Abd Al-Aazzaq. *Tatbīq al-Milkiyyah al-Qānūniyyah wā al-Milkiyyah al-Nāfi'yyah fi al-Tamwīl al-Islāmī*, *Journal of Al-Shariqah University*, vol. 13, no. 1, (June 2016): 12.

⁷⁴ Respondents 101-118.

⁷⁵ Respondents 101, 102, 103, 104, 105, 106, 107, 111, 112, 114 and 115.

⁷⁶ Abū Zahrah, *Payment of Zakāt of Stocks in Modern Islamic Law*, (Jeddah: International *Fiqh* Academy), 59.

receivables, raw material and manufactured goods. Non-*Zakatable* assets are the fixed assets such as building and machinery. A stock represents both *Zakatable* and non-*Zakatable* assets. Thus, if the *Zakatable* assets of the company are 60 percent of the total assets and non-*Zakatable* 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 *Zakatable*.⁷⁷

However, this opinion does not seem to be practicable, because it is difficult to investigate how much assets of the company are liquid (*Zakatable*) and how much are illiquid and fixed (non-*Zakatable*). 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 *hawl* criteria. There are differing opinions among scholars regarding whether dividends should be included in the total wealth calculation for *Zakāt*. Taqī Usmani and Muhammad ibn Adam al-Kawthari argue that since dividends represent income generated by the stocks, they should be included,⁷⁸ while Ibn Bāz and Ibn Uthaimin suggest that *Zakāt* should be paid only on the value of the stocks themselves.⁷⁹

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 *nisāb* and *hawl* criteria. However, if the profit is reinvested immediately, some scholars argue that *Zakāt* is not due until the end of the *hawl* period when the profit becomes part of the total *Zakatable* assets.⁸⁰

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 *Zakatable* assets, including the market value of the stocks, at the end of the *hawl* period.⁸¹ 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.⁸²

⁷⁷ Usmanī, Taqī. *An Introduction to Islamic Finance*. (Karachi: Idaratul Ma'arif, 2002).

⁷⁸ Taqī Usmanī and Muhammad 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 *nisāb* and *hawl* criteria. See, 'Usmanī, Taqī. *Contemporary Issues in Islamic Finance*, (Karachi: Maktaba Ma'arifur Qur'ān, 2001, 132-135; al-Kawtharī, Muhammad ibn Adam. *Islamic Guide to Zakat*. (London: White Thread Press, 2010), 87-89.

⁷⁹ 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.

⁸⁰ 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 *nisāb* and *hawl* criteria.

⁸¹ 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, Al-Qaradawi, Yusūf. *Islamic Finance: The Principles of Zakah*. (Cairo: Dār Al-Qalam, 2002), 76-82.

⁸² 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." See, <<https://www.islamicfiqhacademy.org/guidelines-zakat-calculation>>, (accessed July 3, 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.

vi) *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: Is from the perspective of *Sharī'ah* liability of stockholder in a company limited to his stocks or extends to his personal assets as well, in other words is his liability limited liability or unlimited liability?⁸³

AAOIFI, International *Fiqh* Academy and Modern *Sharī'ah* scholars such as Taqī 'Usmani,⁸⁴ Wahbah Zuhailī⁸⁵ and Abdul Aziz Khayyat,⁸⁶ 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.⁸⁷ 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 whose liability is limited to its capital because that is known to the company stock investor and such awareness on their part precludes deception.⁸⁸

Taqī '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.⁸⁹

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

⁸³ The *Hanafi* school largely accepts limited liability in corporate stockholding, aligning with modern business structures. However, some scholars from the *Mālikī* and *Shāfi'ī* schools argue that unrestricted stock trading may violate *Sharī'ah* principles if ownership is not fully transferred.

⁸⁴ 'Usmanī, Taqī, *An Introduction to Islamic Finance*, (Karachi: Qur'ānic Studies Publishers, 2011), 224.

⁸⁵ Zuhailī, Wahbah, *Al-Fiqh Al-Islami wa Adillatuhū*, (Damascus: Dār Al-Fikr 1989), vol. 4, p. 881.

⁸⁶ Khayyat, *Al-Sharikat fi Al-Sharī'ah al-Islamiyyah wa Al-Qanun al-Wad'i*, (Amman: Dār Albashir, 1994), 89.

⁸⁷ AAOIFI, *Sharī'ah Standard no. 12, Art. 4.1.2.9*.

⁸⁸ *Resolutions and Recommendations of International Fiqh Academy*, (Jeddah, 2000), 130.

⁸⁹ 'Usmanī, Taqī. *Islam aour Jadid Ma'ishat wa Tijarat, (Islam and Modern Economics and Trade)*, (Karachi: 1996), 81.

personal assets are generally protected. This concept aligns with the broader principles of fairness and risk-sharing in Islamic finance.⁹⁰

However, according to *Dār al-Iftā*, *Jami'ah al-'Ulūm Islamiyyah*,⁹¹ and Nyazee⁹² 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.⁹³ Nyazee argues that *Sharī'ah* principles establish the idea of liability through 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.⁹⁴

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.⁹⁵

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.

Comparative Table: *Sharī'ah* Challenges in Stock Custody

The comparative table below highlights the differences between the current stock market practices and *Sharī'ah* principles.

Issue	<i>Sharī'ah</i> Principles	Current Stock Market Practices
Change of <i>Sharī'ah</i> Status of Stocks	Stocks should remain <i>Sharī'ah</i> -compliant unless the core business changes to something prohibited (ḥarām). Investors	Stocks frequently shift between <i>Sharī'ah</i> -compliant and non-compliant status due to business activities, debt ratios, and interest-

⁹⁰ Zarqa, Anas. *Islamic Economics: An Approach to Human Welfare*. (New York: Palgrave Macmillan, 2015), 102-104.

⁹¹ *Jami'ah al-'ulum Islamiyyah*, Current Islamic Banking: *Sharī'ah* Analysis, *Fiqhi* Evaluation, (Karachi, *Dār ul Iftā*, *Maktaba Bayyinat*, 2009), 130.

⁹² Nyazee, Ahsan, *Islamic Law of Business Organization Partnerships*, (Islamabad: IRI, 1998), 90.

⁹³ *Jamia al-Uloom al-Islamiyyah*, *fatwā* titled: "Current Islamic Banking: *Sharī'ah* Analysis, *Fiqhi* Evaluation", *Dār ul Iftā*, *Maktaba Bayyinat*, Karachi, 2009, 130.

⁹⁴ Nawāz, Usmān. Liability of Shareholder from *Sharī'ah* Perspective: A critical Appraisal, *Journal of Managerial Sciences* 101, Qurtuba University, Peshawar, vol. 14, Issue 4, (Oct-Dec 2020), 25.

⁹⁵ ISRA, *Islamic Capital Markets: Principles and Operation*. (Kuala Lumpur: International *Sharī'ah* Research for Islamic Finance, 2015), 38.

Issue	<i>Sharī'ah</i> Principles	Current Stock Market Practices
	must monitor compliance actively.	based income. Investors often rely on periodic screenings.
Disinvestment of <i>Sharī'ah</i> Non-Compliant Stocks	Immediate disposal is required once a stock becomes <i>Sharī'ah</i> non-compliant. Any profit made after non-compliance must be donated.	Investors are often unaware of compliance shifts, and delays in disinvestment may lead to profit retention, raising <i>Sharī'ah</i> concerns.
Income from Non-<i>Sharī'ah</i> Compliant Stocks	Income from non-compliant sources must be purified by donating the non-compliant portion to charity.	No strict purification mechanism exists in conventional markets. Many investors retain non-compliant profits.
Beneficial Ownership of Stocks	Ownership in <i>Sharī'ah</i> requires risk-bearing (ḍamān) and control over the asset. Beneficial ownership alone does not suffice.	CDC system separates legal ownership from beneficial ownership, leading to ambiguity in stockholder rights and liabilities.
<i>Zakāt</i> on Stocks	Stocks are trade assets and should be valued at market price annually for <i>Zakāt</i> calculation. Some scholars suggest paying <i>Zakāt</i> on net assets if stocks are held for dividends.	No standardized <i>Zakāt</i> framework for stockholders. Some investors only pay <i>Zakāt</i> on dividends, while others follow different rulings.
Liability of Stockholders	Debate exists: Classical Islamic law suggests full liability, but modern Islamic scholars differ. Some allow limited liability as long as the company operates ethically.	Conventional stock markets assume limited liability, which may conflict with certain Islamic rulings that require full accountability.

Figure 2: Comparative Overview

The table above presents a structured comparison between *Sharī'ah* principles and current stock market practices in the context of stock custody in PSX. It highlights key *Sharī'ah* issues, such as the transformation of stock compliance status, disinvestment of non-compliant stocks, income purification, beneficial ownership, *Zakāt* obligations and stockholder liability. This comparison aims to illustrate the inconsistencies between Islamic financial principles and existing stock custody mechanisms, providing a foundation for addressing *Sharī'ah*-related challenges in the PSX system.

Recommendations on Legal Issues of Custody of Stocks

The recommendations made on *Sharī'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 *Sharī'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.

Conclusion

The custody of stocks in PSX plays a vital role in ensuring efficient and secure transactions, yet it presents key *Sharī'ah* challenges that require attention. The distinction between legal and beneficial ownership raises concerns about investor rights, while the transition of stocks from *Sharī'ah*-compliant to non-compliant status creates ethical and financial dilemmas. Additionally, issues surrounding *Zakāt* obligations and stockholder liability necessitate clearer guidelines to align custodial practices with Islamic principles.

Addressing these concerns is essential for fostering *Sharī'ah*-compliant investment and maintaining confidence in Islamic finance. Regulatory authorities, financial institutions, and scholars must collaborate to refine the custody framework, ensuring greater transparency and

adherence to *Sharī'ah* requirements. By bridging these gaps, Pakistan's stock market can uphold Islamic financial ethics while supporting sustainable economic growth.

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