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Special considerations for stock trading in the context of the Islamic finance model

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Abstract — The paper analyzes stock trading for identifying speculative and investment transactions in stock by the example of the Moscow Exchange. The analysis uses ticks of 15 issuers for two months of 2023. It is revealed that exchange dealings are predominantly speculative in nature and that stock market speculations do not comply with the Islamic finance rules. Solutions are proposed for bringing the trading mechanism into compliance with the principles of Sharia (the Islamic finance model).

Keywords: Islamic, finance, banking, speculation, stock exchange, number of transactions, stock

JEL codes: G1, G2, Y80, Z12

1. Introduction

The Islamic finance model (IFM) does not negate securities and their trading on exchanges. Accordingly, many of the countries that use, in one form or another, the IFM have stock exchanges. Their trading rules and patterns do not significantly differ from those used on stock exchanges that exist in countries using a fully traditional financial system. It is so because so far the IFM has not set any requirements to the trading mechanism of stock exchanges and, as a result, all “Islamic” exchanges reproduce in every detail the trading rules and methods established on the European and US stock exchanges.

The author’s analysis shows that such slavish assimilation leads to violation of the fundamental principles of Sharia and is inadmissible in terms of the IFM. Hence, this research aims to define IFM-compliant stock market principles.

Quotes/prices have been taken on Finam’s Website at finam.ru/.

2. Literature review

The search for scientific publications in the RSCI by key words such as “Islam, stock exchange, speculation, and stock/shares” produced, as was expected, no results. The search in the SSRN database (www.ssrn.com) yielded in the end six publications.

The earliest publication [1] dates back to 1984, the time when the Islamic finance industry was just taking off. The article was published in a peer reviewed Arab journal and clearly proclaimed one firm conclusion – the Islamic economy undoubtedly needs stock exchanges but stock market speculations are not compatible with the principles of Sharia. Discussion was about the way stock trading should be organized, with variations in stock prices not linked to an entity’s economic performance. One of the proposed measures to counter speculation was to consider setting maximum stock prices.

One would think – OK, the issue is closed, speculation is inadmissible, and there is no need to go back to the matter. However, the authors of two articles that appeared ten years later “do a U-turn” and no longer condemn stock market speculations. The appearance of such publications

can be due to the problems encountered by the Islamic exchange organizers that strove to comply in every respect with the requirements of Sharia. Over the decade, much practical knowledge was gained and demanded explanations.

The article [2] published in 1993 tolerates speculation to a certain extent; at the same time, as a countermeasure the author suggests increasing taxes on capital gains from purchase and sale of stock over a short period of time. Also, the author proposes to ban rapid rise/fall of the quoted stock prices.

The author of the article that appeared two years later [3] argues that “though not always virtuous, speculation should not be constantly condemned: it has both positive and negative aspects”. For instance, in the author’s opinion, speculation helps to stabilize prices. The publication attempts to set a criterion for admissible speculation: “speculation is erroneously treated as gambling, while it is not necessarily so, but the less information is available to professional participants, the more closely speculation resembles gambling”. Trying to prove the significance of speculation for the market, the author puts forward a highly controversial, in our opinion, idea: “Speculators that are better informed than others are of value as a source of information”. How information will be re-distributed is not clarified by the author.

Both publications did not go unnoticed, and a year later were followed by the article [4] that, summarizing in a way the talk, notes the continuing dominance of speculative trends on the Islamic stock exchanges and states that the kind of interaction established between “professional” and “non-professional” market participants deprives the stock market of internal stabilizers and makes it less effective. Admitting by default that stock market speculation is inevitable, the author suggests imposing controls over speculative transactions and the velocity of stock circulation.

Another decade later, during which, in our opinion, nothing had conceptually changed on the stock exchanges in the Islamic countries, the author of the article [5] once again claims speculation to be a kind of gambling, in which “the minority wins what the majority of investors loses” and states that “speculation results in the mispricing of goods and stocks”. According to the author, the problem can be solved by establishing a stock market without speculations; having moderate speculation is not an adequate solution because it’s no more than just a mere trick veiled in “theory and fallacies».

Another publication on the subject (a pre-print) appeared in 2009. The publication [6] describes Saudi Arabia’s efforts to counter stock market speculation and recommends to continue improving the undertaken countermeasures by changing the tick size, the daily price limit, the structure of transaction fees, transparency and types of orders.

Basically, stock market speculation persists in countries with the Islamic economy and finance, even though it is clearly forbidden. Of note in this context is the partner finance experiment launched in Russia in 2023: once it is completed, the country may see the implementation of the Islamic financial model. One of the elements of the model is a Sharia-compliant stock market. Hence, organizing an Islamic stock exchange in Russia will at some point become vital. In this respect, it appears to be appropriate to evaluate the potential of the Moscow Exchange as premises for such a market. It is also worth noting that the authors of the aforesaid publications did not go into particulars of the meaning of the term “stock market speculation”.

3. Specific aspects of stock trading in relation to individual issuers

Just a mere quick overview of the downloaded files with exchange-traded stock quotations delivers substantial results.

Let us take as an example a small fragment of the file with Lukoil stock prices as at 31 January 2023 – the stock is traded on the Moscow Exchange (MOEX). The minimum MOEX lot size for this issuer is 1 share. The fragment header is as follows:

- <DATE> - transaction date;
- <TIME> - transaction time;
- <LAST> - transaction price;
- <VOL> - transaction volume (the quantity of securities traded in the transaction).

<DATE>	<TIME>	<LAST>	<VOL>
230131	95935	3947	1
230131	95935	3947	4
230131	95935	3947	1
230131	95935	3947	3
230131	95935	3947	4
230131	95935	3947	1
230131	95935	3947	4
230131	95935	3947	1
230131	95935	3947	2
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	10
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	20
230131	95935	3947	1
230131	95935	3947	10
230131	95935	3947	25
230131	95935	3947	12
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	1
230131	95935	3947	27

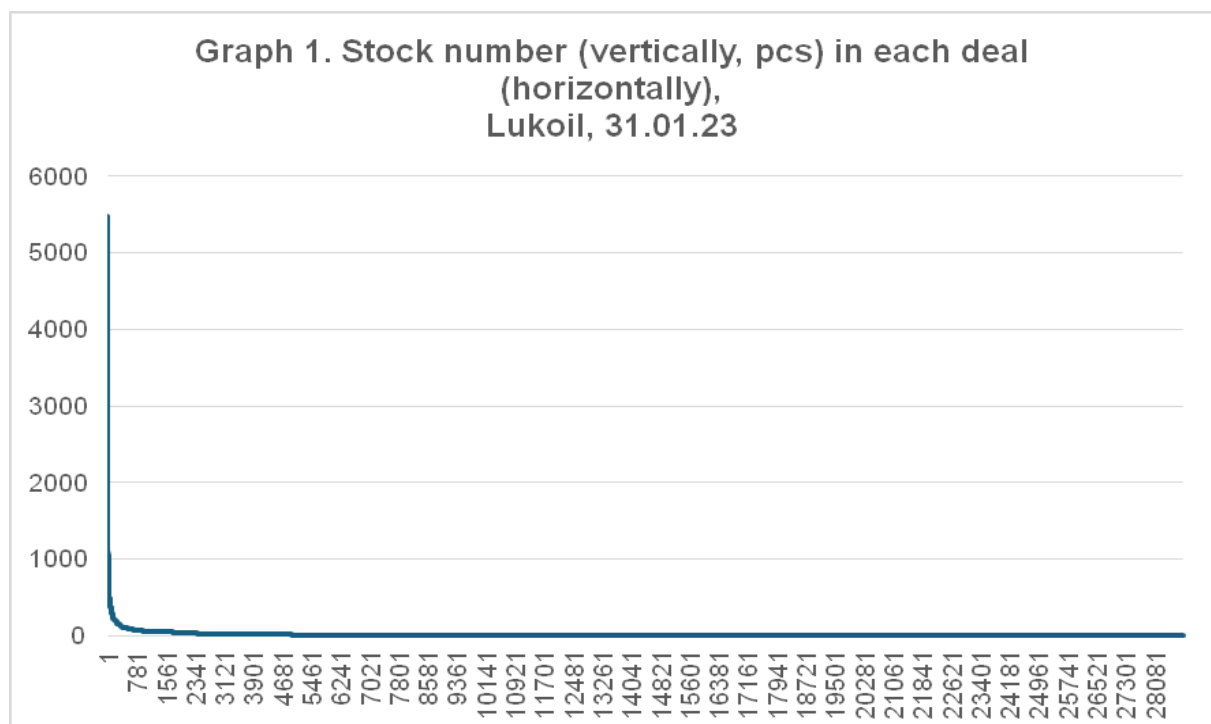
The main thing that is striking is the small quantity of stocks sold/bought in each transaction. Most of the transactions in this fragment are dealings in insignificant quantities of securities,

even with one share. Similar trends can be seen in the rest of the file. All in all, 28,838 transactions were closed on that day, 13 securities per transaction on average. Transactions with the minimum lot (1 security) totalled 11,239 (39% of the total transactions); transactions offering 3 securities for sale totalled 4,529 (16%).

Below is another fragment of the same file with Lukoil stock prices as at 31 January 2023: it shows all transactions with more than a thousand securities sold/bought. They are only nine (let us recall, out of nearly 29,000 transactions closed on that day):

<DATE>	<TIME>	<LAST>	<VOL>
230131	112306	3965	5476
230131	120238	3960	2224
230131	152840	3935	1675
230131	121803	3960	1237
230131	154320	3930.5	1111
230131	112306	3965	1045
230131	131520	3944	1000
230131	132015	3935	1000
230131	155240	3926	1000

Finally, to gain a conclusive insight for that day, all transactions are ranked by the quantity of securities and a trading volume distribution graph is plotted:



Source: finam.ru/, compiled by the author

Hence, a survey of one trading day of a single company shows that the bulk of the dealings are transactions in one or several securities. Large lots are very few.

For further study, in order to understand whether such performance is common/widespread or non-recurring/extrinsic, the analysis should cover more trading days and more stocks of various issuers. Handling bulk data requires a certain classification. So, depending on the quantity of securities in a transaction, transactions have been grouped into three categories:

1. Conditionally* investment transactions: transactions, in which a hundred and more securities per transaction are sold/bought.
3. Conditionally * speculative transactions: all transactions, in which less than a hundred securities per transaction are sold/bought.
2. Unconditionally speculative transactions: transactions, in which one, two or three securities per transaction are sold/bought.

* We use the word “conditionally” because we cannot know the true intentions of traders. Therefore, in our context, “conditionally” implies “with a high degree of probability”.

This kind of categorization of transactions helps to further analyze the situation from the point of view of the IFM. Jumping a bit ahead, let us nevertheless note that even with a modified categorization criterion (100 stocks per transaction) the yielded results are essentially the same.

In the traditional as well as in the Islamic financial systems the difference between investments and speculations is fundamental (see Table 1). Therefore, if one of the categories becomes dominant, this may substantially and profoundly change the nature of the stock exchange and make it either IFM-compliant or non-IFM-compliant.

Key differences between the terms “speculation” and “investment”

Table 1

Criterion	INVESTMENT	SPECULATION
Ownership duration	Long term	Short term
Primary source of income	Dividends	Exchange differences
Transaction trigger	Fact-based analysis of real facts and events	Emotional evaluation of facts and rumours
Impact on price	Drawing the price near the real value	Driving the price away from the company’s real value
Price manipulation	Not applicable	Applicable
Trader’s attitude to issuer	Interested in development	Non-involvement, interested in volatility
Risk level	Market risk	Above-market risk

Compiled by the author

Based on the above example with Lukoil stock for one trading day, the issuer's stock market is clearly speculative; yet, it is not sufficient for evaluating the issuer's stock market in general. For further analysis, another, equally big company has been chosen – Rosneft, and calculations have been made for all trading days in January 2023 (see Table 2).

**Rosneft stock trading structure,
January 2023**

Table 2

Date	T otal transaction s, pcs	S peculativ e transactions, total		S peculativ e transactions with a minimum trading lot		Inv estment transactions, total	
		pcs	% of total	pcs	% of total	pcs	% of total
Rosneft. For reference: minimum trading lot - 1 stock							
20230103	41 292	36 488	88%	16 908	41%	4 804	12%
20230104	36 608	33 321	91%	16 411	45%	3 287	9%
20230105	22 121	19 626	89%	9 937	45%	2 495	11%
20230106	17 876	16 143	90%	8 617	48%	1 733	10%
20230109	45 725	39 478	86%	17 530	38%	6 247	14%
20230110	76 937	68 357	89%	38 128	50%	8 580	11%
20230111	112 849	99 888	89%	50 024	44%	12 961	11%
20230112	26 562	23 801	90%	12 462	47%	2 761	10%
20230113	30 450	27 950	92%	13 692	45%	2 500	8%
20230116	30 268	27 600	91%	15 036	50%	2 668	9%
20230117	43 070	39 987	93%	20 952	49%	3 083	7%
20230118	36 225	32 039	88%	16 318	45%	4 186	12%
20230119	41 594	38 614	93%	21 824	52%	2 980	7%
20230120	44 136	40 359	91%	22 918	52%	3 777	9%
20230123	29 932	27 787	93%	15 202	51%	2 145	7%
20230124	40 366	37 283	92%	21 619	54%	3 083	8%
20230125	29 378	26 871	91%	13 206	45%	2 507	9%
20230126	46 484	43 141	93%	21 274	46%	3 343	7%
20230127	39 206	36 874	94%	17 579	45%	2 332	6%
20230130	37 476	35 231	94%	20 817	56%	2 245	6%
20230131	48 742	45 419	93%	30 484	63%	3 323	7%
Av erag e	41 776	37 917	91%	20 045	48%	3 859	9%

Source: finam.ru/, the author's calculations

The obtained results accurately feature the issuer's stock market:

1. conditionally investment transactions: as little as 9% of the total transactions;
3. conditionally speculative transactions: 91%;
2. unconditionally speculative transactions: 48%;

According to the obtained results, it can be argued that Rosneft stock market is distinctly speculative.

4. Specific aspects of stock trading on the Moscow Exchange

The overall analysis of the MOEX stock market has been conducted using tick quotes of 15 blue chip companies whose stocks are highly liquid. Around 650 files with the companies' quotes have been analyzed to study the structure of each trading day in January and February of 2023. The results are given in Tables 3 and 4.

**Structure of transactions in blue-chip stocks,
January 2023**

Table 3

No.	Issuer	Conditionally speculative transactions, %	Speculative transactions (minimum trading lot), %	Conditionally investment transactions, %
1	LUKOIL	99	54	1
2	Sberbank	91	41	9
3	Gazprom	96	48	4
4	Tatneft	91	43	9
5	Nornickel	100	71	0
6	NOVATEK	96	52	4
7	TKS Holding	99	50	1
8	Surgutneftegas	98	44	2
9	Polyus	99	57	1
10	Severstal	94	45	6
11	Rosneft	91	48	9
12	NLMK	97	47	3
13	Magnit	99	57	1
14	ALROSA	93	46	7
15	MMK	90	48	10

Source: finam.ru/, the author's calculations

**Structure of transactions in blue-chip stocks,
February 2023**

Table 4

No.	Issuer	Conditionally speculative transactions, %	Speculative transactions (minimum trading lot), %	Conditionally investment transactions, %
1	LUKOIL	98	54	2
2	Sberbank	90	36	10

3	Gazprom	95	46	5
4	Tatneft	88	36	12
5	Nornickel	100	69	0
6	NOVATEK	95	49	5
7	TKS Holding	99	53	1
8	Surgutneftegas	97	41	3
9	Polyus	99	54	1
10	Severstal	93	40	7
11	Rosneft	90	48	10
12	NLMK	96	45	4
13	Magnit	99	59	1
14	ALROSA	93	46	7
15	MMK	90	44	10

Source: finam.ru/, the author's calculations

The obtained results clearly represent the market for the most liquid securities (blue chips) on the Moscow Exchange:

1. conditionally investment transactions: from 0 to 10% of the total transactions;
3. conditionally speculative transactions: 50% on average;
2. unconditionally speculative transactions: 90%-100%;

Hence, more or less the same transaction structure is observed for all the companies. Accordingly, it can be said that the Moscow Exchange stock market is predominantly speculative, with half of the transactions on the market being indubitably speculative ones.

Naturally, we may well ask the question about whether such a stock exchange where most of transactions are speculative ones is admissible for Islamic investors.

In an attempt to find the answer to this question, let us clarify the definition of the concept of speculation from the point of view of the IFM.

5. Definition of the concept of speculation

The word “speculation” does not have an entirely negative social connotation. Moreover, speculation in the stock market is perceived by many people as a natural process/activity, the more so because prohibition of speculation in Sharia attributes directly to the trade in agricultural products, so, the securities market participants may think that such prohibition is not applicable to them.

Let us cite direct evidence against speculation in trading relationships. The messenger of Allah said, “Woe to the speculator who rejoices over a rise in cost and grieves over a decrease in cost”, al-Rāzī; “Only a sinner would engage in buying up”, Imam Muslim. Hence, in this respect speculation implies acquiring goods, intentionally holding them back from selling until a certain moment, expecting them to become more expensive, and selling them only after they rise in price. Sharia absolutely forbids this mechanism, i.e. deliberate manipulation of goods for the purpose of creating a deficit of goods.

However, speculation in the stock market does not aim to create a deficit, its mechanism is altogether different. Speculation in the stock market means 1) making/withdrawing bids, and 2) transacting to buy/sell, as a rule, a small-size exchange-traded lot of one and the same asset, based on the forecast direction of price movements in the very near future: hours, minutes, or even seconds.

Speculation should be defined by focusing on the following aspects.

Bidding (1): the methods of making bids and then withdrawing them prior to execution misrepresent intentions of the market participants and, hence, are misleading for everyone; from the point of view of Sharia such methods are an inadmissible conduct and manipulation.

Transacting (2). First, Sharia may not accept as admissible any income from unproductive and useless (above all, socially useless) labour. Speculation is, undoubtedly, a kind of useless labour that does not produce any new goods or services. Hence, the activity, during which nothing new is created, should be prohibited according to Sharia.

Second, it is prohibited to sell goods that are not in possession. On a stock exchange, rights of ownership to stocks arise on the basis of a record in the depository's register. It means that securities can be traded freely if they are recorded in the register; yet, most of the time a stock exchange trader may trade securities that have not yet been recorded on the trader's account with a depository. From the point of view of Sharia, this mechanism is inadmissible, either.

Last, let us speak of another drawback of the present-day mechanism of trading on stock exchanges.

The problem is that a stock exchange allows all trading participants to contract with one another on an unrestricted basis. This implies that an institutional investor can make a deal with a private, a priori less experienced investor. This is obviously an unequal relationship because thanks to its expertise the former is capable of making more detailed and more accurate estimates than the latter (it is like a fight between two boxers from different weight classes). Sharia disapproves of unequal contracts.

All in all, stock market speculation violates:

- The rule for the permissible source of income.
- Prohibition of gharar (excessive risk).
- Prohibition of selling what is not in one's possession.
- Prohibition of manipulation.
- Prohibition of riba (this aspect of the problem was analyzed in detail in the author's paper "Credit in the Structure of the Market Quotation of Financial Assets in Relation to the Islamic Financial Laws", Problems of Modern Economics, No. 1 (33), 2010).

Summarizing the above, it can be said that stock market speculation is inadmissible in Sharia and should not exist in the IFM.

6. Conclusions

- From the point of view of the IFM, stock market speculation is not admissible.
- The present-day/traditional stock exchange is not a place for Islamic investments, even if it is about permissible (halal) securities.

- The Islamic financial system should have stock exchanges that would not encourage speculative transactions.

Accordingly, the mechanism of trading stock on an Islamic stock exchange must be different, specifically, it must use a bigger-size minimum trading lot, two-way quotes, and equal “weight” categories. In practical terms, it can be implemented as a two-tier securities trading system where:

- Tier 1 is “wholesale”, traditional exchange trading in securities, but only with a limited pool of professional institutional securities market participants and with a fold-increased minimum trading lot;
- Tier 2 is “retail”, over-the-counter trading in financial assets, intended for a wide range of investors, where dealer firms act as market makers and buy and sell financial assets with a certain price lag (similar to exchange offices offering services based on two-way quotes).

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