

FUTURE CONTRACTS: ISLAMIC CONTRACT LAW PERSPECTIVE

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ABSTRACT

Futures contracts were a matter of disagreement in Shariah long before the U.S. subprime mortgage market collapsed. Reflective of the diverse interpretations of Islamic law by different schools of thoughts, the scholars are divided over the use of futures contracts, for different reasons. According to western point of view and some moderate Islamic scholars this has left Islamic finance with far fewer hedging devices than their conventional peers. In respond, questions could be raised does Islamic finance needs futures contracts and their risky, uncertain and speculative way of performance. Looking from the input and output point of view, this uncertain and speculative behavior of futures contracts had led to discovery of various hedging devices. If Shariah has clearly defined the basic principles of Islamic contracts, which prohibits uncertainty and speculation, does Islamic finance really needs hedging devices?

Furthermore, conservative scholars (علماء) are questioning a “blind” following of conventional financial engineering. Recent mortgage market collapse, to a great extent based on financial derivatives, distressed the fundamentals of conventional finance. In other hand, Islamic finance was extremely resilient, particularly owing to Shariah and its principles. If Islamic finance confidently follows their conventional peers in development and applications of future contracts and hedging instruments, shell the next financial crisis come from Islamic world?

In view of this, and in the light of the Shariah principle of permissibility (إباحة) that makes all commercial transactions permissible in the absence of a clear prohibition, the rulings of not only the Mecca based Fiqh Academy but also of many Muslim scholars who have proscribed futures contracts disallowed is a most discouraging form of imitation (تقليد). This firm opinion is founded on the analysis that futures contracts do not fulfill the requirements of the conventional Islamic law of contract.

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1.0 INTRODUCTION

The development of future contracts, as part of derivatives instruments, has accelerated rapidly in the last thirty years. However, there is obvious lack of a consensus regarding the permissibility of futures contracts among different Islamic scholars. Even where scholars have agreed on their disallowance, their stated reasons for prohibition is often based on very different grounds. This is further convoluted by diverse elaboration among the different school of thought (مذهب).¹

The purpose of this paper is to elaborate position of futures contracts throughout Islamic law of contract perspective. The first part of paper addresses general principles of contract (عقد) in the Qur'an and the Sunnah and essential elements of a valid Islamic law contract. After Shariah point of view on contract is elaborated, general application of futures contracts is presented.

The main body of the paper concentrates on Islamic scholars' arguments over legitimacy of futures contracts. Opinions of the scholars are "mounted" around five issues. First issue involves the goods and values of sale which are fictional at the time of contract, i.e. goods are not delivered at the time as well as price is not paid. As such, contract in this case is mere paper transaction, not a valid sale. Therefore, futures are built on exchange of promise made for the exclusive purpose of speculative profit making. To make lawful a sale from the perspective of Shariah, it is necessary that goods and values must be present at the time of contract.² The second issue is related to short – selling in which the seller does not possess or owns subject – matter he sells. In this case the principle of ownership is not fulfilled, as from Islamic point of view of contract "sale is to transfer ownership of the matter of sale from seller to buyer".³ If the seller does not possess or have ownership of underlying matter, he cannot transfer ownership. Third

¹ Obiyathulla Ismath Bacha, *Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*. International Journal of Islamic Financial Services 1, no. 1, 1999.

² Mahdi Zahraa and Shafaai M. Mahmood, *The validity of contracts when the goods are not yet in existence in Islamic law of sale of goods*, Arab Law Quarterly 17, no. 4, 2002, pp. 379-397.

³ Nabil Saleh, *Definition and Formation of Contract under Islamic and Arab Laws*, Arab Law Quarterly 5, no. 2, 1990, pp. 101-116.

issue involves principle of “qabd”. Literally, it is failure of taking the subject matter into possession prior to resale⁴. A fourth issue relates to “bay al kali bi l – kali” which factually means sale of one debt for another. In this case the both values are postponed to a future date, which basically converts them to debt – matter, which is forbidden in Islamic law.⁵ Lastly, reflecting previous five stated issues; fifth issue elaborates the relationship between future contract and speculation which is closely related to gambling, uncertainty and risk taking.⁶ Majority of these issues are derived completely from Islamic scholars’ perspective on the validity of conventional sale.

However, paper also addresses the potential affirmative side of future contract, particularly from the point of Ibn Taymiya, Ibn Al-Qayyim and Imam Maliki.

In addition, paper will elaborate some recent studies on futures contracts. Several researches are highlighting the view that derivatives encourage price volatility and tend to destabilize the market.⁷ On the other hand some emphasized the economic benefits of futures contracts as well as their necessity in modern Islamic finance.⁸

Conclusion will readdress all the main concerns, provide some ideas, and touch an issue related to necessity for futures contracts in Islamic finance from perspective of Shariah.

⁴ Mohammad Hashim Kemali, *Islamic Commercial Law: An Analysis of Futures and Options*, Cambridge: the Islamic Texts Society, 2000.

⁵ Hanudin Amin, *An Analysis of the Classical and Contemporary Juristic Opinions on Bay Al- Dayn*, Labuan e-Journal of Muamalat and Society, 2007, pp. 31-43.

⁶ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁷ Obiyathulla Ismath Bacha, *Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*. International Journal of Islamic Financial Services 1, no. 1, 1999.

⁸ Muhammad Fahim Khan, *Islamic futures and their markets: with special reference to their role in developing rural financial markets*, Jeddah: Islamic Research and Training Institute, Research paper no 32, 1996.

2.0 GENERAL PRINCIPLES OF CONTRACT (عقد) IN THE QUR'AN AND THE SUNNAH

The early source of Islamic contract law is apparent through the Quranic revelation of the Ayah:

“O ye who believe! Fulfil (all) obligations”.⁹ يَا أَيُّهَا الَّذِينَ آمَنُوا أَوْفُوا بِالْعُقُودِ

“Fulfil the covenant of Allah when you have entered into it, and break not your oaths after you have confirmed them...”¹⁰ وَأَوْفُوا بِعَهْدِ اللَّهِ إِذَا عَاهَدْتُمْ وَلَا تَنْقُضُوا الْأَيْمَانَ بَعْدَ تَوْكِيدِهَا...

These Quranic verses are the basis of the sanctity of a wide variety of obligations. The Arabic word “عقد” covers the entire field of obligations, including those that are spiritual, social, political, and commercial. In the spiritual realm “عقد” deals with the individual's obligation to Allah (عبادة). In social relations the term refers to relations including the contract of marriage. In the political arena it encompasses treaty obligations, while in the field of commerce (معاملات), it covers the whole spectrum of obligations of parties in regard to their respective undertakings. Hence the generic word “عقد” forms the foundation of contract and attendant liabilities.¹¹ The Quran and the Sunnah have dealt with عبادة (devotional acts and obedience to Creator) in detail and اتعامل (commercial transactions) in general. According to the Muhammad Tahir Mansuri some important principles governing commercial contracts and transactions are as under:¹²

i. *The contract should be by free mutual consent.*

Principle of free mutual consent has been highlighted in a Quran Ayah and Hadith of Prophet (s.a.w.s). The following verse and tradition can be cited in support:

“O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent”.¹³ يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِّنْكُمْ

⁹ Quran 5:1.

¹⁰ Quran 16:91.

¹¹ Noor Mohammed, *Principles of Islamic Contract Law*, Journal of Law and Religion 6, no. 1, 1988, pp. 115-130.

¹² Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions*. Adam Publishers & Distributors, 2006, pp. 3-16.

¹³ Quran 4:29

❖ The Prophet (s.a.w.s.) said: “The contract of sale is valid only by mutual consent”.¹⁴

ii. *The contract should be devoid of Gharar* الغرر

Prohibition of gharar is another principle that governs all contracts and transactions. Literally the Arabic word الغرر means indeterminacy, speculation, hazard and risk. A contract is presumed to suffer from gharar if it is involving (*this part particularly should be considered in future contract elaboration*): (a) a thing whose quantum is unknown; (b) a thing about which is not known whether it exists or not; (c) a thing that is not within the knowledge of the parties; (d) the parties are unaware whether a sale will take place or not.¹⁵

Prohibition of gharar has been mentioned in a numerous Hadith.

❖ The Prophet (s.a.w.s.) said: “If Allah spoiled the fruits what right would one party have to take the money of his brother?”¹⁶

iii. *The contract should be free of Riba* الربا

A further principle that governs transactions is prohibition of riba. It is unanimously agreed that riba means increase or growth, unlawful gain in an exchange. The Prophet (s.a.w.s.) cursed one who charged riba, gives it, records it, and witnesses it.¹⁷ The prohibition of riba appears in eight Ayahs of the Quran, three times in 2:275 (al – Baqarah), and one time each in 2:276; 2:278; 3:130 (al – Imran); 4:161(al – Nisa); and 30:39 (al – Rum).

... وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا “But Allah has permitted trade and has forbidden interest...”¹⁸

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُضَاعَفَةً وَاتَّقُوا اللَّهَ لَعَلَّكُمْ تُفْلِحُونَ “O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful”.¹⁹

¹⁴ Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions*. Adam Publishers & Distributors, 2006, pp. 3-16.

¹⁵ Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions*. Adam Publishers & Distributors, 2006, pp. 3-16.

¹⁶ Rafik Issa Beekun, *Islamic Business Ethics*, University of Nevada and Islamic Training Foundation, 1996.

¹⁷ Mohammad Nejatullah Siddiqi, *Riba, Bank Interest and Rational of its Prohibition*, Jeddah: Islamic Research and Training Institute, Visiting Scholars' Research Series, no 32, 2004.

¹⁸ Quran 2: 275.

- iv. *The contract should not contain an attribute of gambling (القمار) and games of chance (الميسر)*

Qimar comprises every form of increase or money gaining of which depends entirely on luck on chance, for instance acquiring income as a outcome of lottery or lucky draw. Maysir factually means getting something too easy or getting a profit without working for it.²⁰ The Quran has unambiguously forbidden these practices:

يَا أَيُّهَا الَّذِينَ آمَنُوا إِنَّمَا الْخَمْرُ وَالْمَيْسِرُ وَالْأَنْصَابُ وَالْأَزْلَامُ رِجْسٌ مِّنْ عَمَلِ الشَّيْطَانِ فَاجْتَنِبُوهُ لَعَلَّكُمْ تُفْلِحُونَ .

“O ye who believe! Intoxicants and gambling (dedication of) stones and (divination by) arrows are an abomination of Satan's handiwork: eschew such (abomination) that ye may prosper.”²¹

- v. *The contract should be free from fraud and cheating*

Fraud and cheating have been strongly condemned in the Quran and the Sunnah. Fraud includes a number of practices such as giving short measures and short weight, false bidding to rise price of an item, false swearing, hiding defects in sale, etc.²² Quran mentioned prohibition of fraud and cheating in Surah al-Muṭaffifin:

وَيْلٌ لِّلْمُطَفِّفِينَ الَّذِينَ إِذَا اكْتَالُوا عَلَى النَّاسِ يَسْتَوْفُونَ وَإِذَا كَالُوهُمْ أَوْ وَزَنُوهُمْ يُخْسِرُونَ أَلَا يَظُنُّ أُولَٰئِكَ أَنَّهُمْ مَبْعُوثُونَ ...

“Woe to those that deal in fraud, those who, when they have to receive by measure, exact full measure, but when they have to give by measure or weight to man, give less than due. Do they not think they will be called to account on a Mighty Day?”²³

- vi. *Two mutually inconsistent contracts are not permissible*

¹⁹ Quran 3:130

²⁰ Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions*. Adam Publishers & Distributors, 2006, pp. 3-16.

²¹ Quran 5:90

²² Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions*. Adam Publishers & Distributors, 2006, pp. 3-16.

²³ Quran 83: 1-6

Prophet (s.a.w.s.) prohibited two mutually inconsistent contracts. It includes the sale of two articles for two prices, the contingent sale, and the sale of single object for two prices.²⁴

vii. A contract should not be contrary to objectives of Shariah

Any transaction or contract that offends or jeopardizes any of the objectives “makasid” (مقاصد) of Shariah is automatically invalid. Maqasid al Shariah is alternately referred as huquq Allah (rights of Allah) in Islamic Law.²⁵ The objectives of Shariah or huquq Allah have been mentioned in several Ayah of the Quran.

وَلَكُمْ فِي الْقِصَاصِ حَيَاةٌ يَا أُولِي الْأَلْبَابِ لَعَلَّكُمْ تَتَّقُونَ

“In the law of equality, there is saving of life to you, O man of understanding”.²⁶

viii. Entitlement of profit depend upon liability for risk

Another principle that governs contract and commercial transactions is principle of liability for loss and entitlement to profit. This principle provides that a person is entitled to profit only when he bears the risk of loss. This principle operates in number of contracts such as contract of sale, hire or partnership.

ix. Permissibility as a General Rule. “What is not explicitly prohibited is permissible”.

In the field of transactions and contracts everything that is not prohibited is permissible. This rule has been emphasized in number of Ayah in Quran:

“Say (O Muhammad): Who has forbidden the adornment of Allah, which he has brought forth for His bondsmen, and the good things of His providing.”²⁷

²⁴ Razali Hj Nawawi, *Islamic Law on Commercial Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009, pp. 59-100.

²⁵ Muhammad Tahir Mansuri, *Islamic Law of Contract and Business Transactions*. Adam Publishers & Distributors, 2006, pp. 3-16.

²⁶ Quran 2:179.

²⁷ Quran 6:145.

3.0 ESSENTIAL ELEMENTS OF A VALID ISLAMIC LAW CONTRACT²⁸

For a legitimate contract to take place in Islamic contract law, certain conditions must be fulfilled. From the definition of the general theory of contract, a valid Islamic law contract bases itself on several imperative elements. On the whole these elements are related to the three pillars (ركن) of a contract: (i) a statement or a form (صيغة), (ii) two contracting parties (عاقدان), and (iii) the subject of a contract (المعقود عليه).²⁹

With reference to a statement or a form (صيغة) a Hadith narrated that Prophet Muhammad (s.a.w.s.) said: “Sale is constituted by mutual consent”³⁰. Therefore, causes nullifying full consent must be removed. Majority of Muslim scholars support the significance to the statement or صيغة because it utters the mutual consent of both parties involved. If it is missing, the contract will render to be invalid³¹. Statement or صيغة is created through offer and acceptance. Offer and acceptance that led to the mutual consent denote the internal aspects. The offer (الإيجاب) and acceptance (القبول) are considered as external proof of the contract. الإيجاب represents the compliance of a party to do something. الإيجاب is interpreted as a statement that is made first with a view to creating an obligation whilst القبول is defined as a declaration of an accepting the obligation.³² In Islamic contract law offer and acceptance can be expressed in a various ways such as by words, writing, gesture or indication and by conduct. The acceptance must be made to correspond with the proposal. It is compulsory that the acceptance must conform to the offer in

²⁸ Due to its limited length, the paper will give only elementary information related to valid Islamic contract. Depth analysis is deliberately omitted.

²⁹ Razali Hj Nawawi, *Islamic Law on Commercial Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009, pp. 59-100.

³⁰ Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, *The Islamic Commercial Law Principles*, Kuala Lumpur, 2007.

³¹ Abdurrahman Raden Aji Haqqi, *An Islamic Legal Framework Input in the Validity of Electronic Contracts*, Electronic Transactions Conference, Brunei Darussalam, 2000.

³² Abdurrahman Raden Aji Haqqi, *The Philosophy of Islamic Law of Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009.

all its details irrespective of whether such conformity is express or implied. If this conformity does not exist, there will be no consent. This conformity could either be explicit or implicit.³³

A further statement of صيغة that lead to the legality of the contract is that the acceptance of the offer made must be made in the same meeting (unity of session). The doctrine of session of contract states that in order for offer to be conformed to the acceptance, both parties should be present in the same session.³⁴

Scholars have a different opinions on whether a contract is obligatory instantaneously following an offer and acceptance, or parties are allowed to delay for further thinking about it until the end of the session. Majority of scholars (except Hanafi and Maliki) uphold that both parties are endorsed to rethink and delay until end of the session. This view could be supported by a Hadith which narrates: "Both seller and purchaser have the choice (to revoke the contract) unless they have separated from each other".³⁵

Contractual capacity is the second important requirement that is obligatory to have the valid Islamic contract. The parties who have the legal capability to enter into a contract must have the following attributes; (i) puberty, (ii) sanity, and (iii) maturity.³⁶

The Quran revealed:

وَابْتَلُوا الْيَتَامَىٰ حَتَّىٰ إِذَا بَلَغُوا النِّكَاحَ فَإِنْ آنَسْتُمْ مِنْهُمْ رُشْدًا فَادْفَعُوا إِلَيْهِمْ أَمْوَالَهُمْ...

"And test the orphans [in their abilities] until they reach marriageable age. Then if you perceive in them sound judgment, release their property to them".³⁷

³³ Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, *The Islamic Commercial Law Principles*, Kuala Lumpur, 2007

³⁴ Abdurrahman Raden Aji Haqqi, *An Islamic Legal Framework Input in the Validity of Electronic Contracts*, Electronic Transactions Conference, Brunei Darussalam, 2000.

³⁵ Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, *The Islamic Commercial Law Principles*, Kuala Lumpur, 2007

³⁶ Razali Hj Nawawi, *Islamic Law on Commercial Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009, pp. 59-100.

³⁷ Quran 4:6.

In general rule of the Islamic Law of contract, both parties must be sane. The inclusive capacity for the parties to take the contract is when he/she attains full mental growth and maturity. This standard is the puberty.³⁸ However, reaching puberty in itself alone is not ample evidence that a person has obtained capacity for business performance. In addition, one must have the possession of maturity of action when it is considered necessary, not only with regards to financial matters but also in matter of *din* (religion).³⁹

The subject matter of the contract (المعقود عليه) is also one of the pillars of the Islamic Law of contract. This is due to a fact that a contract is an agreement or promise between two parties on a particular subject matter. Therefore, no contract can exist without a subject matter, which is usually in the form of goods or property. The Islamic Law of contract has uttered the following conditions for the subject matter: (i) Suitability, (ii) Precise determination of subject matter, (iii) Existence of subject matter, and (iv) Certainty of delivery.⁴⁰

For the subject matter scholars have collectively retained that a subject matter must be suitable for concluding a contract on it. From the Islamic contract law point of view, suitability of the subject matter refers to its legality. Primarily, the subject of sale must have the value. The goods must have a clear material value, which is verified by the market. Goods without real value cannot be subject of sale or purchase. In addition, the subject matter must be permissible article in Shariah viewpoint. Legitimacy of subject matter also entails ownership (it must be possessed). Lastly, legality of subject matter also requires that there should be no hindrance or right attained to it. The subject of sale should not be a thing used for un-Islamic intentions.⁴¹

³⁸ Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, *The Islamic Commercial Law Principles*, Kuala Lumpur, 2007

³⁹ Razali Hj Nawawi, *Islamic Law on Commercial Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009, pp. 59-100.

⁴⁰ Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, *The Islamic Commercial Law Principles*, Kuala Lumpur, 2007

⁴¹ Abdurrahman Raden Aji Haqqi, *An Islamic Legal Framework Input in the Validity of Electronic Contracts*, Electronic Transactions Conference, Brunei Darussalam, 2000.

The subject matter must be accurately determined by both parties. All scholars generally agree that both parties must know in details the particulars about subject matter. The general principle in Islamic contract law is that the subject matter must be exactly determined in relation to its nature, quantity and value. Likewise, if the subject matter is an obligation or performance, it must be precisely determined at the time of the contract or else the contract will be invalid.⁴²

The subject must be specifically known and identified to the buyer. If the goods are not specified and agreed to up-front, the sale is void, as the goods may differ from goods agreed at the initial point of agreement. If the goods are not agreed initially upon entering the contract there is likelihood of gamble and cheating. The quantity and attributes of the subject matter must be also precisely known and agreed upon together with the certainty of the timing for completion and delivery of the contractual obligations. The price of the subject must be definite and becomes a necessary condition to the validity of the sale contract. If the price is uncertain, the sale is void.⁴³

Islamic contract law also uphold that the subject matter for transactions should be in actual existence at the time of contract and should be competent of being obtained and delivered to a prospective buyer in the future. The subject must exist at the time of the sale. If subject matter does not exist at the time of the sale, it cannot be transferred and its non-existence makes the contract void.⁴⁴

The subject must be in the full ownership. If something is not fully owned, the contract that takes the place becomes void. In addition, the subject must be in physical possession of the owner when he transfers it to another person.⁴⁵

⁴² Arzim Associates Chartered Accountants & Chartered Islamic Finance Professionals, *The Islamic Commercial Law Principles*, Kuala Lumpur, 2007.

⁴³ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons Ltd, 2007, pp. 99-127

⁴⁴ Razali Hj Nawawi, *Islamic Law on Commercial Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009, pp. 59-100.

⁴⁵ Nawawi, *Islamic Law on Commercial Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009, pp. 59-100.

Further necessity in Islamic contract law is that the sale must be instant and absolute. The sale of goods at a future date or event is void except for exceptional conditions that allowed by Islamic Law of contracts as salam or istisna transactions.⁴⁶

The common rule related to deliverability is that the subject matter must exist at the time of contract and must be owned and in possession by the seller before it can be transacted. The delivery of the subject of sale must be certain, not depending on a possibility or chance.⁴⁷

4.0 DEFINING THE FUTURES CONTRACTS: PRINCIPLES AND APPLICATION⁴⁸

A futures contract in general involves an agreement to buy and sell a specified quantity of something at a specified future date.⁴⁹ The price is variable, determined competitively by demand and supply on the trading floor or through a computer-based marketplace. A futures market is a market in which people buy and sell things for future delivery. Futures markets perform the economic function of managing the price risk associated with holding the underlying commodity or having a future requirement to hold it. The futures market is a risk transfer mechanism whereby those exposed to risks shift them to someone else; the other party may be someone with an opposite physical market risk or a speculator.⁵⁰

A futures contract is in essence very comparable to forward contract which is homogeneous with respect to contract size, maturity, product quality, place of delivery, etc.⁵¹ Futures contracts are traded on exchanges that intercede the transactions of all buyers and sellers. Given that numerous buyers and sellers transact through an exchange, the problem arising due to multiple coincidence

⁴⁶ Muhammad Ayub, *Understanding Islamic Finance*, John Wiley & Sons Ltd, 2007, pp. 99-127

⁴⁷ Abdurrahman Raden Aji Haqqi, *The Philosophy of Islamic Law of Transactions*, CERT Publication Sdn. Bhd., Kuala Lumpur, 2009.

⁴⁸ Illustration of the application of a futures contract from real practice: Appendix 1

⁴⁹ Andreas Jobst, *Derivatives in Islamic Finance*, In Syed Salman Ali (ed), *Islamic Capital Markets: Products, Regulation and Development*, Jeddah, Saudi Arabia: Islamic Research and Training Institute, 2008, pp. 97-124

⁵⁰ Muhammad al-Bashir Muhammad al-Amine, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*, Boston: Brill's Arab and Islamic Laws Series 1, 2008.

⁵¹ Comparison Between Futures and Forward Contracts: Appendix 2

will be solved.⁵² Furthermore, futures prices are regarded as fairer since the prices are realized by the interaction of many buyers and sellers, which is important due to elimination of the situation where one party can impose a price upon another. As for counterparty risk, this is solved by the exchange itself being the guarantor for each trade by being the buyer to each seller and the seller to each buyer.⁵³

The main role of exchange is to minimize the risk it bears, which is the potential default risk. This exchange achieves by two processes, one known as „margining“ and the other as „marking to market“. The exchange requires each party to deposit initial deposits, known as initial margins; when losses occur, it will require the party whose position is losing to pay up as the losses occur. This is known as a margin call. Marking to market means that the gain or loss in each contract position resulting from changes in the price of the futures (or option) contracts at the end of each trading day is added or subtracted from each account balance.⁵⁴ Another unique feature of futures is the ability of the buyers and sellers to reverse out of their positions before delivery or maturity. Therefore, in commodity futures physical delivery hardly ever takes place, as compared to forward contracts where delivery does take place.⁵⁵

The main purpose of the futures market is to hedge risks. Thus futures markets do not arise if the price of the commodity is not uncertain. Uncertainty about prices arises from uncertainty about the supply and demand of commodities. Thus, even though most seasonally produced

⁵² Sherin Kunhibava, *Derivatives in Islamic Finance*, Kuala Lumpur: International Shariah Research Academy for Islamic Finance (ISRA), Research paper no. 7, 2010.

⁵³ Obiyathulla Ismath Bacha, *Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*. International Journal of Islamic Financial Services 1, no. 1, 1999.

⁵⁴ Muhammad Fahim Khan, *Islamic futures and their markets: with special reference to their role in developing rural financial markets*, Jeddah: Islamic Research and Training Institute, Research paper no 32, 1996.

⁵⁵ Muhammad al-Bashir Muhammad al-Amine, *Futures trading contracts in commodity markets: An Islamic analysis*, unpublished doctoral thesis, International Islamic University Malaysia, 2001.

agricultural commodities are grown during some part of the year around the world, supply is uncertain because the quantity of the harvest may be affected greatly by weather conditions.⁵⁶

According to the Nevi Danila,⁵⁷ following can be listed as main advantages and disadvantages of futures contracts.

❖ Advantages:

- i. The futures contracts present less initial costs than other similar instruments, due that you only have to deposit guarantee or margin an underlying asset of greater value.
- ii. The future markets can be used as instruments to cover the risks derived from the fluctuations of cash prices before expiration.
- iii. The existence of an organized stock market and of standardized contracting terms gives liquidity and offers to the participants the possibility of closing positions on a date before the expiration.
- iv. The participant's parts on the contract don't assume any risk of insolvency; the clearinghouse guarantees the liquidation of the contract.

❖ Disadvantages:

- i. In a similar way as to what happens in the case of the term contracts, with the futures we are exposed to the risk that our vision of the contract is not correct.
- ii. If you use the futures contracts as covering instruments you will lose the potential benefits of the movement in future prices.
- iii. Being the contracting terms standardized, there doesn't exist futures contracts for all the instruments nor for all the merchandise and they might not cover exactly all the cash positions.

⁵⁶ Muhammad al-Bashir Muhammad al-Amine, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*, Boston: Brill's Arab and Islamic Laws Series 1, 2008.

⁵⁷ Nevi Danila, *Derivatives: An Islamic Perspective*, Journal of International Finance and Economics 9, no. 3, 2009, pp. 83-90.

5.0 ISLAMIC CONTRACT LAW PERSPECTIVE ON FUTURE CONTRACTS

In his book and papers⁵⁸ Mohammad Hashim Kemali looks into arguments and permissibility of future contracts in Islamic law from the point of conservative scholars (علماء). They have clearly criticized the future contracts and have emphasized the following important issues in their dispute: (i) futures contracts are based on goods that are not present at the time of contract, therefore it is not a valid sale, rather paper transaction; (ii) it is contract of sale in which the seller does not have possession of the item he actually sells, (iii) futures fall short of the condition of قبض, or taking ownership of the item preceding possible resale; (iv) in future contracts there is delay from both sides in bargain to a future date, which turns futures into the sale of one debt for another لدين ابيع بالدين; and (v) since in the futures contract the goods are absent and not possessed there is high possibility of excessive speculation which is closely related to gambling.

6.0 ARGUMENTS AGAINST THE USE OF FUTURES CONTRACTS

6.1 " لا تبع ما ليس عندك "

Literally, the above written Arabic phrase represents the Hadith which stated: "Sell not what is not with you". Islamic contract law clearly states that the subject matter of sale must exist⁵⁹ and be owned by the seller at the time of contract.⁶⁰ A future contract, which is essentially selling goods without possession, repudiates the principles of this Hadith.

⁵⁸ Mohammad Hashim Kemali, *Islamic Commercial Law: An Analysis of Futures and Options*, Cambridge: the Islamic Texts Society, 2000. Mohammad Hashim Kemali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and Scientific Creativity 6, no 3, 1995, pp. 7-37.

Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁵⁹ Nabil Saleh, *Definition and Formation of Contract under Islamic and Arab Laws*, Arab Law Quarterly 5, no. 2, 1990, pp. 101-116.

⁶⁰ While discussing the subject matter of the contract of sale, Al-Kasini, an Hanafi scholar, rules that the goods must be already in existence at the time the contract of sale is concluded and that the sale of a not-yet-existing object is void. He elaborates his view saying: "There are several conditions for the contract of sale to be validly concluded. The first condition is that the subject matter must be in existence. The sale of non-existent [goods] and the sale of anything, which is susceptible to the hazard of non-existence, is void. Examples can be found in the sale of offspring of a future-born animal and the sale of a fetus of an animal before its birth, of which the former is considered the sale of a non-existent [object] whilst the latter involves the hazard of non-existence".

Taking into consideration the written Hadith, Muslim conservative jurists have consequently passed prohibitive judgments on futures. However, the Hadith has invoked a variety of interpretations from the علماء and it is necessary to determine its importance by looking not only at its words but also at its underlying rationale and intent.

According to Al-Sancani, Ibn al Humam, and Ibn Qudamaheld⁶¹ sale of what the seller does not possess is forbidden, even for future buying and delivering. The seller must have possession of the object of sale when selling it. In the case that seller does not possess the object, sale could not be concluded, even if the seller obtains ownership of object afterward. The only exception, according to mentioned scholars, in this case is the “salam” sale, where ownership is not a precondition. This opinion is also held by the Organization of the Islamic Conference (OIC) Islamic Fiqh Academy.⁶² Furthermore, Article 197 of the Mejelle, the Ottoman Civil Code (elaborated between 1869 and 1875 and based on Hanafe Fiqh), provides that „the thing sold must be in existence” and Art. 205 further provides that: “the sale of a thing which is not in existence is void”.⁶³

In other hand, Hanafe scholars put emphasize on the seller’s effectiveness (فعالية) of the sale rather than on seller condition of validity (صحة شرط). Their opinion validates a genuine sale by an unauthorized person (فضولي) who does not have possession of the object but sells it nevertheless. Consequently, the sale is legitimate but not effective, and becomes effective upon obtaining the owner’s consent.⁶⁴

⁶¹ Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

⁶² Islamic Fiqh Academy, *Resolutions and recommendations of the Council of the Islamic Fiqh Academy 1985-2000*, Jeddah: Islamic Research and Training Institute, 2000.

⁶³ *The Mejelle, English translation of Majallah el-ahkam-i-adilya and a complete code on Islamic civil law*, Translated by Tyser, C.R., Demetriades, D.G. & Effendi, H.I. (n.d.). Petaling, Malaysia: The Other Press.

⁶⁴ Mohammad Hashim Kemali, *The Permissibility and Potential of Developing Islamic Derivatives as Financial Instruments*, IIUM Journal of Economics and Management 7, no. 2, 1999, pp. 73-86.

The Maliki scholars highlighted that the seller's effective control and ability to deliver is to be taken in consideration rather than ownership or possession. "What is not with you" reflects "a particular object that is not in one's ownership and one's power to deliver" they said. It is likely that the seller has the object but is not able to deliver it, or that the seller possesses the object but has no ownership on it.⁶⁵ In both cases, the seller would dispute mentioned Hadith. In Ibn Taymiyya elaboration of Hadith, accent is on the seller's incapability to deliver, which than leads to risk and uncertainty (المخاطر و الغرر). Sale of "what is not with you" in this case does not only refer to the sale of what is currently not in buyer possession but also inability of seller to deliver goods.⁶⁶

Imam Shafi⁶⁷ uttered that seller may sell what he currently does not possess provided that it is not a specific object, for delivery of a specific item cannot be guaranteed if the seller does not own it. Lastly, in their moderate view, Ibn Qayyim and al Mubarakfuri⁶⁸ expressed that this Hadith refers on the sale of specific objects, not the sale by description of goods that are readily available in the market.⁶⁹

6.2 SALE PRIOR TAKING POSSESSION قبض

The word "قبض" denotes taking and holding something in one's hands.⁷⁰ In its juristic application, "qabd" refers to lawful custody and ownership in a proprietary capacity, even if it does not entail the material operation of holding.⁷¹ The seller has obligation to bring the goods

⁶⁵ Mohammad Hashim Kemali, *Prospects for an Islamic Derivative Market in Malaysia*, Thunderbird International Business Review 4, no. 5, 1999, pp. 523-540.

⁶⁶ Mohammad Hashim Kemali, *Trading Commodity Futures: An Islamic Perspective*, Paper presented at the International Conference on Law and Commerce "Law and Commerce in New Millennium: Adapting to Changing Legal and Business Environment, International Islamic University, Kuala Lumpur, 2002.

⁶⁷ Mohammad Hashim Kemali, *Islamic commercial law: an analysis of futures*. The American Journal of Islamic Social Sciences 13, no. 2, 1996, pp. 197-224.

⁶⁸ Mahdi Zahraa and Shafaai M. Mahmood, *The validity of contracts when the goods are not yet in existence in Islamic law of sale of goods*, Arab Law Quarterly 17, no. 4, 2002, pp. 379-397.

⁶⁹ Ibn Qayyim opinion is rather positive for futures contracts. He stated that the sale of a not-yet-existing object is not necessarily invalid.

⁷⁰ Mohammad Hashim Kemali, *Islamic Commercial Law: An Analysis of Futures and Options*, Cambridge: the Islamic Texts Society, 2000.

⁷¹ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

sold, and the buyer have to pay the price. The buyer, though, is not indebted to accept the goods or take ownership, as it is his right, which he may or may not decide to put into effect.⁷²

One condition of a legitimate sale in Fiqh is that the buyer should not sell the goods purchased until they are in his ownership. When elaborating this decree, Muslim scholars have relayed to the authority of the Hadith. Prophet (s.a.w.s.) said: “He who buys foodstuff should not sell it until he has received it.” Another version of Hadith stated that Prophet (s.a.w.s.) said: “He who buys foodstuff should not sell it until he has taken possession of it.”⁷³

The core rationale of this assessment is to determine whether futures trading can be legalized within the specified conditions of the Hadith and whether hesitation of the scholars in combination with the conservative contract of sale are equally applicable to futures contracts. As for the Hadith basic foundation, the Hidayah⁷⁴ states that the Prophet (s.a.w.s.) forbidden the sale of items, particularly consumable ones that the seller did not own, because of ambiguity and uncertainty over their delivery.⁷⁵ All leading jurists have held, consequently, that one cannot sell foodstuff before taking ownership of it. According to Shafis, one cannot sell anything (e.g., foodstuff, land, or a garden), before taking possession.⁷⁶ Hanifis and Hanbali stated that ownership is not a requirement in the sale of real property, as there is generally no fear of damage and loss. Their moderate position emphasized that possession is not required for the sale either of foodstuffs and real property if ownership of the goods is conveyed in term of gift or

⁷² Mohammad Hashim Kemali, *Prospects for an Islamic Derivative Market in Malaysia*, Thunderbird International Business Review 4, no. 5, 1999, pp. 523-540.

⁷³ Mohammad Hashim Kemali, *Islamic commercial law: an analysis of futures*. The American Journal of Islamic Social Sciences 13, no. 2, 1996, pp. 197-224.

⁷⁴ Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

⁷⁵ Mohammad Hashim Kemali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and Scientific Creativity 6, no 3, 1995, pp. 7-37.

⁷⁶ Mohammad Hashim Kemali, *The Permissibility and Potential of Developing Islamic Derivatives as Financial Instruments*, IIUM Journal of Economics and Management 7, no. 2, 1999, pp. 73-86.

inheritance, as these does not entail financial exchange and the seller is not committed to paying a price to someone else.⁷⁷

According to the al-Kasani (Hanafi), a valid sale can be concluded prior to the seller's taking possession but that it will remain in abeyance until "qabd" has taken place.⁷⁸

Imam Malik restricted this Hadith application to food grains only, which means that non-food grain items (e.g., cotton, palm oil) may be sold prior to taking possession. Furthermore, Maliki also validated the sale of foodstuffs in lump sum (juzafan), that is, without weighing and measuring, prior to taking possession. For liability for loss and destruction in this case is transferred to the buyer at the moment of contract and not upon taking possession.⁷⁹

Ibn Taymiyah differed from the common position by elaborating the notion of "qabd" to its denotation. He stated that neither the Arabic language nor the Shariah has given a specific meaning to qabd. Implication varies from object to object, and the manner in which it occurs is not always the same.⁸⁰ Ibn Qudama stated that qabd in all things refers to an appropriate manner of taking possession. The Shariah stipulated qabd, but the manner in which it is accomplished is determined by custom.⁸¹ Lastly, Ibn Qayyim held that sale prior to taking possession is lawful and illustrated this by the sale, for example, of a person of his share in inheritance before taking possession, or what a person might have received by bequest as well as a woman's sale of her dower.⁸²

⁷⁷ Mohammad Hashim Kemali, *Trading Commodity Futures: An Islamic Perspective*, Paper presented at the International Conference on Law and Commerce "Law and Commerce in New Millennium: Adapting to Changing Legal and Business Environment, International Islamic University, Kuala Lumpur, 2002.

⁷⁸ Sherin Kunhibava, *Derivatives in Islamic Finance*, Kuala Lumpur: International Shariah Research Academy for Islamic Finance (ISRA), Research paper no. 7, 2010.

⁷⁹ Nuradli Ridzwan Shah Mohd Dali and Sanep Ahmad, *A Review of Forward, Futures, and Options From The Shariah Perspective*. "From Complexity to Simplicity". Paper presented at Seminar Ekonomi & Kewangan Islam (SEKI) conference, ESSET Kuala Lumpur, 2005.

⁸⁰ Seif I. Tag El-Din, *The Question of an Islamic Futures Market*, IIUM Journal of Economics & Management 12, no.1, 2004.

⁸¹ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁸² Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

6.3 SALE OF ONE DEBT FOR ANOTHER بيع الدين بالدين

There is consideration and dispute that futures contracts precede over postponed and unpaid debts. A debt is usually formed by a trader who enters the market either as buyer or seller without any material exchange of values.⁸³ Various categories of sales have been integrated under sale of debts (bay al-dayn), and it has been continually argued as to whether some of them do actually meet the criteria as sale of debts. Fiqh notion of bay al-dayn referred to “transactions over debts in the open market without any guarantees”.⁸⁴ Generally, bay al-dayn predicts sale over a due debt linking either two, or sometimes, three parties.⁸⁵ The essential underlying principle of the forbiddance of bay al-dayn was over ambiguity in its settlement. It is naturally possible to involve in bay al-dayn with purpose to delay a payment of a bad debt or one in which the debtor merely wanted a further impediment due to his incapability to pay on time. Successive volatile price changes also could contribute to the uncertainty.⁸⁶ In the future market condition is very different, where all transactions are completed over definite debts. The scholars did argued, passing the judgment which elaborates that since the buyer in futures does not pay the price to the seller as well as does the latter take delivery, they transact over debts and indulge in bay al-dayn, which is prohibited.⁸⁷

Nazih Hammad has recapitulated the disputes against bay al-dayn in the following five points:

(i) there is no valid legal benefit in it, (ii) it becomes a means to riba, (iii) it may lead to divergence and argument between the parties; (iv) it leads to gharar, and (v) the risk in it is

⁸³ Obiyathulla Ismath Bacha, *Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*. International Journal of Islamic Financial Services 1, no. 1, 1999.

⁸⁴ Islamic Fiqh Academy, *Resolutions and recommendations of the Council of the Islamic Fiqh Academy 1985-2000*, Jeddah: Islamic Research and Training Institute, 2000.

⁸⁵ Hanudin Amin, *An Analysis of the Classical and Contemporary Juristic Opinions on Bay Al- Dayn*, Labuan e-Journal of Muamalat and Society, 2007, pp. 31-43.

⁸⁶ Hanudin Amin, *An Analysis of the Classical and Contemporary Juristic Opinions on Bay Al- Dayn*, Labuan e-Journal of Muamalat and Society, 2007, pp. 31-43.

⁸⁷ Seif I. Tag El-Din, *The Question of an Islamic Futures Market*, IIUM Journal of Economics & Management 12, no.1, 2004.

excessive.⁸⁸ Hammad and his follower Tijani have deplored three of these to be less than accurate and not relevant to futures, and have discussed only two, namely the absence of a lawful benefit, and extraordinary risk. Afterward it is proved in some points that bay al-dayn does serve a useful purpose, a conclusion which many have upheld.⁸⁹ With respect to the point over extraordinary risk contained in bay al-dayn and in futures, Hammad and Tijani have held that “the cautious operational measures of the clearing house guarantees over fulfillment of contract, daily clearance procedures and margin taking have eliminated or minimized the risk over the parties’ inability to fulfill their obligations”.⁹⁰

Ibn Qayyim has elaborated that not all diversities of bay al-dayn are forbidden. According to him, the prohibited variety is one which entails the sale or exchange of one deferred debt for another.⁹¹ The reason given is that bay al-dayn of this kind prolongs the liabilities of the parties for no useful purpose. Ibn Qayyim’s assessment of the source confirmation on bay al-dayn furthermore led him to the conclusion that “there is neither explicit nor implicit text in the Shariah on its prohibition”.⁹² Oppositely, the doctrines of Shariah indicate its acceptability. Ibn Taymiyya has also indicated that bay al-dayn, basically consists of one deferred counter value for another, neither of which is taken into possession.⁹³ The Prophet (s.a.w.s.) did not prohibit payment of one debt in exchange for other both of which are established and proven, especially if it involves only the debtor and not a third party. In this case, clearance absolves both sides of their debts, and this is clearly permissible. Several scholars have tried to illustrate bay al-dayn

⁸⁸ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁸⁹ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁹⁰ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁹¹ Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

⁹² Mohammad Hashim Kemali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and Scientific Creativity 6, no 3, 1995, pp. 7-37.

⁹³ Mohammad Hashim Kemali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and Scientific Creativity 6, no 3, 1995, pp. 7-37.

through salam saying that an outstanding debt could not be assigned into the price of a salam contract as this will amount to bay al-dayn.⁹⁴

The Maliki have also advocated the legality of certain types of bay al dayn prior to delivery and qabd when the debts involved within do not appear from the exchange of food goods and useable goods, and the transaction is also free of gharar.⁹⁵ They argued that there is no excessive gharar in deferring both counter values compared to the deferment of one of them only. If one of the counter values has been delivered while the other is deferred to a future date, or when both are so deferred, the level of risk would be the same and no additional gharar is likely when both are deferred.⁹⁶

It could be concluded then that bay al-dayn, which is involved in futures, is in the nature of the completion of outstanding obligations and of debt repayment by the debtor. According to Kamal Hashim⁹⁷ this is clearly permissible and conforms to the Qur'an norm on the fulfillment of contracts:

يَا أَيُّهَا الَّذِينَ آمَنُوا أَوْفُوا بِالْعُقُودِ... “O you who have believed, fulfill [all] contracts”.⁹⁸

Holly Qur'an also addresses the concept of debt in Surah Al – Baqarah:

وَلْيُمْلِلِ الَّذِي عَلَيْهِ الْحَقُّ وَلْيَتَّقِ اللَّهَ رَبَّهُ وَلَا يَبْخَسْ مِنْهُ شَيْئًا

“Let him (the debtor) who incurs the liability dictate, and he must have Taqwa of Allah, his Lord, and diminish not anything of what he owes”.⁹⁹

Allah's statement, indicates that the debtor should dictate to the scribe what he owes, so let him fear Allah. In this case the duty and requirements of contract falls entirely on debtor. Only one

⁹⁴ Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

⁹⁵ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁹⁶ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

⁹⁷ Mohammad Hashim Kemali, *Islamic Commercial Law: An Analysis of Futures and Options*, Cambridge: the Islamic Texts Society, 2000.

⁹⁸ Quran 5:1.

⁹⁹ Quran 2:282.

counter value has been involved. Based on this it could be concluded that only one counter value could be delayed.¹⁰⁰

6.4 SPECULATIONS, UNCERTAINTY AND GAMBLING WITH FUTURES المصرو الغرر

A widespread disapproval of futures speculation is that it causes a volatile price movement that has for outcome significant privation to those engaged in more fruitful quest.¹⁰¹ Extensive exposure is given to the relatively notable manipulations that cause many to conclude that speculation is synonymous with gambling. Speculators have lead to some shocking events throughout history. Some early instances of manipulation could be seen in America in 1980, all of which resulted in price volatility. Since then, balance has returned to the market and this, aided by the introduction of regulatory and punitive legislation, has diminished the prospects for such manipulation.¹⁰² Furthermore, existing data do not confirm the suspicion that futures trading are dominated by large speculators. Data may vary from market to market, but, regardless of market, the total holdings of large speculators' long and short positions are less than 20 percent of the total holdings of small traders. Large speculators probably constitute less than 2 percent of the total futures trading population. Major price movements are usually caused by basic changes in the supply or demand for a given item and only rarely by a group of speculators creating a self-fulfilling prophecy. Statistical analysis shows that the volatility of futures prices is approximately the same as that of equity prices. What makes futures trading more prone to speculative risk taking is the high degree of leverage that results from low margin requirements.

¹⁰⁰ I would like to express my sincere appreciation to Prof. Dr. Zainal Azam Abdul Rahman who provided me with particular input and elaboration.

¹⁰¹ Sherin Kunhibava, *Shariah Parameters of Islamic Derivatives in Islamic Banking and Finance*, ISRA International Journal of Islamic Finance 1, no. 1, 2009, pp. 147-150

¹⁰² Sherin Kunhibava, *Derivatives in Islamic Finance*, Kuala Lumpur: International Shariah Research Academy for Islamic Finance (ISRA), Research paper no. 7, 2010.

This low margin facility is not available in the stock market and is the main factor that is accountable for the high volume of speculative trading in futures.¹⁰³

Ibn Taymiyya pointed out that if a sale contains gharar and involves the usage of the property of others, it is the same as gambling, which is clearly forbidden. Unlawful usage or devouring of the property of others takes two forms: usury (riba) and gambling (maysir).¹⁰⁴ The Qur'an has forbidden both, and the Sunnah has only explained and elaborated upon the Qur'an. He also mentioned that gharar sales, which the Prophet forbade, generally partook in gambling. There were certain types of sales that were common among the Arabs and subsequently forbidden by the Prophet on these grounds.¹⁰⁵ Ibn Taymiyya therefore attempted to establish a common denominator between gharar and gambling, and that is the devouring and unlawful appropriation of the property of others. A commercial transaction cannot be equated with gambling unless it is accompanied by this factor. He based this conclusion on Qur'an 4:29, where unlawful devouring of the property of others is declared forbidden and Muslims are encouraged to conduct "trading by mutual consent".¹⁰⁶ Unlawful devouring is a broad Qur'anic concept that includes gambling, fraud, usurpation, bribery, and profit gained from unlawful transactions. The text under discussion was revealed concerning the touch-and-throw sales, consisting usually of clothes, in which the deal was struck when the buyer touched the material or when it was thrown in his/her direction, and sale of yet-to-be-born animals.¹⁰⁷ Ibn Taymiyya stated that if such sales became final prior to the buyer's viewing the object, it involved risk taking and gambling, for the object may be good and to the buyer's liking or not. If the buyer is bound by the sale without actually

¹⁰³ Sherin Kunhibava, *Derivatives in Islamic Finance*, Kuala Lumpur: International Shariah Research Academy for Islamic Finance (ISRA), Research paper no. 7, 2010.

¹⁰⁴ Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

¹⁰⁵ Mohammad Hashim Kemali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

¹⁰⁶ Mohammad Hashim Kemali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and Scientific Creativity 6, no 3, 1995, pp. 7-37.

¹⁰⁷ Mohammad Hashim Kemali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and Scientific Creativity 6, no 3, 1995, pp. 7-37.

knowing about the object, this would be gambling. But if both parties have seen the cloth and one tells the other that the deal is done, this is a conditional sale that resembles a “give-and-take sale” and contains no element of gambling. If one of the parties involved received its due but the other did not and the latter remained open to risk in a way that frustrated and nullified his right, the sale would contain gharar and gambling simultaneously. Evidently, there is no misappropriation of another’s property in futures, for the buyer in such a contract is engaged in a transaction aimed at making profit through trading and not through the dishonest appropriation of another’s property. Speculative risk taking in commerce, which involves investment of assets, labor, and skill, is not forbidden; what is forbidden is excessive gharar and gambling. Financial risk taking is likely to involve gambling if it is staged and created for its own sake, but not if it is incidental to beneficial activity and trade.¹⁰⁸

Classic descriptions of qimar and maysir also suggest the involvement of two parties in a combative game played for the sole purpose of winning at the expense of one’s opponent. One party’s gain is equivalent to the other’s loss. The gain accruing from such a game is unlawful, as is the act of playing it, for it diverts one’s attention from productive occupation and virtuous conduct.¹⁰⁹ Speculation in futures does not necessarily involve a combative game played in order to beat an opponent or to acquire someone property. The speculative risk undertaken in futures bears a greater affinity to commercial risk taking for profit rather than gambling, qimar, and maysir.¹¹⁰ Mohammad Hashim Kemali elaborated that the exchange authorities and the government must be cautious in order to ensure that commercial speculation is genuinely reflective of the natural flow of market forces. Imposing quantitative limits on daily trading

¹⁰⁸ Mohammad Hashim Kemali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

¹⁰⁹ Mohammad Nejatullah Siddiqi, *Riba, Bank Interest and Rational of its Prohibition*, Jeddah: Islamic Research and Training Institute, Visiting Scholars’ Research Series, no. 32, 2004.

¹¹⁰ Mohammad Hashim Kemali, *Prospects for an Islamic Derivative Market in Malaysia*, Thunderbird International Business Review 4, no. 5, 1999, pp. 523-540.

volume and position limits, as is normally practiced in futures markets, is one way to contain speculation within acceptable bounds. But this is a matter that can best be dealt with through house rules and operative floor procedures by the exchange authorities. On the other hand, legislative guidelines should seek to regulate contractual relations between the parties, brokerage activities, and disciplinary procedures in serious violations.¹¹¹

7.0 ISLAMIC JUSTIFICATION OF FUTURES CONTRACTS

According to Mohammad H. Kamali to endorse the people's wealth through trade is very positive and contributes in "maslaha".¹¹² In his argumentation he questioned illicit view of futures passed by Fiqh. He based his argument on fact that decision was primarily brought for earlier times and that negative judgments on futures trading without clear Shariah evidence is practically the same as to acting contrary to "maslaha". The basic position of Shariah is prohibition in the realm only of "cibadat", and it is permissibility in "mucamalat" and commerce.¹¹³ According to him, since there is no important verification on the prohibition of futures, then its acceptability in Shariah is recognized. An operation is legitimate from the Shariah viewpoint when it does not infringe a crucial rule, its free of interest and gambling, and does not contribute in excessive gharar.¹¹⁴ When these necessities are met, the transaction in question is valid and may be performed. However, in conclusion he said that Islamic finance need to remain engaged, in a continued progression to develop more advanced safeguards against abuse, excessive speculation, and gharar.¹¹⁵

¹¹¹ Mohammad Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options*, Cambridge: the Islamic Texts Society, 2000.

¹¹² Mohammad Hashim Kamali, *Commodity futures: an Islamic legal analysis*. Thunderbird International Business Review 49, no. 3, 2007, pp. 309-339.

¹¹³ Mohammad Hashim Kamali, *Fiqhi Issues in Commodity Futures*, ed. by Munawar Iqbal and Tariqullah Khan, Financial Engineering and Islamic Contracts, New York, 2005, pp. 20-57.

¹¹⁴ Mohammad Hashim Kamali, *The Permissibility and Potential of Developing Islamic Derivatives as Financial Instruments*, IIUM Journal of Economics and Management 7, no. 2, 1999, pp. 73-86.

¹¹⁵ Mohammad Hashim Kamali, *The Continued Domination of Taqlid in Islamic Commercial Law: A Case Study of Future Trading*, Islamic Thought and & Scientific Creativity 6, no 3, 1995, pp. 7-37.

Muhammad F. Khan advocates that the Prophet (s.a.w.s) said “he who makes a future sale should do that for a specific quantity, specific weight, and for a specific period of time”. In addition, he states that the motive for allowing future sale is that the product is a public necessity and a payment is settled at the beginning of the contract.¹¹⁶ However, in the forward and futures markets, the payment is settled at the end of the contract. Therefore, there is strong argument that forward and futures contradict the Shariah rules.

In reference to public necessity, scholars have allowed “bai salam” sale. Basic definition of bai salam is “the sale of what one does not have, but can be brought into existence, such as generic products”.¹¹⁷ Apart from this, it has one condition, buyer has to pay the price at the time of contracting, and the seller has an obligation to deliver the product at a future date.¹¹⁸

In other hand Imam Hanafi gave support for futures related to manufactured products. This is called “bai istina”.¹¹⁹ He advocates some flexibility in terms of the completion from both ends. Following above mentioned, completion can be deferred to a future date. The reason for this flexibility is that there will be no room for speculation in price variations, because the products cannot be easily found in the market place.¹²⁰ However, it can be debatable that futures contracts do not have same application as bai salam and bai istina. Thus, futures contracts are not acceptable in the Islamic culture.

Imam Maliki also authorized delay of the counter value for three days and for more than three days in some cases. This is permitted as long as the intention is to deliver and take delivery of the asset and is not speculation. Therefore, the emphasis is not on ownership or possession, but fairly on the seller's efficient control and ability to deliver. In this case, a short sale is permitted as long

¹¹⁶ Muhammad Fahim Khan, *Islamic futures and their markets: with special reference to their role in developing rural financial markets*, Jeddah: Islamic Research and Training Institute, Research paper no 32, 1996.

¹¹⁷ Seif I. Tag El-Din, *The Question of an Islamic Futures Market*, IIUM Journal of Economics & Management 12, no.1, 2004.

¹¹⁸ Seif I. Tag El-Din, *The Question of an Islamic Futures Market*, IIUM Journal of Economics & Management 12, no.1, 2004..

¹¹⁹ Abdul Rahim Al-Saati, *Sharia Compatible Futures*, Journal of King Abdulaziz University: Islamic Economics 15, no 1. 2002, pp. 3-25.

¹²⁰ Abdul Rahim Al-Saati, *Sharia Compatible Futures*, Journal of King Abdulaziz University: Islamic Economics 15, no 1. 2002, pp. 3-25.

as the objects are not fungible goods, which can be replaced and substituted.¹²¹ Mohammad H. Kamali furthermore argues that if the goods and their counter value are delivered on a specific date in the future, there will be no risk.¹²²

In the cooperate outline, the meaning of futures contract is that two parties negotiate on a future transaction, where the seller agrees to deliver the commodity in a future date to the buyer and the buyer agrees to pay money to the seller at that time.¹²³ Moreover, in the “Jo’alah” viewpoint, the futures contract is defined as a contract in which the buyer proclaims that if the seller delivers the product at a determined time in the future, he will deliver the money to him. The futures contracts in the two frameworks above are permissible.¹²⁴

Ibn Taymiyyah implies that agreed upon requirements between parties are binding to them based on the principle of the freedom of contractual requirement, thus in a forward contract, the parties can make requirements of the postponement for both the asset and its counter value.¹²⁵

Ali Salehabadi & Mohammad Aram believe that deployment of future instruments are of necessity because national budgeting. As a result national development programs can be planned and implemented with a higher degree of accuracy. Futures, according to them, could be precisely applicable for safe guarding against negative effects of price fluctuation either in oil (such as a major producer and exporter) or in wheat and sugar (as a major importer and consumer).¹²⁶

¹²¹ Mohammad Hashim Kemali, *Trading Commodity Futures: An Islamic Perspective*, Paper presented at the International Conference on Law and Commerce “Law and Commerce in New Millennium: Adapting to Changing Legal and Business Environment, International Islamic University, Kuala Lumpur, 2002.

¹²² Mohammad Hashim Kemali, *Prospects for an Islamic Derivative Market in Malaysia*, Thunderbird International Business Review 4, no. 5, 1999, pp. 523-540.

¹²³ Obiyathulla Ismath Bacha, *Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration*. International Journal of Islamic Financial Services 1, no. 1, 1999.

¹²⁴ Mohammad Saleh Ali Ayyash, *Shariah Alternatives to Non-Shariah Elements in Modern Commodity Futures Trading*, in In Syed Salman Ali (ed), *Islamic Capital Markets: Products, Regulation and Development*, Jeddah, Saudi Arabia: Islamic Research and Training Institute, 2008, pp. 147-179.

¹²⁵ Nuradli Ridzwan Shah Mohd Dali and Sanep Ahmad, *A Review of Forward, Futures, and Options From The Shariah Perspective. “From Complexity to Simplicity”*. Paper presented at Seminar Ekonomi & Kewangan Islam (SEKI) conference, ESSET Kuala Lumpur, 2005.

¹²⁶ Ali Salehabadi and Mohammad Aram, *Islamic Justification of Derivative Instruments*, International Journal of Islamic Financial Services 4, no. 3, 2002.

8.0 CONCLUSION

The best way to start concluding remarks on presented paper is to quote former prime minister of Malaysia Tun Dr. Mahathir Mohamad who said: “They may promise good returns but as we have seen in the end abuses of financial systems will bring about disaster”.¹²⁷ Similarly, after performing detailed research on performance and application of derivatives in Islamic Finance, Dr. Samir Abdel Hamid Radwan at the end of his book noted: “I swear in God's name that to the best of my knowledge, based on the research conducted to prepare for the book, my finding is that derivatives, as they are, are far from being Shariah compliant”.¹²⁸ Furthermore, it could be useful to present question to, and answer from, great Mufti Taqi Usmani related particularly to Islamic Futures. The Mufti has been provided with following scenario and asked following questions:

“Two individuals, A and B enter into a contract on January 1 under which A would sell a stock of company X at a price of \$100 to B after an expiry of six months. B has an obligation to purchase at this price irrespective of the market price on June 30. (i) Is this contract permissible in Shariah? (ii) Can this contract or the rights and obligations of A and B be transferred by either of them to a third party C? (iii) If the object of transaction is any commodity, or gold, silver or currency and not stocks, as in the case above, in what way is the validity or otherwise of the contract affected? It may be noted that the non- transferability of rights and obligations severely limits the possibility of speculation on Futures Exchanges. A commonly held belief is that

¹²⁷ Islamic Finance News Daily, *Tun Mahathir's Speech at the Opening Ceremony of the 5th International Shariah Scholars Forum*, Organized in conjunction with the Global Islamic Finance Forum, Kuala Lumpur, Malaysia, 2010.

¹²⁸ Samir Abdel Hamid Radwan, *Al-Mushtaqat al- Maliyyah: dirasah muqaranah bayna al-nuzum al-wadi'yyah wa ahkam al-shariah al-islamiyyah*, Dar al-Nashr li'l Jamiaat, Cairo, 2005. I would like to express my sincere appreciation to Prof. Dr. Zainal Azam Abdul Rahman who provided me with particular input and translation.

Futures contracts are prohibited when they are used for speculation. Does this imply that Futures contracts are permissible when these are used for hedging?¹²⁹

His answer was following “(i) this is an example of a futures transaction. The futures transaction as in vogue in stock and commodities markets today is not permissible for two reasons. Firstly, it is a well recognized principle of the Shariah that sale or purchase cannot be affected for a future date. Therefore, all Forward and Futures transactions are invalid in Shariah. Secondly because in most of the Futures transactions, delivery of the commodities or their possession is not intended. In most cases, the transactions end up with the settlements of difference of prices only, which is not allowed in the Shariah. (ii) As futures are not permissible, no rights or obligations can emanate there from. Therefore the question of transferring these rights and obligations does not arise. (iii) futures transactions as explained above are totally impermissible regardless of their subject matter. Similarly, it makes no difference whether these contracts are entered into for the purpose of speculation or for the purpose of hedging”.¹³⁰

Essentially, futures and other derivatives are matters of disparity among scholars. The large majority of scholars, among them members of OIC Fiqh academy and Fiqh academy in Mecca, hold derivatives to be impermissible. Reasons for such verdict may be summarized in three groups, firstly, derivatives involve oppressive and prohibited elements like gharar, speculations and gambling, future contracts are large paper transaction not genuine purchases or sales, sale what the seller does not own, sale of debt for debt, selling prior possession (without any physical transfer or delivery), subject matter is unacceptable, etc. Furthermore, conservative scholars claimed that derivatives cannot be driven out as any traditional contract in Shariah. Lastly,

¹²⁹ Taqi Usmani, *What Shariah Experts Say: Options, Futures and Swaps*, International Journal of Islamic Financial Services 1, no.1, 1999, pp. 36-39.

¹³⁰ Taqi Usmani, *What Shariah Experts Say: Options, Futures and Swaps*, International Journal of Islamic Financial Services 1, no.1, 1999, pp. 36-39.

derivatives cause great harm to people, causing price distortion (price is not determined by market forces) and financial crises. For these reasons they are forbidden.

If majority of scholars clearly agreed that derivatives should be prohibited, further question could be raised does Islamic finance needs derivatives contracts and their risky, uncertain and speculative way of performance. Looking from the input and output point of view, this uncertain and speculative behavior of futures contracts had led to discovery of various hedging devices. If Shariah has clearly defined the basic principles of Islamic contracts, which prohibits uncertainty and speculation, does Islamic finance really needs hedging devices? The reality is that risk management is entrenched in the Islamic law of contract and financial transactions such that if they are really applied as endowed, there is essentially no actual need to elaborate the concern of risk in the manner it is practiced in the conventional model. Thus, the principal question to address is whether all that need to be pursued in mode of Maqasid Shariah are essentially realized. Additionally, some conservative scholars have voiced their serious consternation at the conduct(s) and manners Islamic finance has been performed of late. They are particularly questioning a “blind” following of conventional financial engineering. Recent mortgage market collapse, to a great extent based on financial derivatives, distressed the fundamentals of conventional finance. In other hand, Islamic finance was extremely resilient, particularly owing to Shariah and its principles (Maqasid Shariah). If Islamic finance confidently follows their conventional peers in development and applications of future contracts and hedging instruments, shell the next financial crisis come from Islamic world? In view of this, and in the light of the Shariah principle of permissibility that makes all commercial transactions permissible in the absence of a clear prohibition, the rulings of not only the Mecca based Fiqh Academy but also of many Muslim scholars who have proscribed futures contracts disallowed is a most discouraging

form of imitation. This firm opinion is founded on the analysis that futures contracts do not fulfill the requirements of the conventional Islamic law of contract.

From above discussion, it could be concluded that contemporary trading in derivatives is impermissible as it includes prohibited categories of sale of debts, riba and it is a field in which artificial finance industry builds its basis. However, taking into consideration the need of Islamic finance for efficient hedging methods, there is belief that use of some derivatives for mere hedging purposes may be accepted provided some important adjustments.

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Appendix 1

Sample and Application of Future Contract¹³¹

Contract size:	25 metric tones
Delivery months:	current and the next five succeeding months, and thereafter alternate months up to twelve months forward.
Price Quotation:	Malaysian Ringgit per metric ton.
Minimum Price Fluctuation:	RM 1.00 per metric ton.
Daily Price Limits: RM 100 per metric ton above or below the Settlement Prices of the preceding day for all month. Limits are expanded when the Settlement Prices of all three quoted months, which immediately follow the current month, in any day are at limits as follows:	
<u>Day</u>	<u>Limit</u>
First	100
Second	150
Third	200
Daily price limits will remain at RM 200 when the preceding day's settlement prices of all three quoted months immediately following the current month settle at a limit RM 200.	
Repotable Position: 100 or more open contracts, either long or short, in any one-delivery month	
Speculative Position: 500 contracts net long or net short, for any delivery months combined.	
Transaction Limit: Each single transaction shall not exceed twenty lots.	
Last Trading Day: A contract month expires at noon of the fifteenth of the month; if the fifteenth is a nonmarket day, it expires the preceding business day.	
Tender Period: First business day to the twentieth day of the delivery month; if the twentieth is a nonmarket day, the preceding day.	
Contract Grade and Delivery Points: Crude Palm Oil of good merchantable quality, in bulk, unbleached, in Port Tank Installations located at the option of the seller at Port Kelang, Butterworth/ Prai and Pasir Gudang. Free Fatty Acids (FFA) of Palm Oil delivered into Port Tank Installations shall not exceed four percent and from Port Tank Installations shall not exceed five percent moisture and impurities shall not exceed 0.25%.	
Deliverable Unit: Twenty – five metric tons, plus or minus not more than two percent. Settlement of weight differences shall be based on the simple average of the daily Settlement Prices of the delivery month from: (a) the first business day of the delivery month to the business day immediately preceding the last day of trading, if the tender is made on the last trading day or thereafter	
Trading Hours:	Malaysian Time, on each business day 10:30 a.m. – 12:30 p.m. 3:00 p.m. – 6:00 p.m.

¹³¹ Muhammad al-Bashir Muhammad al-Amine, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*, Boston: Brill's Arab and Islamic Laws Series 1, 2008.

Appendix 2

Comparison Between Futures and Forward Contracts¹³²

Item	Futures	Forwards
1. Market Place	Specific market place that is reserved to listed members only	Does not need any specific market
2. Mode of Contract	Through open outcry	The parties have the right to conclude the contract as they wish
3. Subject Matter	Confined to commodities of standard specification (lots)	Tailored according to the specific needs of the contracting parties
4. Discharging of Obligation	Possible to discharge obligations by entering into a matching contract	Parties are under obligation to take delivery at the maturity date.
5. Delivery Time	Limited to only brief periods during a year.	According to what agreed upon between the parties
6. Breach of Contract and Claim for Damages	Entangles the individual party with the Futures Exchange and not the party on the other side of the agreement.	The settlement of the dispute will involve the two contracting parties only.

¹³² Muhammad al-Bashir Muhammad al-Amine, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*, Boston: Brill's Arab and Islamic Laws Series 1, 2008.