

## The role of borrowing securities mechanism, for the purpose of selling, in providing liquidity in the stock exchange.case study of “Egyptian Stock Exchange”

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### **Abstract:**

This study aims to identify the application of " borrowing securities" mechanism for the purpose of selling and the guidelines of dealing with them in the stock market, as well as knowing how this technique was applied by the Egyptian Stock Exchange in December 2019 , and its impacts on liquidity.

The mechanism of borrowing securities for the purpose of selling works on balancing supply and demand in the market, especially in light of the application of "margin buying system". It can also guarantee to the investor ,who owns securities, the ability to invest his securities without being exposed to risks of direct trading. As a consequence, it facilitates "the hedging process", balances the price differences, rebalances and revives the market, and causes a major rise in trading volumes and liquidity.

**Keywords:** borrowing a security, lending a security, short selling, stock exchange.

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## **1. INTRODUCTION**

The technique of borrowing securities for the purpose of selling is one of the most important financial engineering tools widely used in international financial markets. Investors use this tool in order to hedge the risks of investing in securities.

In the Arab world, borrowing securities for the purpose of selling is one of the emerging financial instruments, which many financial market regulatory institutions are still studying the possibility of allowing its application. Egyptian Stock Exchange is among the Arab stock exchanges that sought to implement it in 2019, in an effort to achieve liquidity, develop and raise the efficiency of the stock exchange.

### **Research question:**

Based on this proposition and within the framework of the general objective of the study, we decided to formulate the problematic of our research as follows:

**Can the application of borrowing securities for the purpose of selling system, increase the liquidity in the Egyptian Stock Exchange?**

### **Sub-questions:**

In light of the foregoing, the problem can be formulated in the following sub-questions:

- 1. What do we mean by the system of borrowing securities for the purpose of sale?**
- 2. What are the main reasons for adopting this system by both investor and stock exchange?**
- 3. What are the executive procedures for practicing securities borrowing operations for the purpose of selling in Egyptian Stock Exchange?**

### **Study hypotheses:**

To process the research problem that was raised, we relied on some hypotheses that we see as the closest response to the possible answers:

- It is a contract through which the ownership of securities is temporarily transferred from their owner (the lender) to the borrower with the engagement to return them back at the request of the lender.
- Among the reasons for adopting the mechanism of borrowing securities for the purpose of selling is hedging and raising the liquidity of the security and the market as a whole.
- The mechanism for borrowing securities for the purpose of selling was activated in the Egyptian Stock Exchange in December 2019, as the stock exchange updated the trading guide by adding its own rules.

### **Research importance:**

The importance of this research arises from the sensitivity of the subject of borrowing securities for the purpose of selling in stock exchanges, as a new technique that increases trading on securities, which leads to an increase in the liquidity of securities and development of stock exchanges.

**Research aims:**

The study mainly aims to focus on the possibility of activating the technique of borrowing securities for the purpose of selling and its impact on market liquidity by:

- Demonstrate the technique of borrowing securities for the purpose of selling.
- Identify the rules of dealing with this technology.
- Knowing how this technique was applied by the Egyptian Stock Exchange and its impact on market liquidity.

**Research Methodology:**

In order to be able to answer and be well informed about the subject and test the approved hypotheses, we followed the descriptive and the analytical approach, through collecting, analyzing and organizing data. We used the historical method also to study the emergence of this system in the Egyptian Stock Exchange, in order to reach the desired goals and answer the aforementioned research question.

**2.1 Definition of borrowing securities for the purpose of selling mechanism:**

This mechanism refers to an agreement between a client (borrower) and the custodian according to which the custodian - on behalf of the client - borrows securities owned by another client (lender) for the purpose of selling and returning them at a later time on the terms agreed upon. It's possible that a custodian lends another custodian according to the conditions determined by the Stock Exchange. **(Tawfik, 2018)**

- It can also be defined as an agreement between a brokerage company and one of its clients: the company on behalf of the client borrows securities owned by another party (a lender) through the securities lending system. This is for the purpose of selling these securities and returning them at a later time on the terms to be agreed upon **(The Egyptian Stock Exchange, 2020)**.

- It is the sale of borrowed securities in the hope that the price will decrease. If the price drops, the dealers in securities buy the securities that they sold and return them to their owners. It can also be considered as a sale of securities that are not owned by the seller when the sale order is issued, then borrow them from the broker on the day of execution to deliver them to the buyer and the broker keeps the price with him in the hope that the prices of these securities will decrease, the broker buys them for the client's account and returns them to its original owner, and the trader gets the difference between the selling price and the purchase price, the broker also gets the commission and interest on the loan.

**(Al-Adawi, 2011)**

as we mentioned, it can be said that borrowing securities for the purpose of selling is a mechanism through which securities are borrowed from their owner and sold in the market, to repurchase them at a later time when their price drops in order to return them to their first owner and achieve a profit margin represented in the difference between the selling price and the purchase price of the security after calculating the costs.

## **2.2 Conditions of borrowing securities for the purpose of selling**

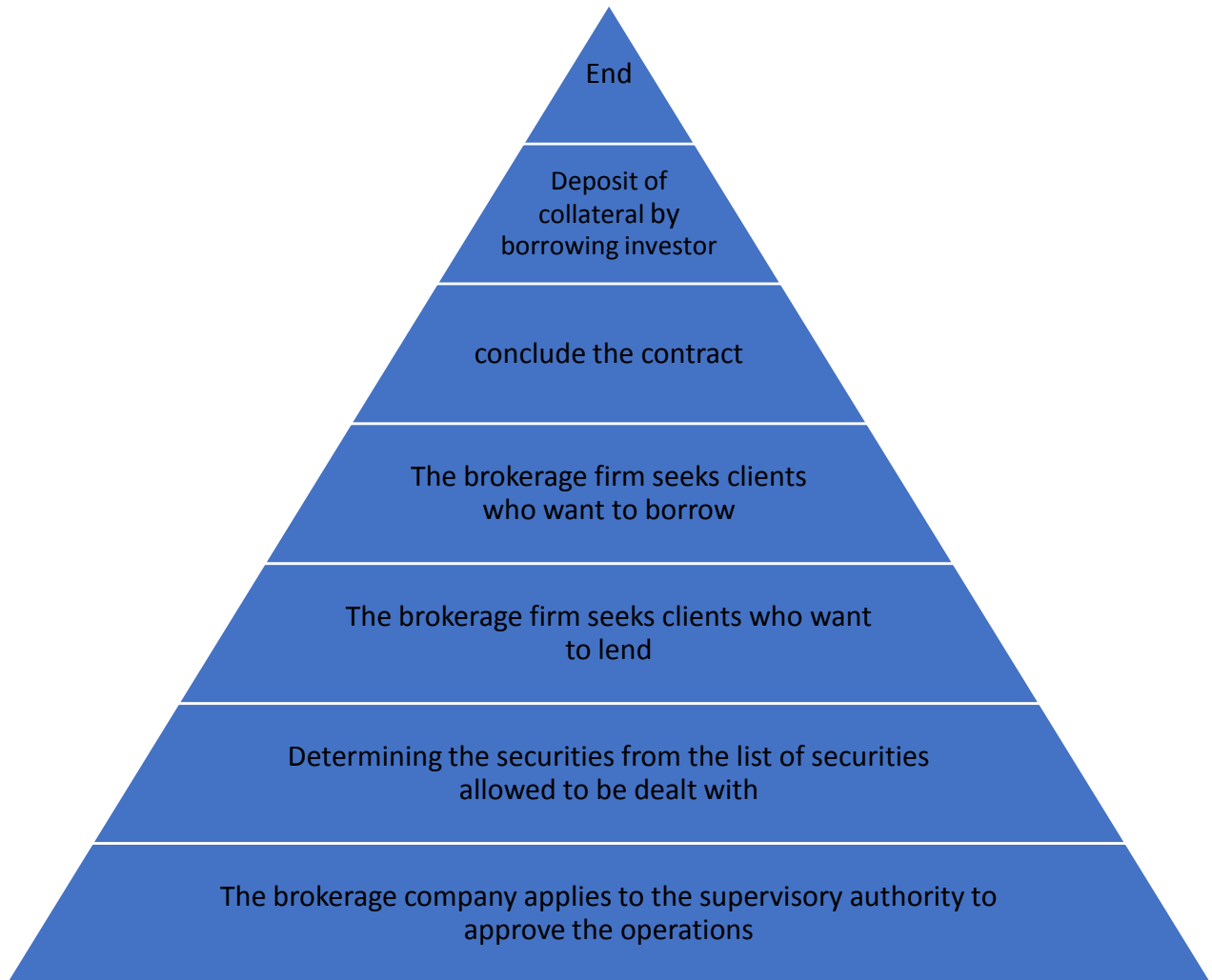
To conclude a mechanism for borrowing securities for the purpose of selling, a set of conditions must be met, which are as follows:

- **The borrowing customer:** It is every investor who concludes an agreement with the brokerage company to borrow securities through the lending system for the purpose of selling and returning them at a later time on the terms to be agreed upon.
- **The lending customer:** It is every investor who owns the securities and concludes an agreement with the custodian in order to make his securities available for lending.
- **Borrowed Securities:** These are the securities that meet the criteria set by the Stock Exchange and approved by the Authority
- **Brokerage Company:** It is one of the Securities brokerage firms that have the authority's approval to engage in borrowing operations for the purpose of selling, it is based on system management able to provide for the lender and borrower clients.
- **Custodian:** is the one who concludes a contract with the lending client and creates securities available for lending.
- **Lending date:** is the settlement date of selling the borrowed securities.
- **Lending period:** the period of time from the sale settlement of the borrowed securities until the borrowing client returns the securities to the lending client.
- **Guarantee:** sums of money or securities deposited by the borrower to the lender in exchange for the borrowed securities, in accordance with the prescribed percentage of the market value of the borrowed securities and with the provisions of these controls.
- **Lending and Borrowing Management Systems:** They are electronic systems and automated lines of connection for securities borrowing operations for the purpose of sale, through which the Central Depository Company is provided with all lending and borrowing operations through the brokerage company and the custodian. All data of orders and contracts related to lending operations are included in these systems. Borrowing with brokerage firms and custodians, and presenting borrowing requests

## **2.3 Procedures of "the Borrowing for Sale" Mechanism:**

The mechanism of borrowing securities for the purpose of selling goes through a set of procedures that can be highlighted through the following form:

**Fig.1. Procedures for the mechanism of borrowing securities for the purpose of sale**



**Source:**The Financial Supervisory Authority, Regulating the Practice of Borrowing Securities for the Purpose of Sale, Decision of the Authority’s Board Chairman No. 268, 02/26/2019, pp. 1-14:

[https://egx.com.eg/en/Membership\\_rules.aspx](https://egx.com.eg/en/Membership_rules.aspx)

We note from the figure that the process of borrowing securities for the purpose of selling goes through several stages:

**- The brokerage company submits a request for the practice approval:**

at this stage, the brokerage company is engaged to obtain a prior approval of the supervisory authority to deal through the mechanism of borrowing securities for the purpose of sale, in accordance with the guidelines and procedures granted by it. This application accompanied by data sheets and documents about the brokerage company.

The supervisory authority shall have the right to approve or reject it according to the market needs.

**- The brokerage company finds clients who want to lend:**

at this stage, the brokerage company presents the securities in the lending system based on the desire of the lender client and after completing all necessary documents and procedures. In this system, the custodians create a special container for the securities available for the lending process. this container has all the papers of the contract concluded between the lending client and the custodian who records all the data of the securities available for lending and the details of the lending operations that are carried out through the system of managing the lending and borrowing process for securities and the automated connection lines, then sends them to the Central Depository Company.

**- Contract conclusion:**

The brokerage company, the borrowing customer and the lending customer conclude a contract for borrowing and lending securities, which contains all the details of the borrowing process and the duration of lending. The broker records the borrowing operations and notifies the custodians and the central depository company who process the transfer of securities to be borrowed from the account of the lending customer to the account of the borrowing customer. Selling orders for borrowing operations are valid for one day, and if they are not executed during the day, the borrowing process for the purpose of selling is considered non-existent and does not entail any rights or obligations. However; the brokerage company must record the unexecuted borrowing requests and send them to the central depository company, which returns the securities from the borrowing customer's account to the lending customer's account.

It can be pointed out that the lending investor may lend more than one investor within the limits of the quantity he owns and that is available for lending.

**- Deposit of guarantees by the investor borrower.**

The brokerage company is obliged to receive the guarantee submitted by the borrowing client and deposit it in a separate account for the borrowing operations for the purpose of selling before their implementation. The guarantee is a cash amount of not less than 50 percent of the market value of the borrowed securities calculated on the last closing price of the security. It also receives the return of selling borrowed securities and invest it from the date of lending. those entire returns are directed to the lending client after deducting commissions and expenses.

**- Selling securities in the market:**

At this stage, the investor sells the securities he has borrowed in the market, and the sale amount is kept with the broker (**Exchange, 2021**).

**- Follow-up the investor's position:**

Assuming that an investor expects a share price to decline for a listed company in the market in the future, the investor borrows 1,000 shares of that company from another investor who wants to lend those securities. Assuming that the share price in the market is 100 DZD per share, the borrower sells the securities in the market with a total return of 100,000 DA, with the need to deposit a cash guarantee of 50,000 DZD or its equivalent in securities. If the investor's expectation is fulfilled, and the stock drops, for example, to 95 DA, and the investor wishes to close his investment position, he must repurchase those shares and return them to the lender, so the cost of repurchasing the shares becomes 95,000 DZD and a return of 5,000 DZD is added to the return on the investment of the guarantee with the deduction of the cost of borrowing.

In the case of the share price rising to 105 DZD and the borrower wishes to close his position and stop his losses, he buys back those shares and returns them to the borrower. However; the cost of repurchasing the shares now becomes 105,000 DZD with a loss of 5,000 DA. The loss and the borrowing cost are subtracted from the investment of the cash guarantee when the operation is achieved.

As for the lending investor, he obtains a return as a result of lending securities, in addition to the traditional advantages that he obtains as a result of owning shares, which is his obtaining dividends and free shares, as well as participating in voting and subscription rights...etc.

**- Ending the mechanism of borrowing for the purpose of selling :**

Ending the mechanism of the borrowing for the purpose of selling shall be done according to one of the following alternatives:

- The borrowing client instructs the brokerage company to terminate the borrowing process for the purpose of selling in part or in whole, by requesting the transfer of the borrowed securities from his account. The brokerage company notifies the custodian company, implements the transfer and settles the guarantee according to the last closing price of the security.
- Purchasing the required quantity and settling the transaction from the cash of the guarantee account on the settlement day.
- The brokerage company purchases the securities from the borrower's client's account in case he fails to return the securities on the specified date, and calculates their market value on the settlement day based on the closing price of the purchase day.

**2.4 Obligations and rights of the parties to the contract of borrowing securities for the purpose of selling;**

**- Obligations and rights of the brokerage firm:**

In the borrowing contract for the purpose of selling, the financial brokerage company is committed to a set of obligations that can be presented as follows (**Authority, 2019**):

- Verify the clients' ability to fulfill their obligations resulting from securities borrowing operations in light of their financial condition, investment objectives, the funding sources available to them, and other information available to the company about them before contracting, and the brokerage company must re-evaluate the client's condition whenever it seems necessary, at least once every 12 months withholding records and documents indicating that.
- The brokerage company shall enable the stock exchange's supervisory authority to view and obtain all data and documents related to securities lending operations for the purpose of selling through the electronic link line.
- The client (the investor) shall receive a statement while concluding the contract that clarifies the concept of borrowing securities for the purpose of sale, its procedures, advantages, risks, and the basic provisions, with a statement sent at least once annually as soon as any amendments occur in the basic provisions of the process of lending securities for the purpose of sale.
- Keep separate books and accounts to record securities borrowings for the purpose of selling.
- Maintaining at all times the minimum net liquid capital in accordance with the solvency standards issued by the Authority.

As for the rights arising from the process of borrowing securities for the purpose of selling to the brokerage company, they are as follows:

- Not to conduct any sale of borrowed securities except on securities that meet the criteria set by the Stock Exchange and approved by the authority, and which the company accepts as a guarantee.
- The company accepts all securities that meet the criteria set by the stock exchange.
- Warn the borrower customer about the necessity of providing additional guarantees or increasing the value of the guarantees if its value decreases.
- Taking measures to purchase borrowed securities without referring to the client if the borrowing client did not increase the guarantees.
- Collecting the value of the returns for any security and receiving the free or retail shares or any other rights related to the securities presented as a guarantee, in order to settle any amounts owed by the borrowing customer.
- The company has the right to request additional data from the client to avoid money laundering operations.
- The company has the right to receive its fees, commissions, and amounts due to it in return for carrying out its obligations.

**Obligations and rights of the borrower:**



There is a set of obligations for the borrowing investor, which are as follows:

- Opening an account with the brokerage company and signing all documents and papers related to the borrowing of securities for the purpose of selling.
- Authorizing the brokerage company to buy the borrowed securities or sell the guarantees without referring to it.
- Issuing orders to buy and sell borrowed securities to the brokerage company in accordance with the methods prepared and agreed in the account opening agreement.
- Pay the value of the guarantee in advance, not less than 50% of the market value of the borrowed securities, calculated on the last closing price of the security.
- Feed the account or increase the guarantees in case the prices of securities rise after the conclusion of the contract.
- Returning the borrowed securities at any time or at the end of the lending period through the brokerage company to the account of the lender customer, with all financial rights and other benefits, and the returning is done either by issuing his orders to the company to purchase the securities required for his account in the market or making similar securities available to them again from the stock of securities owned by him.
- If the borrower executes more than one borrowing operation for more than one security through the company, these operations are considered as one account for the customer, and the value of the guarantee should be increased when the balance of the customer's account reaches the prescribed percentages.
- End the borrowing process for the purpose of selling in cases of completion or non-compliance, the brokerage company has the right at any time to end the borrowing process and return the securities of the lending clients to their available balance with the custodians.
- Pay the expenses and commissions resulting from the process of borrowing securities.

As for the rights arising from the process of borrowing securities for the purpose of selling to the borrower; they are as follows:

- Close the contract at any time by requesting the transfer of the same amount of borrowed securities from the available balance of the same borrowed security or issuing instructions to the company to return the borrowed securities by requesting the repurchase of the borrowed securities and paying the commissions and expenses agreed with the company.
- Refund of more than the offered guarantees if the value of the guarantees exceeded the agreed ratios as a result of a decrease in the market value of the borrowed securities or an increase in the market value of the offered guarantees if it was security.
- Replacing the deposited guarantees with others, with the approval of the brokerage company.
- Request the brokerage company to invest the cash guarantee provided by him and

deposited with it.

**Lender rights:** The Egyptian Stock Exchange, a comparison between the mechanism of borrowing securities for the purpose of selling and the mechanism of buying on margin:

- Achieving a fixed return resulting from the brokerage company reinvesting the value of the sale of his shares through the borrower client, after deducting the prescribed commissions and expenses.
- The right to all profit distributions and profits made by the issuing company.
- The right to vote in the general assembly of the issuing company, after submitting in time, a request to redeem his shares.
- The right to get back the borrowed securities in the system in whole or in part at the end of the lending period or according to what is agreed before with the borrowing customer.
- The right to purchase the right to subscribe to shares in order to increase the capital of the issuing company, after requesting the refund of its shares.

### **2.5 Activity Risks:**

- The possibility of doubling the loss, as it is possible for the investor to achieve losses up to the value of his initial investment.
- Deposit cash or securities in case he receives any request from the brokerage company.
- taking away some of the guarantees provided by the borrower if he fails to fulfill the requirements of the brokerage company.
- bear the costs.

### **3. The effect of activating the securities borrowing mechanism on liquidity in the Egyptian Stock Exchange:**

The mechanism of borrowing securities for the purpose of selling was activated on the Egyptian Stock Exchange in December 2019 despite the issuance of the legislation establishing it in 2004 when the Egyptian Stock Exchange updated the trading guide by adding the rules for the mechanism of borrowing securities for the purpose of sale. This mechanism, as was mentioned before, relies on the idea of anticipating a decrease in the price of the security in the market and then repurchasing it at a price lower than the price that the borrowing customer sold at on the date of borrowing, thus achieving a profit margin represented in the difference between the two prices. The borrowing customer is committed to refunding all the financial rights of the lender even from the cash guarantee submitted by him.

The securities borrowing mechanism is a balancing mechanism between supply and demand in the Egyptian Stock Exchange, especially in light of the application of the margin buying

system, which supports the demand side in the market. On the other hand, the mechanism of borrowing securities for the purpose of selling supports the supply side to achieve balance in the market, if a fall in stock prices happened, there would be an investor who wants to sell the borrowed shares for the purpose of buying them at a later time at lower prices to achieve profits.

As for the borrowers, this mechanism guarantees many benefits, foremost among which is that the investor who owns a balance of shares in a particular company can invest this balance without exposure to the risks of direct trading in the market and move the stagnant balance of shares in a safe manner that guarantees him a guaranteed return on the shares he owns.

**Securities allowed to be dealt with through the mechanism of borrowing securities for the purpose of selling on the Egyptian Stock Exchange from 04/02/2020:**

It is not allowed to trade according to the Securities Borrowing System except on the securities that meet the criteria set by the Stock Exchange and approved by the Authority. The stock exchange publishes a list of the names of those securities, and the following is the list of companies allowed to be dealt with by borrowing for the purpose of selling on the Egyptian Stock Exchange from 4/2/2020.

**Table 1. Shares allowed to be dealt with by borrowing for the purpose of selling from 4-2-2020**

Security Name	ISIN code
EzzSteel	EGS3C251C013
Palm HillsDevelopmentCompany	EGS655L1C012
Sidi KerirPetrochemicals	EGS380S1C017
Citadel Capital - Common Shares	EGS73541C012
Pioneers Holding	EGS691L1C018
Alexandria MineralOilsCompany	EGS380P1C010
ELSWEDY ELECTRIC	EGS3G0Z1C014
MedinetNasrHousing	EGS65571C019
HeliopolisHousing	EGS65591C017
Telecom Egypt	EGS48031C016
T M G Holding	EGS691S1C011
Six of October Development & Investment (SODIC)	EGS65851C015
Emaar Misr for Development	EGS673Y1C015
OrascomDevelopmentEgypt	EGS70321C012
Commercial International Bank (Egypt)	EGS60121C018
GB AUTO	EGS673T1C012
Egyptian Financial Group-Hermes Holding Company	EGS69101C011
Oriental Weavers	EGS33041C012
CleopatraHospitalCompany	EGS729J1C018
Abou Kir Fertilizers	EGS38191C010
EasternCompany	EGS37091C013

EgyptianKuwaiti Holding	EGS69082C013
Ibnsina Pharma	EGS51201C012
CI Capital Holding For Financial Investments	EGS691D1C018
EGX 30 INDEX ETF	EGS69491M015

**Source :** Author(s), year, page

**The effect of applying the mechanism of borrowing securities for the purpose of selling on the total trading (liquidity)**

Liquidity refers to the ability to close deals quickly and at a price close to the price at which the last deal was concluded (**El-Desouky, without publication year**) with the ability to convert the security into cash by the investor at any time he wants, and its value increases when the following characteristics are available:

- Depth of the market, which means the presence of trading orders for securities on an ongoing basis.
- Market breadth, which includes the availability of a large number of buy and sell orders for securities in the market.

Liquidity allows the investment of private securities portfolios to be changed quickly and at an easy cost, which makes financial investment less risky and facilitates long-term investment, and illiquid markets are faced with caution by investors because they were not able to exit the market at the time they wanted. In the highly liquid market, the opportunity for listed companies increases to obtain their continuing needs of financial resources at a reasonable cost, whether by issuing bonds or increasing their capital, by issuing more shares. An economy characterized by the presence of a liquid stock market makes financial assets more acceptable as a guarantee for bank loans, and boosts investment (**Mbarki, 2004**).

**1. Total trading volume index (total value of shares traded):**

The total trading volume means the value of the securities traded at various prices during a certain period of time. The trading volume reflects the total value of the securities traded during a certain period of time, usually a year.

The trading volume can be measured through the following relationship:

**Total trading volume during the period = the amount of trading during the period \* in the market value during the period**

The following table n ( ) shows us the value of trading in the Egyptian Stock Exchange during the period 2019-2021 (Egyptian billion pounds)

**Table 2.the value of trading in the Egyptian Stock Exchange during the period 2019-2021 (Egyptian billion pounds)**

<i>Period</i>	<i>Quarte r 4 2019</i>	<i>Quarte r 1 2020</i>	<i>Quarte r 2 2020</i>	<i>Quarte r 3 2020</i>	<i>Quarte r 4 2020</i>	<i>Quarte r 1 2021</i>	<i>Quarte r 2 2021</i>	<i>Quarte r 3 2021</i>	<i>Quarte r 4 2021</i>
<i>Trading value</i>	117.4	213.1	170.2	144.1	162.3	241.7	221.7	277.2	299.5

*Source:* Egypt Stock Exchange, Quarterly Report 2019-2021, Upload date 01/11/2021:  
[www.kse.com.kw](http://www.kse.com.kw)

The above shows the upward trend of trading values in the Egyptian Stock Exchange by 68.2 % between 2020 and 2019 and by 33 % in 2021 compared to 2020, despite the slight decreases between each quarter during the year 2020 and the difficult conditions imposed by the Corona pandemic and its negative effects on the global markets. So the application of the mechanism of borrowing securities for the purpose of selling had an impact on the trading values in the Egyptian Stock Exchange, which, in turn, led to raising the market liquidity.

### **Trading Amount:**

It is the number of shares traded, which represents what has been traded in the stock market during the specified period of trading activity and at various market prices. Trading Amount is issued with financial statements with all its financial details.

The following chart shows the amount of shares traded on the Egyptian Stock Exchange during the period 2019-2021.

**Table 3. The total volume of trading in the Egyptian Stock Exchange during the period 2019-2021 (million papers)**

<i>Period</i>	<i>Quart er 4 2019</i>	<i>Quart er 1 2020</i>	<i>Quarte r 2 2020</i>	<i>Quarte r 3 2020</i>	<i>Quarte r 4 2020</i>	<i>Quarte r 1 2021</i>	<i>Quarte r 2 2021</i>	<i>Quarte r 3 2021</i>	<i>Quarte r 4 2021</i>
<i>Trading amount</i>	11.78	13.06	20.47	28.32	30.98	40.07	32.42	31.76	31.97

*Source:* Egypt Stock Exchange, Quarterly Report 2019-2021, Upload date 01/11/2021:  
[www.kse.com.kw](http://www.kse.com.kw)

From the previous figure, we note the upward trend of the amount of shares traded on the Egyptian Stock Exchange that goes from 11 million papers during the fourth quarter 2019 to 30 million papers during the fourth quarter 2020 to constitute a slight decrease in 2021, reaching 32 million papers. It is obvious that the application of the securities borrowing mechanism had an impact on the amount of trading and affects, in return, the liquidity of the market.

### **4. CONCLUSION:**

The mechanism of borrowing and lending securities is one of the important tools that stock exchanges must apply because of its positive effects on the demand side of securities and enabling the investor who owns the security to face the risks of lower prices of those securities in the future.

## **Results and Recommendations:**

### **- Results**

- The mechanism of borrowing securities for the purpose of selling works on balancing supply and demand in the market, especially in light of the application of the margin buying system.
- The mechanism of borrowing securities for the purpose of selling ensures that the investor who owns the securities can invest his securities without being exposed to the risks of direct trading.
- The mechanism of borrowing securities for the purpose of selling facilitates the process of hedging and balancing price differences.
- The application of the mechanism of borrowing securities for the purpose of selling increases the degree of market liquidity, which is an important factor for local and foreign investors to invest in the Egyptian Stock Exchange.
- The mechanism of borrowing for the purpose of selling allows investors to make gains in case the prices of securities decline in , which restore and revive the market balance and cause a significant jump in trading volumes and liquidity.

### **- Recommendations:**

- The necessity of informing customers and investors about the nature of the mechanism of borrowing securities for the purpose of selling before the application process, in order to be able to study and know the risks.
- It is necessary to develop a program that reports the daily trading volume of the borrowing mechanism for the purpose of selling.
- We recommend that the stock exchanges, especially the Algerian Stock Exchange should be interested in the mechanism of borrowing for the purpose of selling because of its impact on the quantity and volume of trading in the stock market, which, in return, leads to raising liquidity and market depth. as a result, the efficiency of the stock exchange raises also.

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