

## CHAPTER ONE

### INTRODUCTION

#### *Background of the Research*

The mastery of risk is a stupendous challenge. It may be regarded as the distinguishing feature of modern times. Someone has rightly remarked that the elimination of risk has replaced the elimination of scarcity as a major preoccupation.

There are several risks which need to be managed by financial institutions, be they Islamic or conventional. They include, among others, market risk, interest rate risk, credit risk, liquidity risk, operational risk, litigation risk, regulatory risk, and foreign exchange risk. The nature of some of these risks is briefly discussed below:

Market risk is the risk originating in instruments and assets traded in well-defined markets. Market risks can result from macro and micro sources. Systematic market risk results from overall movement of prices and policies in the economy. The unsystematic market risk arises when the price of the specific asset or instrument changes due to events linked to the instrument or asset. Volatility of prices in various markets gives rise to different kinds of market risks. Thus market risk includes equity price risk, interest rate risk, currency risk, and commodity price risk.

Interest rate risk is the exposure of a bank's financial condition to movements in interest rates. In Islamic financial institutions, due to the prohibition against charging and paying interest, rates are not directly affected by risk. However, they are indirectly affected by this risk in their bid to determine their return. Islamic financial institutions use the London Inter Bank borrowing rate (LIBOR) as a benchmark in their transactions. Thus, the effect of interest rates can be transmitted to Islamic banks indirectly through this benchmark. In case of a change in the LIBOR, the Islamic banks could face this risk in the sense of their paying more profit to future depositors as compared to receiving less income from the users of long-term funds.

Credit risk is the risk that a counterparty will fail to meet its obligations in a timely manner and fully in accordance with the agreed upon terms. This risk can occur in the banking and trading books of the bank.

Liquidity risk arises due to insufficient liquidity for normal operating requirements, thus reducing the ability of banks to meet its liabilities when they fall due. This risk may result from either difficulties in obtaining cash at reasonable cost from borrowing (funding or financing liquidity risk) or the sale of assets (asset liquidity risk). One aspect of asset-liability management in the banking business is to minimize the liquidity risk. While funding risk can be controlled by proper planning of cash-flow needs and seeking newer sources of funds to finance cash shortfalls, the asset liquidity risk can be mitigated by diversification of assets and setting limits on certain illiquid products.

Operational risk may arise from human and technical errors or accidents. It is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and technology or from external events. While human risk may arise due to incompetence and fraud, technology risk may result from telecommunications system and program failure. Process risk may occur due to various reasons, including errors in model specifications, inaccurate transaction execution, and violating operational control limits. Due to problems arising from inaccurate processing, record keeping, system failures, compliance with regulations, etc., there is a possibility that operating costs might be different from what is expected and therefore affect net income adversely. Given the newness of Islamic banks, operational risk in terms of human risk can be sometimes acute in these institutions. Operational risk in this respect particularly arises as the bank may not have enough professional personnel to conduct Islamic financial operations. Moreover, given the nature of business, the computer software available in the market for conventional banks may not be appropriate for Islamic banks.

Legal risks relate to risks of unenforceability of financial contracts. This relates to statutes, legislation, and regulations that affect the fulfillment of contracts and transactions. This risk can be external in nature, like regulations affecting certain kinds of business activities or internal matters related to a bank's management or employees, like fraud, violations of laws and regulations, etc. Legal risks can be considered as a type of operational risk. Regulatory risk arises from changes in the regulatory framework of a country. Given the different nature of their financial contracts, Islamic banks face risk related to their documentation and enforcement. As there are no standard forms of contracts for various financial instruments, Islamic banks prepare these contracts according to the advice of their respective Shariah Board and the needs and concerns of local laws. Lack of standardized contracts and the absence

of a litigation system to enforce contracts by counterparty increase the legal risks associated with Islamic financial agreements.<sup>1</sup>

Thus, risk is an ever-present factor, especially in business, but industrialization brought risks previously unknown in trade and agriculture. Industrial production often involves long periods of time, and the longer the period of production, the greater the uncertainty. The scope of the market has expanded to cover the entire globe, introducing new kinds of risk.<sup>2</sup>

In Islamic banking, the management of risk becomes more challenging due to its peculiar risk characteristics and the requirement for compliance to Shariah principles. While the Basel II initiatives on the identification of credit, market, and operational risks can be assimilated into Islamic banking, the initiatives have to be complemented with consideration of the other dimensions of risks that are inherent in the Islamic financial transactions. The risk management infrastructure in Islamic financial institutions needs to identify, unbundle, measure, control, and monitor all the specific risks in the Islamic financial transactions and instruments. This is to ensure that the systems and controls will be effective in the quantification and management of the risks arising from the operations.

An important aspect of risk management is the need for the Islamic banking industry to develop a derivatives market. In the current, increasingly uncertain, global financial environment, investors need to be in a position to mitigate and manage these emerging new risks. Islamic banking institutions, in particular, have, to a large extent, long-term assets, which include long-term Islamic housing mortgages and Islamic financial instruments that are funded by short-term deposits, thus giving rise to a maturity mismatch between the assets and liabilities. There is, therefore, a need for the development of a broader range of Islamic financial market instruments to provide the industry with effective risk mitigating instruments.<sup>3</sup>

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<sup>1</sup> For more elaboration see Tariqullah Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in Islamic Financial Industry*, Occasional Paper no. 5, Islamic Research and Training Institute, Islamic Development Bank, 2001.

<sup>2</sup> Mohammad Nejatullah Siddiqi, "Islamic Banking and Finance," a lecture delivered at UCLA International Institute in a 2001 seminar for the business community.

<sup>3</sup> Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz, "Governor's Keynote Address" at The 2nd International Conference On Islamic Banking: Risk Management, Regulation and Supervision—"Building a Robust Islamic Financial System," jointly organized by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank and

It is important to distinguish between gambling, which is not permissible under Islamic law and must be avoided, along with other kinds of risk-taking. In the words of Irving Fisher, a gambler seeks and takes unnecessary risks. Such is the nature of games of chance. But life is full of risky situations that cannot be avoided. Business especially involves risk because the production of wealth involves the future, and it is impossible to have full and certain information regarding the future. People find mutually advantageous ways to face these uncertainties.

The economies of many Muslim countries rely to a great extent on raw materials and commodities. The production, investment, and pricing of these commodities are largely affected by the use of derivatives for risk management and trading in the international market. Questions normally arise regarding the Islamic position in the use of these instruments.

Derivatives markets deal in almost all the basic worldwide commodities, such as corn, wheat, cotton, crude oil, heating oil, gasoline, cocoa, palm oil, timber, rubber, aluminum copper, zinc, nickel, tin, coffee, sugar, etc. Hence, almost everybody feels the impact of these markets.

If we take oil, for instance, one of the world's most important commodities, without which it is impossible to conduct world commerce, its price is generally determined by the use of oil derivatives transactions.

Derivatives instruments largely evolved in a non-Islamic environment; thus, they are loaded with values which may not be totally in compliance with Islamic principles. Therefore, there is a need for a systematic analysis of these tools of price determination as well as risk management and hedging devices from an Islamic perspective.

More importantly, the availability of excess liquidity in many Islamic financial institutions, which require viable and permissible channels for investment, makes the study of these new tools of financial engineering in the international commodities markets a timely undertaking. Many questions arise regarding the evaluation of their compliance or disharmony with Islamic principles and the possibilities for new avenues of investment for Islamic financial institutions.

Furthermore, the widely held opinion that derivative instruments do not comply with *sharī'ah* regulations whether due to *ribā* (interest), gambling or other illegal activities, may not be entirely accurate in regard

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the Islamic Financial Services Board (IFSB). Le Meridien Hotel, Kuala Lumpur, 7 February 2006.

to at least certain forms of derivatives. Yet, the prevalence of this negative attitude has hindered the Islamic institutions from venturing into areas of investment that are open to conventional financial institutions. Therefore, it is important to address and analyze the available alternative avenues of investment so that Islamic financial institutions do not find themselves in a disadvantageous position.

A series of studies on the subject have been conducted by certain Islamic institutions such as *Majma' al-Fiqh al-Islami* (Islamic Fiqh Academy based in Jeddah), *al-Majma' al-Fiqh al-Islami* (Islamic Fiqh Academy based in Mecca), and by individual Muslim jurists. However, despite the welcome scholarly effort made so far, there are issues which still call for a systematic study and evaluation of the existing works and to address the shortcomings of some of these studies and the generalizations of others.

The present study will focus and elaborate on those issues which have not been well elaborated by previous works or which have been excluded from discussion despite their fundamental importance in understanding the issue of futures trading and derivatives.

The forward contract plays a pivotal role in the modern financial markets and serves as the basic building block for more advanced and sophisticated financial instruments. It is one of the most commonly used contracts in export–import trading, especially in essential commodities. It is also an important tool in risk management and business planning. However, in its actual form the majority of Muslim scholars declared it not permissible because it involves the prohibited sale of *bay' al-kali' bi al-kali'* (the sale of debt for debt) and the sale of nonexistent entities. The present study will explore these principles and look at their application to the conventional forward contract. It also draws an analogy between the conventional forward contract and similar contracts in Islamic law, such as *salam* (A sale contract to purchase an underlying asset at a predetermined future date but at a price paid on spot), *istisna'* (A contract whereby a manufacturer agrees to produce and deliver a well-described good at a given price on a given date in the future) and *bay' ala al-shifa* (sale by description).

Trading gold on a forward basis is a sensitive and controversial issue. The majority of scholars held that the *'illah* (effective cause, *ratio legis*) behind prohibiting the exchange of gold on a deferred basis is because gold and silver are currencies (*athman*) and, therefore, should not be exchanged unless the exchange is hand to hand. It is maintained that the prophetic injunctions not to trade gold and silver on a deferred basis

should be upheld whether gold and silver lose their characteristic of being *thaman* or not as they are money by creation. However, it is also argued by others that if gold and silver lose these characteristics, they would be a kind of commodity and could therefore be exchanged on a deferred basis. Thus, there is a need to analyze the different opinions advanced and look at their relevance to gold trading on a forward basis.

The forward currencies market is a very important mechanism in managing price risk. However, it is commonly agreed upon among Muslim scholars that trading currencies on a forward basis is illegal and it contravenes the rules of *ṣarf* (currency exchange) in Islamic law. Several alternatives have been suggested and there is a need to assess the *sharī'ah*' basis of these proposals.

Although the forward contracts have been able to overcome some of the problems associated with risk management, especially price risk and better planning of business, they are still inadequate to meet current business needs in some respects. Thus, the futures contract was introduced in the modern financial system in order to overcome these problems. A futures contract is basically a standardized forward contract with regard to the contract size, maturity, quality, place of delivery and the characteristic of being traded in an organized market. However, the futures contract might contravene the principle of not selling prior to taking possession and that of the sale of debt for debt. The present study will elaborate on the legal aspects of these two principles and try to find out how they could affect the legality of the futures contract. Moreover, the study will address the relation, if any, between the futures contract and speculation.

The futures contracts have been able to overcome some of the problems of the forward contract associated with risk, especially price risk and better planning of business, but they are still inadequate in some respects. The futures contracts are associated with certain problems, such as the possibility of exposure to subsequent price movement or their unsuitability for the management of contingent liabilities and contingent claims. Thus, a new tool of risk management is needed and the options contracts have been introduced due to their potential for managing such risks. The present study will examine the legality of options trading from an Islamic point of view by expounding on their concept, economic benefits, types, and scope.

*Khiyār al-shart* (the option to rescind a sales contract based on condition) and its variant *khiyār al-naqd* (the right of either of the parties to confirm the contract or to cancel it by means of the payment of the

price) seem to be the first alternative to conventional options from an Islamic point of view. This study will address the legal basis of these two contracts, the terms of *khiyār*, ownership of the commodity during the period of *khiyār*, liability for damage during this period and how *khiyār al-sharṭ* and *khiyār al-naqd* can be devised as tools to manage risk in *murābahah* (Sale at a specified profit margin, *ijārah* (lease) or stock trading).

*Bay' al-'arbūn* or *'arbūn* (a sale contract, in which a down payment is paid by the buyer) on the other hand, could be a very effective tool of risk management and an Islamic alternative to options. It should be noted that although the legality of *'arbūn* was disputed among the classical Muslim jurists, there is almost a consensus among contemporary scholars that it is a valid contract. On the other hand, asserting the legal status of *'arbūn* is of great importance in the use of *'arbūn* as an alternative to options. Therefore, the study will investigate whether *'arbūn* is a kind of liquidated damages or whether it is a kind of penalty or can be used as an exchange of the right to cancel the contract.

The present study will also investigate the sale of pure rights in the writing of classical scholars after expounding on the concept of right in Islamic law and how it could include pure rights, like that of options. It will also discuss the different cases involving the sale of pure rights accepted by Muslim jurists and draw an analogy between the sale of rights in these cases and the rights in conventional options. Finally, the study will address the relationship, if any, between options and gambling.

### *Objectives of the Research*

The present study analyzes the pertinent issues on derivatives which have given rise to differences among Muslim scholars. Included among these derivative instruments are the forward, futures and options contracts. This study will critically address their compliance or lack thereof with Islamic principles. The study will also analyze the other Islamic alternatives available so that Islamic financial institutions do not find themselves in a disadvantageous position. To summarize the main points:

- The present study attempts to investigate the possibility of admitting the forward contract into Islamic law. This will include the forward

contract in commodities, the possibility of forward contract in gold trading and the forward contract in currencies. Thus, the study will analyze the legal grounds of these contracts and the different opinions advanced by modern scholars whether in favor of or against the acceptance of these contracts.

- The study will also investigate the permissibility of futures contracts by analyzing the different objections raised against the permissibility of other related contracts, such as the sale of debt for debt, the sale prior to taking possession, and speculation.
- An Islamic evaluation of the different functions performed by the clearinghouse, the futures brokers, and the regulation of the futures market is necessary for deciding the legality of the futures and options contracts in Islamic law. Reference will be made regarding these issues to the Malaysian Futures Industry Act and Securities Industry Act in order to see whether these modern forms of trading comply with Islamic principles or not.
- This study also elaborates on the permissibility of options contracts and the possible Islamic alternative based on *khiyār al-sharṭ* and *bayʿ al-ʿarbūn*. The sale of pure rights such as in the case of options is generally held not to be a valid subject matter of a contract in Islamic law. The study explores the issue based on the writing of classical Muslim scholars. It will also draw an analogy between the right of holding an option and other admitted rights in Islamic law as subject matter in order to identify any similarity or dissimilarity that may exist between them.
- Finally, the study will explore the relationship, if any, between options and gambling.

### *Research Methodology*

The study is based on a selective study of Islamic law. It relies on the work of the major Sunni schools of Islamic Law, namely the Ḥanafī, Mālikī, Shafīe, Ḥanbalī, Zāhirī schools and the writing of modern scholars. Reference to the Imāmī School will only be made if it is derived from papers presented at the Islamic Fiqh Academy (Jeddah). The study does not support the opinion of a specific school of Islamic law and it is not under obligation to accept the opinion of the majority. But any opinion supported by evidence from the Qurʾān and Sunnah that could be the basis for solving certain problems related to futures trading may be used.

On the other hand, the study refers only to Malaysian Law in order to clarify or to compare the different aspects of futures trading discussed. In particular, references are made to the Malaysian Futures Industry Act and the Malaysian Securities Industry Act. However, this is by no means a comparative study; the Acts are used just for the sake of clarifying certain concepts or as a means of paving the way for certain analysis.

### *Organization of the Study*

This study examines the concept of Derivatives trading in conventional sources on the different issues discussed, followed by the views of Muslim scholars, the sources of law they relied upon, and a critical analysis of these views.

Thus, throughout the study of the three different parts of derivatives instrument trading, namely, forward, futures, and option are examined from an Islamic point of view. The present research begins with the definition and concept of keys terms as they are elaborated in the conventional sources. Yet, as it is said in Islamic law, “a right judgment or ruling about anything is part of its accurate conceptualization” (*al-ḥukm ‘ala al-shai’far’ an taṣawwurihi*).

The conventional concept of derivatives trading, and in particular its contractual aspect, is followed by the opinion of Muslim scholars on the issue and the legal basis they advanced for its permissibility or not.

The study is nonempirical, and thus, it is based on library research. It is a critical analysis of the contemporary writings on forward, futures, and options trading from the Islamic point of view. It relies on the classical sources of Islamic law to approve or disapprove of the ideas discussed. This requires, first, an investigation into the different concepts raised in order to invalidate derivatives instrument trading, such as *bay’ al-kālī’ bi al-kālī’* or, more generally, the sale of debt where both countervalues are deferred to a future date after assessing the authenticity of the relevant “*ḥadīth*” (saying, deed and approval of the Prophet) and “*ijmā’*” (consensus of Muslim scholars on specific issue) about it.

Regarding the permissibility of trading gold on a forward basis, numerous arguments have been advanced on this issue. The present study will critically analyze the divergence of opinions and the evidence advanced on the issue, although a final decision would seem to require a collective *ijtihād* (the intellectual effort of Muslim jurists to

reach independent religio-legal decisions) due to the complexity and sensitivity of the question. The objective from addressing this specific issue is to state the fact that there is no economic or financial system unless there is a clear and unambiguous concept of money.

The study will also investigate the claim that the futures contract violate the principle of sale prior to taking possession, *bay' al-dayn bi al-dayn*, or it involves excessive speculation. This is because it is almost impossible to build a viable Islamic futures market without answering these problems. The main issues addressed in the present study with regard to options are how *khiyār al-sharṭ* and *bay' al-'arbūn* could be defined in order to be suitable Islamic alternatives to options. More important, the study will investigate the claim that the subject matter of contract in option is a pure right that could not be exchanged for a monetary value in Islamic law.

No English translation will be provided for Arabic terms which are commonly used in English works about Islam such as *Qur'ān*, *sunnah*, *sharī'ah*, *ijmā'and ḥadīth* while new terms such as "collective *ijtihād*" (or legal ruling based on the opinion of a number of Muslim scholars after discussion and consultation), *ḥaq māli* (right related to property) *ḥadānah* (custody), *ḥuqūq al-irtifāq* (rights of easements), and *tahjīr* (barren land) will be followed as possible by a brief English translation to clarify their meaning. A detailed table on the meaning of Arabic is attached for better reference.

### *Scope and Limitations of the Study*

"The derivatives market is a market where traders buy and sell futures and/or options contracts to receive or deliver a specified quantity and grade of a commodity at a specified future time. The contracts are offered by authorized Boards of Trade commonly known as commodity exchanges." Therefore, the scope of the present research is limited to the forward, futures, and options contracts in commodity markets, although at times references to shares market will also be made. Thus the forward, futures, and options contracts on currencies, bonds, and interest rates are not covered by this research due to their clear prohibition. Commodity in the present study means physical or tangible commodities, usufruct and right and not the general concept of commodity, which includes currencies, bonds, etc.

Meanwhile, although literally “right” is not a commodity, it is generally accepted in Islamic law that a right could be a subject matter of contract and could be bought and sold as any commodity. Because of this fact, the study of options which involve right trading is considered as part of derivatives trading contracts in the commodity market from an Islamic perspective. Moreover, the underlying asset in option trading could be a commodity and, therefore, there is a genuine need to study its legality from an Islamic point of view.

However, due to the importance of the forward currencies market in modern finance and its clear prohibition in Islamic law due to the involvement of *ribā*, several proposals on how to manage risk associated with currency fluctuation are discussed. There are many types of options, such as exotic options, compound options, options on options, lookback options, and others. However, the present study is only concerned with the basic types of options, namely, call and put options, which constitute the fundamental and most widely used kinds of options. Thus, the legality and benefit of other kinds of options depend on them. A call option gives the holder the right to buy an asset by a certain date for a certain price. A put option, on the other hand, gives the holder the right to sell an asset by a certain date for a certain price.

### *Outline of Chapters*

The present analysis begins, in the first chapter, with a critical review of the major studies which have addressed the issue so far. The bulk of the study is then divided into three major parts: the forward market, the futures market, and the options market, in addition to the introduction and the conclusion.

The first part, subdivided into three chapters, addresses the forward market in commodities, the permissibility or otherwise of trading gold on a forward basis, and the forward market in currencies. Considering the fact that a forward contract, as it is applied in the conventional system, is a contract where both countervalues are deferred to a future date, the second chapter draws an analogy between this contract and the contracts of *salam* (A sale contract where two parties agree to carry out a sale/purchase of an underlying asset at a predetermined future date but at a price determined and fully paid on spot, *istiṣnāʿ* (A contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good at a given price on a given date in

the future and *bay' al-ṣifah* (Sale based on detailed description of the object of sale) in Islamic law. The second chapter also investigates the concept of *bay'al-kālī' bi al-kālī'*, that, of sale of the nonexistent and their relation with the forward contract.

Chapter 3 addresses the possibility of trading gold on a forward basis, and starts with a brief history of the world monetary system. That discussion is followed by a critical analysis of several *fatwās* on the issue of gold trading, and then expounds on the 'illah behind the prohibition of selling gold on a deferred basis and its implications on trading gold on forward basis.

The fourth chapter discusses the general rules regarding paper money and how a forward currency exchange will involve *ribā*. The chapter then proceeds to discuss the different possible alternatives to the forward sale in currency in order to ascertain their *sharī'ah* basis.

The second part of this study addresses the permissibility of the futures contract in Islamic law. Chapter 5 expounds on the different characteristics of a futures contract as distinct from the forward contract. This is followed by a brief history of the commodity market in general and the Malaysian commodity futures market in particular. The chapter touches also on the economic benefits of the futures market and some of the major objections raised to the futures contract such as speculation and financial crisis.

Chapter 6 elaborates on the assumption that a futures contract involves sale prior to taking possession or the sale of debt for debt. The opinion of Muslim scholars in this regard will be analyzed in order to ascertain their relevance to futures trading.

One of the important organizational features of futures exchange is the clearinghouse. It provides several crucial functions, such as the registration of contracts, the substitution of counterparties, the management of physical delivery, the settlement of contracts, and the monitoring of members' positions. This will be the focus of chapter 7. The chapter will also touch on the role of brokers, fidelity funds, and the trading offences in the futures market as it is stipulated in the Malaysian Futures Industry Act and it will assess their compliance with Islamic law.

The third part of this study comprises four chapters, all of which address the legality of options as a tool of risk management. Chapter 8 of the study will address the concept of options, their economic benefits, the difference between American and European options, major types of options: namely, call and put options, the exchange traded, and the over-the-counter options. It also touches briefly on the history of

options trading and the scope of options from an Islamic perspective. Moreover, the chapter discusses the claim asserting that options are a kind of gambling and provides a suitable response.

Chapter 9 focuses on *khiyār al-sharṭ* as a tool of risk management and as an alternative to options. The chapter also addresses the legal basis of this contract, the terms of the *khiyār*, the ownership of the commodity during the period of *khiyār*, liability for damage and loss during this period, and how *khiyār al-sharṭ* can be devised as tools to manage risk in *murābaḥah*, *ijārah* or stock trading.

‘*Arbūn* can be a useful tool of risk management. Chapter 10 of the present study investigates whether ‘*arbūn* is a kind of liquidated damages or whether it is a kind of penalty or an exchange of the right to cancel the contract for monetary value. The chapter will also address the use of ‘*arbūn* in currency exchange or *ṣarf*; ‘*arbūn* in commodities and services; ‘*arbūn* in shares trading; ‘*arbūn* in *murābaḥah* (a sale at a cost plus or with a specified profit margin) ‘*arbūn* in *salam* and ‘*arbūn* in *istiṣnāʾ*. Moreover, it will elaborate on the possibility of using ‘*arbūn* as an alternative to call and put options.

However, a successful Islamic options market would not be possible unless the legality of selling “pure rights” in Islamic law is addressed. This will be elaborated on in chapter 11. The chapter will analyze the concept of the sale of pure rights in the writing of classical scholars, after expounding the concept of rights in Islamic law and how it could include pure rights, like that of options. The chapter will also discuss the different cases involving the sale of pure rights that are acceptable to Muslim jurists and draws an analogy between the sale of rights in these cases and the right in conventional options.

### *Distinctive Features of the Research*

One of the distinctive features of the present research is that it is selective research whereby the study is limited to the Sunni schools of Islamic Law. Moreover, with regard to modern legislation, reference is limited to the Malaysian law.

The present study is a multidisciplinary study in the sense that although it is initially a study in *fiqh* (Islamic law), it also includes discussions of *uṣūl al-fiqh* (Islamic Jurisprudence) ‘*ulūm al-ḥadīth* (science of the ḥadīth), conventional law, as well as some economic concepts.

## LITERATURE REVIEW

Several institutional studies and a number of individual works have addressed the issue of derivatives and futures trading. The present study will divide its review of the previous studies into two sections, whereby opinions on the forward and futures contracts will be dealt with in the first section, while the second section will focus on options contracts.

*Forward and Futures Contracts**Institutional Studies*

The first institutional discussion about the legality of forward and futures contracts was undertaken by the Makkah-based *Fiqh* Academy.<sup>4</sup> This present study will summarize the main points of the Academy's resolution and point out its shortcomings. The Academy acknowledges the benefits of forward and futures trading as follow:

- Forward and futures contracts provide opportunity for industrial and commercial institutions to finance their projects through the issuance and sale of stocks and financial instruments.
- They also provide a permanent venue for traders in commercial instruments and commodities.

However, this clear *maṣlahah* (Public interest as determined in the light of the rules of Shariah) according to the Academy's resolution is accompanied by transactions which are forbidden in the *sharī'ah*, such as gambling, exploitation, and the unlawful devouring of the property of others. The major objections to forward and futures contracts could be summarized as follow:

- Forward and futures contracts are by and large paper transactions and not genuine purchases and sales as they do not involve the delivery or taking of possession of their underlying commodities.<sup>5</sup>

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<sup>4</sup> For the complete text of the resolution, see Al-Majmā' al-Fiqhī al-Islāmī li-Rābiṭat al-'Ālam al-Islāmī, *Qarārāt Majlis al-Majmā' al-Fiqhī al-Islāmī*, seventh session, from 11–16 Rabi' al-'Ākhīr, 1404, "Sūq al-'Awrāq al-Māliyyah wa al-Badā'i' (al-Būrṣah)," pp. 120–124.

<sup>5</sup> Ibid.

- They entail oppressive practices on the part of those who engage in them through a kind of monopoly by making large sales and purchases of contracts in commodities, only to force smaller traders to take a loss and suffer hardship as a result.
- Forward and futures trading tends to bring about price distortion. Price is not entirely the function of market forces of supply and demand or genuine purchases and sales by parties who need to conclude a certain transaction. A variety of other factors are known to cause unnatural price fluctuation. These include not only cornering and profiteering by the market participants, but also false rumors and the like, which are detrimental to economic life and unacceptable from the viewpoint of the *sharī'ah*.
- Some economists have even called for the abolition of forward and futures contracts due to a number of historical events and crises that played havoc in the world economy and inflicted devastating losses on market participants at short notice due to the practice of these instruments.

Having highlighted the advantages and disadvantages of futures contracts, the Academy added that in view of these considerations and in the light of the relevant information on the nature of futures market transactions in financial instruments and commodities from the Islamic perspective, we observe that the benefits of futures markets are mixed with disadvantages which contravene the principles of the *sharī'ah*.

The Academy maintains that spot transactions, in which delivery takes place and the seller sells a commodity that he owns and which exists at the time of contract, are clearly valid from the *sharī'ah* point of view, provided that the transaction does not involve transactions or trading in unlawful substances such as alcohol.<sup>6</sup>

The Academy continues its argument that deferred contracts, which are concluded on the basis of a description of the asset and commodity which the seller does not own, are unlawful. This is because a person sells what he does not own but concludes the sale in the hope of subsequently purchasing the subject matter of the contract in order to make delivery later. This is forbidden in *sharī'ah* on the authority of the *ḥadīth* in which the prophet PBUH said, "Sell not what is not with you."<sup>7</sup> Also, it is reported on the authority of Zayd Ibn Thābit that the prophet

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<sup>6</sup> Ibid.

<sup>7</sup> Abū Dā'ūd, *Sunan*, vol. 3, p. *ḥadīth* no. 2187.

PBUH prohibited the sale of a commodity which is bought unless the traders take it into their possession and carry it.”<sup>8</sup> Thus, according to the Academy the forward and futures contracts that are concluded in the commodities market do not qualify as *salam* sales, which the *sharī'ah* has validated. There are two reasons to support this:

- Forward and futures do not involve the payment of the price by the buyer at the time of the contract, which is a requirement in *salam*.
- Futures involve the sales of assets that have become personal obligations on the part of the parties involved. The first buyer in the chain does not receive the underlying commodity and such is the case with every other sale that follows suit. They all tend to be involved in giving or taking price differentials, like gamblers who undertake risks in a zero sum game in order to procure profit. In *salam*, on the other hand, the buyer is not permitted to sell prior to taking possession of the underlying commodity.<sup>9</sup>

It should be noted that despite the fact that the Academy acknowledges that futures trading involves different kinds of contracts, which need to be addressed separately, this is not reflected in its resolution. It is nevertheless clear that the contracts in stock indices are different from those in currencies or bonds and all these are quite different from those in commodities and shares. Moreover, the possibility of selling a purchased item before taking possession, or the sale of the *salam* before taking delivery are not explored despite the fact that many Muslim jurists have opted for their legality. Furthermore, the reason behind the possibility of deferring the price of *salam* in the Mālikī school has not been taken into consideration. Thus, the Academy resolution did not examine the different views that are available in the classical *fiqh* and has not attempted to come up with new alternatives that will guarantee the benefits it has recognized. However, it should be noted that our criticisms are based only on the resolution of the Academy. Unfortunately, we did not examine the different papers delivered in this session so as to obtain an accurate and precise evaluation.

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<sup>8</sup> Al-Ḥākīm, *al-Mustadrak*, Dār al-Ma'rifah, Beirut, vol. 3, pp. 39–40; Abū Dā'ūd, *Sunan*, Dār Iḥyā' al-Sunnah, Cairo, vol. 3, p. 283.

<sup>9</sup> See Al-Majmā' al-Fiqhī al-Islāmī li-Rābiṭat al-'Ālam al-Islāmī, *Qarārāt Majlis al-Majma' al-Fiqhī al-Islāmī*, “Sūq al-'Aw'r āq al-Māliyyah wa al-Badā'i' (al-Būrṣah),” pp. 120–124.

The position of the Islamic *Fiqh* Academy based in Jeddah regarding the stock market practices in general and derivative instruments trading in particular had evolved through different seminars and workshops where several papers were presented. However, in the seventh meeting of the Academy in Jeddah, a special session was devoted to the issue of derivative instruments trading. This session presented the main position of the Academy regarding futures trading, since the final resolution was issued thereafter. However, even the previous meetings had some merit in our evaluation of the Academy's stand. One may discover some personal views of the participants in these different meetings.

The first time the issue of futures trading was raised was in the sixth session in Rabat, Morocco, in 1989. However, no final resolution was reached although the general benefit of such a trade was recognized in the final communiqué and a call for further research on the issue was made. However, the single paper which discussed certain issues concerning options and futures was Mohamed Ali Elgārī's paper.

Concerning commodity forward and futures contracts, El-Gārī maintained that:

- Although there are some similarities between the forward and futures contracts on one hand and *bay' al-salam* on the other, in *salam* the price must be paid at the time of the conclusion of the contract, which is not the case in forward or futures contracts.
- The transaction, he added, will be a kind of *bay' al-kālī' bi al-kālī'*, which is prohibited.
- El-Gārī pointed out that if we consider *salam* as a contract in accordance with *qiyās* (analogy), then there is room for the admissibility of these contracts. Unfortunately, he did not elaborate on this possibility.
- He also argued that in futures contracts, the commodity in the first contract could be sold prior to taking possession, which is not the case in *salam*. However, he added that there is room for approving such transaction since some scholars did not see any legal problem in selling the *salam* prior to taking possession. El-Gārī once again did not expound this possibility. He raised the point that the '*illah*' or cause of prohibition of many contracts here is risk-taking or *gharar*. It is a complex issue, he added, which needs a careful investigation in relation to the modern types of contracts. Unfortunately, he did not proceed further, although many of the objections he raised pertaining to *gharar* may not necessarily exist in the modern types of futures contracts.

- El-Gārī also compared futures contracts with *istiṣnāʿ* and concluded that both types of contracts involve *bayʿ al-kālī bi al-kālī*.<sup>10</sup> But he considered the view that a *istiṣnāʿ* or *muqāwalah* contract should be approved by Islamic law on the basis of necessity or *ḍarūrah* (necessity). However, one may ask if *istiṣnāʿ* is admitted on the basis of *ḍarūrah*, why not admit futures and forward contracts on the same ground?

It is worth noting that El-Gārī's position on this issue has not changed much in the nine years since this session was held. Thus, in a seminar entitled *Islamic Financial Services and Products* held at the Institute of Islamic Understanding, Malaysia, August 1998, he reiterated almost the same thing about futures in his paper entitled "Futures Trading—Islamic Perspective." However, he concluded: "Building a model of futures trading on the basis of a *salam* contract should not be excluded altogether." Unfortunately, he did not go beyond that to explore this possibility.

Returning to our discussion of the Academy position, it should be noted that El-Gārī's paper was followed by a discussion session, which deliberated primarily on the essence of these new types of contracts. The session ended without resolution regarding futures or options.

The sixth session of the Islamic Fiqh Academy which discussed futures trading was followed by another session in Bahrain in 1991, jointly organized by the *Fiqh* Academy and the Islamic Research and Training Institute (IRTI) affiliated with the Islamic Development Bank.<sup>11</sup> However, the session in its final communiqué endorsed the resolution issued by the *Fiqh* Academy based in Makkah and reproduced its resolution word for word with regard to forward and futures commodity contracts and called for further research on the issue of options. Unfortunately, we have not been able to go through the different papers presented so as to give an accurate evaluation of the session or perhaps to come across some personal views. However, from the resolution it is clear that the participants have reiterated the same arguments and analysis

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<sup>10</sup> It seems the author based his argument on the majority's view that *istiṣnāʿ* should fulfill the conditions of *salam* including the payment of the price at the time of the contract. However this view has been overruled even by the Islamic *Fiqh* Academy in its resolution no. 66/3/67, one year after he presented his paper.

<sup>11</sup> The session was held under the auspices of the Islamic bank of Bahrain from 25–27 November 1991.

presented in the Makkah-based Academy, and eventually came to the same conclusion.

Thus, it could be said that the Jeddah session in 1992 represents the real position of the Academy regarding derivative instruments. Different rulings related to stock market trading in general and derivative instruments trading in particular have been passed in resolution no. 64/1/7.

Regarding the forward contract in commodities markets in particular, the ruling was that it is an illegal type of contract since both counter-values are deferred. Nevertheless, it could be modified so as to fulfill the established conditions of *salam*. Moreover, it is not permissible to sell the commodity in the first *salam* before taking delivery.

As for commodity futures, where the contracting parties could offset their position through a similar contract, the resolution considers it an illegal contract as a matter of principle.

Concerning the foreign currency exchange, similar rulings have been issued. Namely, spot foreign exchange is permissible if it fulfills the conditions of the classical *ṣarf* contract, while the forward and futures foreign exchange are declared to be illegal. Concerning the trade on stock indices, the resolution described it as pure gambling.

On the other hand, the Academy recognized the role of brokers (*samāsirah*) in the stock market and considered the role as part of a lawful public interest. However, it passed a negative judgment on the issue of the selling of interest-based loans from the brokers and the selling of shares not yet possessed by the seller.

In its recommendations the Academy called for the establishment of an Islamic stock market based on *salam*, *bay' al-ṣarf*, the promise to sell in the future, *istiṣnā'* and other types of Islamic alternatives. Last, the Academy called for detailed studies on the different Islamic alternatives and their modes of implementation. Perhaps because of this requirement, the issue was raised once again in 1993. However, the resolution passed therein confirmed what had been decided in the previous resolution regarding the issue of futures trading.

Given the fact that resolution no. 64/1/7 is the resolution which concerns us most in our study of futures trading, it is necessary to give a brief review of the different papers presented and the follow-up discussions to understand the rationale behind the Academy's resolution.

Six papers were presented on derivatives trading. Five of them were on options (*ikhtiyārāt*) and were presented by Mohammad Mukhtār al-Salāmī, Wahbah al-Zuhailī, Ṣiddīq al-Ḍarīr, 'Abd al-Wahhāb abū

Sulaimān, and ‘Abd al-Satattār abū Ghuddah. The last paper was on commodity futures, and it was presented by Muhammad Taqī al-Usmānī, That paper will be reviewed in this section while the papers on options will be studied in the following section.

In his single paper about commodity futures, Taqī al-Usmānī concluded that the futures contract is a *ḥarām* (not permissible) transaction for the following reasons:

- It does not fulfill the conditions of *salam*, which requires payment of the price at the time of the contract.
- Futures contracts are a kind of *bay‘ al-kāli’ bi al-kāli’* and, therefore, they are not permissible in Islamic law. However, Sheikh Taqī did not discuss the weakness of the hadith.
- Generally, no delivery is possible in these contracts and the commodity is sold again and again prior to taking possession, which is not permitted in *salam*<sup>12</sup> despite the difference of opinion on the issue.

The discussions of commodity futures fared somewhat better in elucidating the different issues related to commodity futures and opposing and clarifying some of Sheikh Taqī al-Usmānī’s generalizations. Nevertheless, to allocate just one brief paper to such an important issue, which has a major effect on the Muslim economy, falls short of expectations, especially from a highly respected institution. Furthermore, despite the fact that some of the participants defended the public interest or *maṣlahah* behind commodity futures, this stand was not reflected in the Academy’s resolution. I do not propose to discuss everything in this review, but just show how the Academy’s resolution had been made on very simplistic grounds. Many issues, which were to be discussed, were left out. Moreover, if all necessary conditions were taken into account, and another session were held on this subject, before reaching any resolution (as one of the participants—‘Abd al-Salām al-‘Abādī—suggested during the discussion on options), one could have expected some different resolutions.

What is needed from the Academy, as a respected academic forum, is to address the controversial issues on the subject. For instance, they need to examine the authenticity of the different rulings formulated by

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<sup>12</sup> Taqī al-Usmānī, “Uqūd al-Mustaqbaliyyāt fi al-Silaa’,” *Majallat Majma’ al-Fiqh al-Isālmī*, 1992, no. 7, vol. 7, p. 275.

some classical scholars based on the weak *ḥadīth* about *bay' al-kālī bi al-kālī* and the alleged *ijmā'* (consensus<sup>13</sup> on the subject, although some scholars have already disputed its authenticity. The Academy would have done a great service if it had ascertained the '*illah* (effective cause, *ratio legis*) behind the prohibition of sale prior to taking of possession; the '*illah* (effective cause, *ratio legis*) behind the *ḥadīth* "do not sell what is not with you" whether the application of these principles would differ in an organized market like that of futures and compared to ordinary market; the sale of "right" and the reasons why some schools allowed it while others prohibited it? And why did the latter-days Ḥanafī scholars change the *fatwā* of the *madhhab* about the sale of "right" when they were confronted by the change of custom? If these issues and other important subjects related to the legality of futures and options had been systematically discussed, one might have expected a different resolution from the Academy. Unfortunately, nothing of that nature actually happened.

Another institution which addressed the issue of futures trading is the Permanent Research Committee of the Board of Great Scholars in Saudi Arabia in its study entitled "Min Ṣouwar al-Burṣah" (*Forms of Stock Markets*), divided into three lengthy articles in *Majallat al-Buḥūth al-Islāmiyyah*.<sup>14</sup> The study quoted many verses and *aḥādīth* (saying of the Prophet) related to *ribā* with their commentary from the traditional works, including *Tafsīr al-Qur'ān al-'Azīm* of Ibn Kathīr; *Aḥkām al-Qur'ān* of Ibn al-'Arabī; *Fath al-Bārī* of Ibn Ḥajar; and *Nayl al-Awtār* of al-Shawkānī. In addition, parts of some familiar *fiqhī* books, such as *Bidāyat al-Mujtahid* of Ibn Rushd and *al-Mughnī* of Ibn Qudāmah, were reproduced. The committee also reproduced the descriptive research on futures trading submitted by the director of the Saudi Monetary Agency with brief commentaries in the footnotes. In the last part of the study, the committee reproduced the works of some contemporary Muslim jurists, which seem to legalize parts of the transactions in futures contracts. Thus, they quoted a *fatwā* from Rashīd Ridā in his reply to some traders in the futures cotton market, and part of Moḥammad Yūsuf Muṣā's book *Fiqh al-Kitāb wa al-Sunnah fī al-Mu'āmalāt*

<sup>13</sup> Regarding the weakness of the *ḥadīth* and the debate on the *ijmā'*, see chapter 6 of the present study on the sale prior to taking possession and the sale of debt for debt.

<sup>14</sup> General Secretariat of the Great 'Ulamā's Board, *Majallat al-Buḥūth al-Islāmiyyah*, Riyadh, Saudi Arabia, 1996, no. 46, pp. 26–140; no. 47, pp. 23–120; no. 48, pp. 27–90.

*al-Maṣrifīyyah*, followed by some commentaries in the footnotes to refute their argument.

What we want to stress here is that despite its respectable standing as an influential institution, the Board's study lacks reasonable analysis. It has tried to apply just the interpretations of Muslim jurists in the past centuries to contemporary problems. Yet, while the *sharī'ah* is sacred and unchangeable, the *fiqhī* interpretations can change according to time and place and according to *maṣlahah*. Moreover, passing a prohibitive judgment is in no way going to solve the problem. In contrast, it may raise doubts among some people about the ability of *sharī'ah* to respond to contemporary problems. Yet, such a prohibitive judgment without proposing a viable alternative did not and will not change anything in business practice; the oil and other basic commodities from the Muslim countries will continue to be traded according to supposedly forbidden contracts without any Islamic input. Finally, if such simplistic attitudes on the part of those who are learned people in Islamic law have not changed, the possibility of freeing Muslims from *ḥarām* transactions looks very remote. Yet, the existence of some Islamic financial institutions here and there with deposits estimated at less than 5 percent<sup>15</sup> of the market share of the Muslim economies is not a real solution.

### *Individual Studies*

As we have mentioned before, besides the institutional discussions, several individual works also addressed the issue of futures trading and derivatives. However, two different approaches characterized these studies. The first approach lays emphasis on the need to purify the conventional types of futures trading contract in order to bring it in line with Islamic principles. At the same time, it aims at rebutting some of the criticisms raised by certain Muslim scholars against futures contracts. The second approach, on the other hand, rejects the western types of

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<sup>15</sup> The Central Bank of Malaysia in its Annual Report (2000) stated that for the year 2000 the Islamic Banking sector registered a strong performance in tandem with the continued improvement of the Malaysian economy. The market share of the Islamic banking system increased to 6.9 percent during the year from 5.5 percent in 1999. (See Nik Norzrul Thani, *Legal Aspects of the Malaysian Financial System*, Sweet & Maxwell Asia, 2001, p. 165.). In the Gulf Cooperation Countries the market share is 5–10 percent (see, Hossein Askari & Zamir Iqbal, "Opportunities in Emerging Islamic Financial Market," *BNL Quarterly Review*, 1995, p. 260.)

derivative contracts and tries to formulate a purely Islamic alternative based on the existing types of Islamic contracts.

The first study which addressed the issue of derivatives contracts from an Islamic point of view was Muhammad Akram Khān's study entitled "Commodity Exchange and Stock Exchange in Islamic Economy," published in 1988 in the *American Journal of Islamic Social Sciences*.<sup>16</sup> The author discussed first the general principles of the market's functioning in Islam before addressing the validity of the forward contract. He maintained that Islamic law provided for situations involving forward transactions, different contracts such as *bay' al-salam bay' al-istiṣnā*, *al-bay' al-mu'ajjal* (deferred sale) and *bay' al-istijrār* [A contract between a client and a supplier, whereby the supplier agrees to supply a particular product on an ongoing basis, for example monthly, at an agreed price and on the basis of an agreed mode of payment] and concluded that "There is hardly anything objectionable in the basic operation of the forward market." However, he admitted that "Individual transactions may have certain elements which need to be modified in the light of Islamic law." Unfortunately, he did not specify these elements or how the modification would be implemented.

Addressing the legality of futures contracts, Muhammad Akam Khān maintained that:

- A futures contract involves the sale of a nonexistent commodity and does not involve physical delivery; therefore, it is unlawful.
- Moreover, according to Akram Khān, speculators are the winners, small investors hardly ever win, brokers carry out dual trading by conducting business to their account first, which regulation fails to eradicate, and manipulation persists despite all the safeguards undertaken so far.

However, Sayyid Abdul Jabbār Shahhabudīn, the chief executive of the Kuala Lumpur Commodity Exchange, dismissed these shortcomings, contending that there are adequate safeguards to protect users of the market, such as the time-stamping of orders, the prohibitions of trading ahead or against clients' orders, the segregation of clients' accounts,

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<sup>16</sup> Muhammad Akram Khān, "Commodity Exchange and Stock Exchange in Islamic Economy," *American Journal of Islamic Social Sciences*, vol. 5, Issue no. 1, 1988, pp. 92–114.

reportable position and position limit, etc. Moreover, there is a free flow of information into and out of the market on a real time basis around the world.<sup>17</sup>

Addressing the issue of currency exchange, Akram Khān concluded that the conventional spot currency exchange, which allows a two-day lag, cannot be accepted in an Islamic framework and the alternative could be that the exchange is effected simultaneously by involving correspondent banks or agents at the same time. Regarding the forward currency exchange, he concluded that it is illegal in Islam. Moreover, he added that “At best the two banks ‘agree’ or ‘promise’ to transact an exchange business at a future date. Such an agreement is only morally enforceable and no court in an Islamic state would enforce it.”

However, the categorical rejection of the possibility of enforcing such a promise<sup>18</sup> may not be justified. This is true because of the decision of the Islamic Fiqh Academy endorsing such an “agreement” as enforceable in the sale of *murābaḥah*, and the extension of this rule by some scholars to currency exchange. Moreover, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) in its standard on currency has clearly endorsed the permissibility of such transaction.

The author ruled out any possibility of swap and futures currency exchange in the Islamic economy while admitting that the need for Islamic financial institutions to deal in forward and futures transactions arises, partly, from the desire to invest their surplus funds over short periods of time. Regarding options trading, he compared it with *bay’ al-salam* and *bay’ al-khiyār* (sale with option) and concluded that it did not fulfill the conditions of either of the two contracts and, therefore, options trading is unlawful.

The most extensive and in-depth analysis of futures trading so far is Mohammad Hāshim Kamālī’s work entitled *Islamic Commercial Law: An Analysis of Futures and Options*. The study addressed the major points on futures and options from the Islamic point of view. It also represents the

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<sup>17</sup> Sayyid Abdul Jabbar Shāhābudin, “Comments on Muhammad Akram Khān’s Commodity Exchange and Stock Exchange in an Islamic Economy,” *Journal of Islamic Economics*, International Islamic University Malaysia, vol. 1, issue 2, July 1988, pp. 71–76.

<sup>18</sup> For a detailed discussion regarding the issue, see chapter 4 of the present study.

major work in the first approach to adopting futures contracts in Islamic law. This approach, as we have mentioned before, is mainly concerned with the elimination of the un-Islamic elements in futures trading and with refuting some of the criticisms against futures trading.

The author reviewed the major literature available on the subject and the opinion of different scholars either in favor of or against futures and option trading. But the important study missing is that of the Jeddah-based Islamic *Fiqh* Academy. Thus, Kamālī rebutted for instance ‘Umar Charpa’s criticism of short selling; he rebutted Akram Khān’s interpretation of the *ḥadīth* injunction, “Sell not what is not with you;” and he rejected Aḥmad Yusuf Sulaimān’s interpretation of some *fiqh* rulings, such as the sale of the nonexistent, and the resolution of the Islamic *fiqh* Academy based in Makkah. Then, he gave a brief history of futures trading.

It should be noted that despite the fact that the author traced back the origin of futures trading to the forward contract and touched upon the differences between the two types of contracts, he did not address separately the legality of the conventional forward contract from an Islamic perspective. Yet, it could be said that establishing the legality of futures contracts implies that the legality of forward contract is also established. However, it is likely that a separate discussion will have its own merit. Some Muslim investors may be convinced of the legality of the forward contract and remain reluctant about futures. This is partly due to the rejection of futures contracts by some influential Islamic institutions and, on the other hand, due to its recent introduction in the financial market.

Moreover, *salam* and *istiṣnā’* contracts, which have some similarities with the modern forward contract, also have some differences and, therefore, could not be considered as the absolute alternative to the conventional forward contract, although they fulfill some of its objectives. Furthermore, the majority of Muslim jurists are still reluctant to accept the modern forward contract and insist that it should fulfill the conditions of *salam*. In addition, if the futures market is still at its early stages in the Muslim world, it may take time to be widely implemented; the forward contract is already in use in every Muslim country despite the negative judgment about its validity given by the majority of contemporary Muslim jurists. Nevertheless, it is a necessary economic tool that would be applied regardless of the juristic position. Perhaps for this reason, some have even considered it as a pressing need (*mimmā*

*ta'ummu bihī al-balwā* or a general need).<sup>19</sup> What we are trying to say is that a few pages about forward contracts would have added to the merit of Kamālī's study.

Kamālī then discussed the benefits of the futures contract and its validity on the basis of *maṣlaḥah* or public interest. Further, he outlined the differences between futures contracts and the classical types of contracts. He described in detail the market procedures and technicalities of trading in futures and options and the main players, such as the clearinghouse, the hedgers, and speculators. However, considering the magnitude of the study, the Islamic analysis of the issue of speculation and hedging in particular is insufficient to address all relevant issues. What concerns us more here is the *fiqhī* discourse on futures trading.

Kamālī then proceeded to discuss some of the immediate issues about futures trading, such as uncertainty and risk (*gharar*); he examined the jurists' analysis about the existence of the subject matter in a sale contract; he further mentioned the sale of unseen (*bay' al-ghā'ib*) commodities and the different interpretations of the *ḥadīth*, "Sell not what is not with you." The analysis of these issues has been thoroughly dealt with, and the present study will only add more evidence from the classical sources of Islamic law to strengthen the argument already advanced. However, other issues discussed by Kamālī in this connection, which seem to be in need of elaboration, are the issues of sale prior to taking possession, debt trading, or *bay' al-dāyn bi al-dāyn*, and speculation.

Having analyzed the different principles related to futures contracts and having refuted some contending opinions, especially those of Yusuf Sulaimān,<sup>20</sup> and the resolution of the Makkah-based *Fiqh* Academy and 'Abd al-Bāsīt Mutwalī's fatwā,<sup>21</sup> Kamālī gave his approval to the main legal features of futures contracts. His discussion of the *ḥadīth*, "Do not sell what is not with you," led to the conclusion that it applies only to sales involving specific objects and not to fungible goods. Moreover,

<sup>19</sup> See the Islamic *Fiqh* Academy guideline for research papers to be submitted as part of the forthcoming Encyclopedia of *fiqh* related to economic issues *Majallat Majma' al-Fiqh al-Islāmī*, no. 9, vol. 4, p. 766.

<sup>20</sup> Yusouf Sulaimān, "Rai' al-Tashrī' al-Islāmī fi Masā'il Burṣah", *al-Mawsū'a'h al-'Ilmiyyah wa al-'Amaliyyah li al-Bunūk al-Islāmiyyah*, Cairo, International Association of Islamic Bank, vol. 5, pp. 428–443.

<sup>21</sup> Bayt al-Tamwīl al-Kuwaiti, *Al-Fatāwā al-Shar'iyyah fi al-Masā'il al-Iqtisādiyyah*, Kuwait, 1988, p. 528.

the *ḥadīth* is mainly concerned with the prevention of *gharar* and “since delivery is always guaranteed by the clearinghouse procedures, the seller’s ability to deliver is not a matter of concern in futures trading.” Regarding *bay‘ al-kāli‘ bi al-kāli‘*, he concluded that there is no definitive statement in the sunnah of its prohibition, the Qur’ān’s *‘āyat al-Mudāyanah* validated deferred sales, and the manifest texts seem to accommodate an affirmative ruling on futures trading.

He sustained his conclusion by discussing the opinion of some contemporary Muslim jurists, who expressed a positive judgment on some aspects of futures trading, such as Ali ‘Abd al-Qādir<sup>22</sup> in his comment on Sulaymān’s article; ‘Abd al-Karīm al-Khatīb in his book *al-Siyāsah al-Māliyyah*;<sup>23</sup> al-Jundī in his book, *Mu‘āmalāt al-Burṣah*,<sup>24</sup> Aḥmad Muḥyi al-Dīn who defended vigorously the forward contract in one of his books but raised some reservations about it in his later book,<sup>25</sup> and Majd al-Dīn ‘Azzām in his reply to ‘Abd al-Bāsīt’s fatwā.<sup>26</sup>

We would like to make a brief comment here regarding Majd al-Dīn ‘Azzām’s methodology that is not addressed by Kamālī’s work. Although Majd al-Dīn’s conclusion is correct, part of his methodology might not be acceptable. He maintained that the norm concerning *mu‘āmalāt* or Islamic commercial transactions is permissibility, which means that contracts are generally permissible unless they are clearly prohibited by the texts (*nuṣūṣ*). This prohibition could be either definitive (*qaṭi‘*), which leaves no room for doubt, or speculative (*zannī*), such as the prohibition conveyed in a solitary *ḥadīth* (*ahād*). ‘Azzām added that we fully accept and rely on the first part of this principle, but concerning its second part, he asserted that the prohibitive evidence pertaining to civil and commercial transactions must not be anything less than decisive. This is because the fundamental permissibility of such transactions is based

<sup>22</sup> *Al-Mawsū‘ah ‘al-‘Ilmiyyah wa al-‘Amaliyyah li al-Bunūk al-Islāmiyyah*, Cairo, International Association of Islamic Banks, vol. 5, pp. 444–451.

<sup>23</sup> ‘Abd al-Karīm al-Khatīb, *al-Siyāsah al-Māliyyah fi al-Islām wa Ṣilatuhā bi al-Mu‘āmalāt al-Mu‘āsirah*, Dār al-Fikr al-‘Arabī, Cairo, 1976.

<sup>24</sup> Al-Jundī, Mohammad Shahhāt, *Mu‘āmalāt al-Burṣah fi al-Sharī‘ah al-Islāmiyyah*, Dār al-Nahdah al-‘Arabiyyah, Cairo, 1988.

<sup>25</sup> Aḥmad Ḥassan Muḥyi al-Dīn, *‘Amal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-‘Ālamīyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa ‘Athārūhā al-‘Inmā‘iyyah fi al-Iqtisād al-Islāmī*, Dallah al-Barakah, Jeddah, 1996.

<sup>26</sup> Bayt al-Tamwil al-Kuwaitī, *Al-Fatāwā al-Shar‘iyyah fi al-Masā’il al-Iqtisādiyyah*, p. 590.

on decisive evidence, that is, the principle of *ibāḥah*, and this should prevail unless there is decisive evidence to warrant the opposite.<sup>27</sup>

It is worth noting, however, that rejecting any prohibition based on a solitary *ḥadīth* (*āḥād*) is a dangerous precedent which may lead to the rejection of the sunnah. Yet, there are some differences of opinion about the acceptance of a solitary *ḥadīth* in the area of *‘aqīdah* (belief and creed) but not in *mu‘āmalāt* (commercial transaction). Thus, it seems that by adopting such a methodology Majd al-Dīn undermined some of the credibility of his argument, although it is basically correct.

Another scholar who addressed the legality of futures trading in Islamic law is Fahīm Khān in his book *Islamic Futures and their Markets*.<sup>28</sup> However, unlike Kamālī, he limited himself just to futures contracts. The study represents another approach in tackling the issue of futures markets from an Islamic perspective. Departing from the previous approach adopted by some scholars, where the main focus was to identify the non-Islamic elements in the futures market for modern commodities, and to look for the Islamic alternative, Fahīm Khān preferred to choose *bay’ al-salam* [a sale or purchase of a deferred commodity for the present price] as the basis for any Islamic futures market. Yet, he discussed briefly *istiṣnā‘* and *ju‘ālah* [(A party pays another a specified amount of money as a fee for rendering a specific service in accordance to the terms of the contract stipulated between the two parties.)] as possible classical contracts with features of futures trading as well. He stressed that “we are not looking forward to ‘Islamizing’ an intrinsically non-Islamic activity, but instead we are trying to revert to our own traditions to develop similar institutions that would not only bring the parallel economic benefits to the society that they are meant to provide but that will also be in line with Islamic legal framework.”<sup>29</sup>

However, it seems that such a methodology has little merit by itself since “wisdom is the lost property of a Muslim who is its rightful owner wherever he gets it.” The author submitted to the fact that even in his approach to an Islamic futures market, the major structures of the conventional futures market were still needed. Thus, there is a need for establishing an exchange as a central place where buyers and sellers meet

<sup>27</sup> See Bayt al-Tamwīl al-Kuwaitī, *al-Fatāwā al-Shar‘iyyah fi al-Masā’il al-Iqtisādiyyah*, al-Kuwait, 1985, pp. 527–545.

<sup>28</sup> Fahīm Khān, *Islamic Futures and their Markets with Special Reference to Their Role in Rural Financial Market*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, 1995.

<sup>29</sup> *Ibid.*

to undertake transactions. There is also a need for a statutory agency to regulate and monitor the futures market and a clearinghouse in order to facilitate and regulate the enforcement and settlement of contracts or the principle of standardization of the futures market. Yet, Fahīm raised some points of difference between the conventional procedure of the clearinghouse and that of an Islamic one stressing that “the clearinghouse of an Islamic Futures exchange will not serve as another party in any futures contracts. It will serve only as a guarantor that all contracts are honored.” However, he acknowledged that there might be some problems in such a mechanism. He concluded, the “clearinghouse in this model will no more be involved in such silly and irrational activities as selling to or buying from itself.”

Nevertheless, there seems to be nothing in Islamic law which prohibits a person from being an agent for the buyer and the seller at the same time if he is acting in good faith. Moreover, the agent would be responsible for any liability if the contractual agreement stipulates so.

Addressing the scope of futures trading in an Islamic framework, Fahīm Khān concluded rightly, concerning stock indices, that it is nothing but pure gambling in word and spirit that is played in the market place. Concerning a foreign currency exchange, he acknowledged the need for an Islamic concept of foreign currency futures although he did not elaborate on the subject.

The author also addressed the problem of speculation. Although he was critical throughout his discussion, he rightly concluded that dealing in the market does require speculation on price. But we have to distinguish between two types of speculation, particularly regarding the futures market. One form of speculation is not related to any real activity and is meant to be merely a financial or monetary transaction or nonproductive exchange. This should be disallowed as it falls under the category of gambling. The other aspect of speculation is the one that is part of some real activity and helps in shifting risks from the vulnerable producers, who cannot afford bearing all the risk, to those who can afford to bear it. Such speculation is desirable and permissible. Similarly, activity that provides liquidity to farmers to improve production decisions, or enables them to increase the volume of their production, is also desirable and permissible, even if it involves speculation on futures prices.<sup>30</sup>

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<sup>30</sup> Ibid., p. 46.

Since the solution to the problem of liquidity is one of the major objectives of a futures market, Fahīm Khān tried to reconcile his suggested *salam*-based futures market and the problem of liquidity. He argued that such a market provides liquidity to the producers rather than to traders and curbs speculation. However, in a *salam*-based futures market, as suggested by Khān, advance payment is necessary and as a consequence even genuine traders may face liquidity problems which may be a serious hindrance for the development of such a market. Another problem which may arise as a result of advance payment is the problem of matching the sellers and buyers of futures contracts. Khān acknowledged this by saying “this too may not be very conducive in creating competitive conditions in the Islamic futures market.” To solve the problem, Khān suggested that these “shortcomings arising out of liquidity constraints upon traders can be overcome by the introduction of Islamic banks or of specialized Islamic financial institutions to finance the futures trading.” However, it seems that such a mechanism would not be without practical problems, especially when we know that earlier failures by Islamic banks to practice *salam* was mainly due to certain policies adopted by these banks.<sup>31</sup>

On the other hand, concerning the relation between the futures and cash market and the effect of hedging, Fahīm Khān argued that “since the futures market and cash market are independent, a farmer will hardly be a good player in the futures.” However, this argument seems to be fundamentally incorrect since it ignores arbitrageurs and arbitrage activity. Furthermore, any market or instrument that consistently exploits one party of the transaction will see its trading volume reduced and will die out naturally. This is because the constantly losing party would be naturally unwilling to continue using this instrument.

However, Fahīm Khān’s *fiqh* analysis throughout the discussion is shallow. For instance, he did not make any effort to ascertain the possibility of selling the *salam* countervalues before taking delivery. Although he raised the difference of opinion among the jurists, he did not proceed to analyze the different evidence advanced and the *ratio* behind the prohibition or legality of such a sale. Moreover, the effect of such analysis on the development of the futures market is totally absent,

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<sup>31</sup> See Samī Ḥammūd, “*Ṣiyagh al-Tamwīl al-Islāmī Mazāyā wa ‘Aqabāt kulli Ṣīghah*,” *Abḥāth Nadwat Ishām al-Fikr al-Islāmī fi al-Iqtisād al-Mu’āṣir*, held in Washington from 6–9 September 1988, International Institute of Islamic Thought, 1992, pp. 193–247.

despite the author's acknowledgement that a prohibitive judgment may be a hindrance for the development of a secondary market. The same problem of juristic analysis is obvious in Fahīm's disregarding of the Mālikī's opinion, which allows deferring the payment of *salam* for three days; or the opinion of some modern writers that it is necessary to install such payment in *salam* in order to solve the liquidity problem which may face even genuine traders.

Another commentator who addressed the issue of futures trading is Husein Salmon. His paper is entitled "Speculation in the Stock Market from the Islamic Perspective."<sup>32</sup> It should be noted that many commentators have considered futures trading invalid because of the problem of speculation involved. Salmon acknowledged that some degree of speculation is essential in any financial activity. However, some issues he raised about speculation may not be easily accepted. He divided speculators into two types: first, there are careful investors who invest their capital after making a careful assessment. They analyze the strengths of the company based on reliable fundamental factors, including real assets and property as well as the performance of the company in the past. This is what he termed rational speculation.

The second kind of speculators are those who do not conduct any study or analysis. They study the trend of price movements and market sentiment, and sometimes they base their decisions to buy on whispered rumors in the market. The evaluation of the second group may not be totally accepted due to the fact that rumors and manipulation are unacceptable in principle in the Islamic stock market, and, therefore, to invalidate futures trading on this aspect is baseless. On the other hand, many other commentators, without any legal grounds, have also advanced the claim that any benefit from price movements or price fluctuations is not legitimate.<sup>33</sup> Salmon suggested that it is necessary that traders keep their shares for at least six months to one year before selling them to a third party.

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<sup>32</sup> Husein Salmon, "The Problem of Speculation in Stock Market from an Islamic Perspective: Investment as an Alternative," *The First International Conference on Islamic Management: Management of Economic Development in an Islamic Perspective*, Jointly Organized by the Islamic Development Management Project (IDMP), The School of Social Sciences, University Sains, Malaysia, and the Islamic Research and Training Institute affiliated to Islamic Development Bank (IDB), Jeddah, Saudi Arabia, from 8–10 December 1998, pp. 1–50.

<sup>33</sup> See chapter 5 of the present study for more elaboration on the issue of speculation.

It seems that there is nothing in Islamic law which prevents a person from buying and selling without having the intention to make use of the commodity or to keep it for a long time. The topic will be investigated later since many commentators rely on it as grounds to invalidate futures.

Salmon calls for a total exclusion of options contracts because they bring additional uncertainty and they are not comparable to *bay' al-salam*. He rejected the possibility of taking a fee for a premium or option without any discussion. However, it seems that there are no grounds for comparison between the two contracts. On the other hand, his criticisms of short-selling and margin sale deserve consideration.

Furthermore, Aḥmad El-Ashkar in his article, "Towards an Islamic Stock Exchange in a Transitional Stage," observed that speculation could hardly be viewed as a game of chance or be equated with gambling. He pointed out the difference between speculation and *najash* (to bid up the price of the item, not with the intention to purchase the item, but rather to raise the price for the customers intending to deceive the buyers) to refute the allegations of some scholars. He concluded that "the Islamic securities Market should not be envisaged as a speculation-free market. A reasonable degree of speculation would be required, and indeed needed, if the market is to be active and operative."<sup>34</sup>

Frank E. Vogel and Samuel L. Hayes III in their study *Islamic Law and Finance, Religion, Risk, and Return* also dealt with the issue of derivatives and futures trading. Concerning the sale of debt, especially that of *bay' al-kālī bi al-kālī*, they acknowledged that the profound implication of the prevailing restrictions in this area may be an obstacle for the development of a futures market. Thus, they maintained that

On such matters Islamic law has many complex rules, all designed to avoid *ribā* and *gharar*. The restrictions these rules impose were less important in the past, when most contracts were promptly executed on at least one side. However, in today's world, futures financial obligations are among the most important forms of property; indeed, such obligations are the core of many forms of investment traded in huge volumes in financial markets. Accordingly, Islamic law restrictions in this general area are very significant in the development of new instruments, particularly if these are to be traded on secondary markets.<sup>35</sup>

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<sup>34</sup> Aḥmad El-Ashkar, "Towards an Islamic Stock Exchange in a Transitional Stage," *Islamic Economic Studies*, Islamic Development Bank, Jeddah, Saudi Arabia, vol. 3, no. 1, December 1995, pp. 79–112.

<sup>35</sup> Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance, Religion, Risk, and Return*, Kluwer Law International, The Hague, 1998, p. 114.

However, their discussion regarding the issue is very shallow and almost followed the conservative approach. We may be able to understand the reason behind this conservative approach if we examine their methodology in this area. For instance, they maintained that

Of course the most direct way to achieve the goal of risk management would be a bold redirection in *fiqh* thinking (*ijtihād*) drawing on new interpretations of the revealed sources and of basic principles. This *ijtihād* will declare what about risk management is legitimate in Islamic law, and what is illegitimate. But... it is ordinarily the most conservative, literal and legalistic approach that are followed in Islamic finance and accordingly, . . . , we will follow only such an approach. While doing so, however, we should try not to lose sight of the larger issue just sounded the proper scope, if any, for risk management in Islamic law.<sup>36</sup>

At the end of their discussion on the sale of debt for debt, they concluded that the general agreement among the scholars including Ibn Taymiyyah is against the bilateral executory contract; the force of the debt for debt maxim in this matter is unlikely to dissipate soon. They went on to argue that recently two authors have argued for its reversal. One did it on the ultimate ground of necessity,<sup>37</sup> while another offered more nuanced and challenging arguments. He argued that delayed payment should be permitted in supply contracts until the goods are delivered even for fungible goods or goods by description. Pointing to the more liberal rules that apply to delay in contract with an *ʿayn* (tangible property) on the one side, he argued that, first, the central distinction between *ʿayn* and *dayn* (debt) should not rest on whether the goods are unique, but on whether they already exist. Second, where goods under a supply contract are continuously available in the market, the contract should tolerate postponement of paying until the goods are received, just as they would if the goods were *ayn*. The Maliki position requiring payment delay in sales of absent *ʿayn* should apply to such modern contracts.<sup>38</sup>

However, the point which we would like to make here is that to claim that just two authors have argued for the reversal of the prohibition to postponing both countervalues is out of touch with reality. Many Muslim scholars have argued against this maxim, sometimes even before Nazīh

<sup>36</sup> Ibid., pp. 154–155.

<sup>37</sup> Nazīh Ḥammād, *Bayʿ al kālīʿ bi al-kālīʿ*, Markaz Abhāth al-Iqtisād al-Islāmī, Jāmiʿat al-Malik ʿAbdul Azīz, Jeddah, Saudi Arabia, 1986, pp. 28–29.

<sup>38</sup> ʿAbd al-Wahhāb abū Sulaimān, “ʿAqd al-Tawrīd.” Unpublished paper. In the forthcoming *Mawsūʿat al-Muʿāmalāt al-fiqhiyyah*, Islamic Fiqh Academy, OIC Jeddah, as quoted by Vogel and Hayes, p. 87.

Ḥammād and Abū Sulaimān, both in Arabic and English works.<sup>39</sup> However, a close look at the data adopted in this work, especially in the area of derivatives and futures trading, reveals that the authors confined themselves to limited sources of information.

Regarding forward contracts, the study maintains that *salam* contract is the closest Islamic approximation to the conventional forward contract.<sup>40</sup> With regard to futures contracts, the study concluded that there is no direct equivalent of futures contracts in Islamic finance. In addition to the already discussed problem of forward contracts, namely the postponement of both the price of the goods and the payment, futures require a daily marking to market, which is also forbidden in Islam. But the study did not exclude the possibility of a kind of Islamic futures based on *salam*.<sup>41</sup> Here again some proposals have been made based on parallel *salam* whose legality will be ascertained in subsequent chapters. As in the case of our review of the studies on forward and futures contracts, the present study will review the institutional studies in options, followed by the individual studies.

### *Options Contracts*

There are several institutional as well as individual studies addressing the legality of options contracts in a similar line to that adopted in forward and futures contracts.

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<sup>39</sup> See, for instance, Kamālī's study, "Islamic Commercial Law: An Analysis of Futures," *American Journal of Islamic and Social Sciences*, vol. 13, Summer 1996, no. 2, pp. 201–203; and it seems that the authors are aware of his opinion on the issue. As Kamālī mentioned in the acknowledgement of his manuscript, *Islamic Commercial Law: An Analysis of Futures and Options*, Research Center International Islamic University, he was invited by Vogel to deliver a lecture on Futures from the Islamic point of view at Harvard University. Moreover, many other scholars' writings in Arabic have argued against this maxim, such as al-Ḍarīr in his book *al-Gharar wa 'Atharuhū fi al-'Uqūd*, Dallah al-Barakah Jeddah, 1995, pp. 329–336; Aḥmad Ḥassan in his book *'Amal Sharikāt al-Istithmār al-Islāmiyyah fi al-Aswāq al-'Ālamiyyah*, pp. 286–321; Rafīq al-Maṣri, in his book *al-Jamī' fi Uṣul al-Ribā*, pp. 339–347; and Majd al-Dīn Azzām in his reply to the fatwā of the *Sharī'ah* adviser of Kuwait Finance House; see *al-Fatāwā al-Sharī'iyah fi-al-Masā'il al-Iqtisādiyyah* pp. 539–545 and 'Isāwī Aḥmad Isawī, "Bay' al-Dayn wa Naqlihī," *Majallat al-Azhar*, Cairo, no. 2, 1956, pp. 168–170.

<sup>40</sup> *Ibid.*, p. 223.

<sup>41</sup> *Ibid.*, pp. 225–226.

*Institutional Studies*

As mentioned earlier, the Islamic Fiqh Academy addressed the issue of derivatives through El-Gārī's paper in which he performed an analysis on options. He compared options with *khiyār al-sharṭ*, *salam*, and *bay' al-'arbūn* and concluded that:

- There is an apparent difference between *khiyār al-sharṭ* and options because options contracts are traded separately from the contract of the underlying commodity while in *khiyār al-sharṭ* the option is part of the contract of the commodity traded. Therefore, in options there is a combination of two contracts, namely, the premium and the price of the underlying asset while *khiyār al-sharṭ* is just a single contract.
- Options are also different from *salam*. The option contract is traded separately from the contract of the underlying commodity, which is not the case in *salam*.
- Next, he compared options with *bay' al-'arbūn* and concluded that the paid price in *bay' al-'arbūn* is part of the whole price of the commodity, while in options it is totally separated.

El-Gārī also makes the assumption of considering an options contract as a combination of a promise that is followed by a contract. But he raised the legality of selling a promise and gave a negative answer. Furthermore, he added that options contracts combine two contracts in a single transaction, which is prohibited in Islam. Finally, he discussed the legality of selling just a "right," as it is in the case of a premium in options, and he concluded that although Islam allows the sale of some "rights," the right in options is totally different from those already approved by Muslim jurists.

El-Gārī concluded that, "despite the fact this transaction has some characteristics of a sale, it is harmful in most cases and the objective of the participants in such a market is similar to that of gamblers who act on the basis of luck and risk. Furthermore, it involves high-risk or *gharar fāhish* and the motive behind it is risk itself."<sup>42</sup>

However, El-Gārī's harsh position regarding options seems to have changed drastically a few years later. Thus, in his article "Toward an

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<sup>42</sup> Mohamed Ali El-Gārī, "al-Aswāq al-Mūliyyah," *Majallat Majma' al-Fiqh al-Islāmi*, 1990, no. 6, vol. 2, pp. 1610–1617.

Islamic Stock Market,” he rebutted the criticisms raised by some that options do not serve any economic purpose, but are only a method of gambling. He pointed out that “the possibility of using this type of contract for gambling purposes is not ruled out; however, this element does not accompany the concept of options by necessity.”<sup>43</sup> In addition, he suggested some essential measures to avoid the element of gambling. El-Gārī has taken a very similar position in his article published as part of the *Encyclopaedia of Islamic Banking and Insurance*.<sup>44</sup>

The issue was discussed again in the seventh Islamic Fiqh Academy meeting and a resolution was adopted. The resolution stated that “options contracts as traded nowadays in the international market do not fall under the purview of any one of the nominated contracts. They are new types of contracts and since the subject matter in these types of contract is not *māl* (wealth), *manfaʿah* (usufruct), or *ḥaq māli* (right related to property) which could be legally exchanged, then, they are illegal types of contract and their trading is prohibited.”

The different papers on options presented at the Academy seventh session followed almost the same line of discussion that they received from the Academy’s secretariat. Thus, they touched on the definition of options, their position in the general theory of contracts, their relation with other types of contracts, especially *bayʿ al-ʿarbūn*, *salam*, *khiyār al-shart*, sale through description, gift, and the possibility of buying and selling an absolute “right.” This was followed by two separate discussion sessions on the two topics.

A close look at the different papers might explain the different rulings in the resolution. For instance, some of the scholars who delivered papers on the issue passed a prejudgment on options prior to any discussion or deliberation on the issue. Sheikh al-Salami, for example, said “from their introduction and objectives, options would not accept any Islamic modification. Moreover, any modification to make these types of contracts [come] in[to] compliance with *sharīʿah* principles could be considered only if it is possible to implement them. However, options in their market do not accept any alteration and the Islamic world is

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<sup>43</sup> Mohamed Ali El-Gārī, “Toward an Islamic Stock Market, *Islamic Economics Studies*, vol. 1, no. 1, December 1993, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, pp. 1–20.

<sup>44</sup> Institute of Islamic Banking and Insurance, *Encyclopaedia of Islamic Banking and Insurance*, London, 1995, pp. 164–173.

not in need of these contracts in its economy.”<sup>45</sup> For his part, al-Ḍarīr in the first sentence of his study on options said, “This is a new type of contract and it is an illegal contract...” He concluded, saying “There is no need to look for alternatives to these transactions from the Islamic point of view because it does not lead to any significant public interest which needs to be safeguarded.”<sup>46</sup>

It is worth noting that a great deal of Islamic law is based on *maṣlahah* (public interest) and need. However, it seems that the benefits of options, as tools of risk management, had not been very well explained to these jurists and scholars by the Muslim economists associated with the Islamic *Fiqh* Academy. Accordingly, some of these jurists concluded that the Muslim economy is not in need of these contracts.

It is clear that this attitude of prejudgment would not be of much help in reaching a systematic and fair conclusion. Perhaps because of the misgivings, the participants did not even make the effort to modify these new types of contract or to look for an Islamic alternative. Moreover, to think that options have no benefit at all is to deny an internationally recognized reality.<sup>47</sup> Still, it is possible to argue that despite their benefits, options may involve high risk and harm, and, therefore, should not be allowed in Islamic finance in their present form. But to exclude them altogether is out of touch with reality. If there were no benefits in options, one might ask why the issue has been raised from an Islamic point of view by Muslim economists and financial institutions, such as the Islamic Development Bank. Moreover, it should be taken into consideration that the major part of the Muslim world economy is based on commodities such as petroleum, cotton, palm oil, rubber, tin, etc., which are traded in futures markets whether in relation to forward, futures, or options contracts.

Another example of these prohibitive attitudes, which may be behind the Academy’s resolution, is seen when Sheikh al-Salāmī maintained in his paper that options are just an expansion of gambling and new ways to gain money without effort.<sup>48</sup> This claim was also made by some other

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<sup>45</sup> Mohammad Mukhtār al-Salāmī, “al-Ikhtiyārāt,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 241.

<sup>46</sup> Ṣiddīq al-Ḍarīr, “al-Ikhtiyārāt,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 271.

<sup>47</sup> See chapter 10 on the economic benefits of options.

<sup>48</sup> Mohammad Mukhtār al-Salāmī, “al-Ikhtiyārāt,” *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, p. 235.

discussants. However, when Sheikh ‘Ali al-Taskhīrī warned against labeling these contracts as gambling contracts without a strong basis, Sheikh al-Salāmī revised his initial position, saying “Yes, sometimes they may involve gambling but sometimes they are a kind of buying and selling with the intention of hedging against the risk of price fluctuation,”<sup>49</sup> and he cited an example of a farmer.

### *Individual Studies*

Among those who addressed the legality of options is Kamālī. He reviewed some of the existing literature on options, addressing its shortcomings, especially that of ‘Abd al-Wahhāb Abū Sulaimān, “al-Ikhtiyārat: Dirāsah Fiqhiyyah Taḥlīliyyah Muqārānā in “*Majallat al-Buḥūth al-Fiqhiyyah al-Mu‘āṣirah*,” and that of Aḥmad Ḥassan Muḥyi al-Dīn, “*‘Amal al-Sharikāt al-Istithmār al-Islāmiyyah Fi al-Sūq al-‘Ālamiyyah*.” He compared options with *khiyār al-sharṭ* and *bay‘ al-‘arbūn*. He also discussed the issue of whether it is lawful to charge a fee for granting an option and whether an option could be bought and sold as a valuable instrument in its own right. He concluded thus:

This analysis is affirmative not only on the parties’ freedom to insert stipulations in contracts but also that a monetary compensation or a fee may be asked by one who grants an option or a privilege to the other. If the seller is entitled to stipulate for a security deposit or a pawn then it is a mere extension of the same logic that he may charge the buyer and impose a fee or compensation in respect of such options and stipulations that are to the latter’s advantage. When the buyer, for example, stipulates that he will ratify or revoke the contract within a week or a month, this may well prove to be costly to the seller and he may therefore charge a fee/compensation for granting the option. We thus conclude that options may carry a premium and [there]should be, therefore, no objection to this.<sup>50</sup>

However, this argument will solve the problem only if we consider the premium as part of the whole price of the underlying commodity and that it cannot be traded separately. Still, although Kamālī’s argument here is similar to that of the Ḥanbalī school in allowing *bay‘ al-‘arbūn*, and it will really fulfill some of the benefits of options, the question

<sup>49</sup> *Majallat Majma’ al-Fiqh al-Islāmī*, 1992, no. 7, vol. 1, pp. 581–584.

<sup>50</sup> Mohammad Hāshim Kamālī, *Islamic Commercial law: an Analysis of Futures and Options* (unpublished manuscript), Research Center International Islamic University, Malaysia, pp. 356–357.

that remains is the following: is it permissible to trade such an option separately from the underlying commodity? This is what Kamālī's work did not discuss and the present study proposes to address it in detail.

Moreover, this argument limits such a benefit to the seller, and it may be asked if it is possible for the buyer to make a similar stipulation. And only at that stage, could we state that at least the simple types of options, namely put and call options, could be accommodated in Islamic law. It should be noted that the classical scholars did not discuss such things in their works. However, the door is not totally closed. Thus, we believe that the issue of buying and selling just a "right," like the one in options, needs more investigation, especially when we find that it was the main grounds for the rejection of options by the Islamic *Fiqh* Academy and the different workshops jointly held with the Islamic Development Bank.

On the other hand, despite the fact that Kamālī considers *bay' al-'arbūn* as closely resembling options, especially in respect to options that relate to the payment of a nonrefundable premium, and in the sense that both can be used as risk reduction strategies, Kamālī preferred to accommodate options through *khiyār al-sharṭ*. He stressed that

Although *khiyār* and *'arbūn* share the same rationale and can both provide the necessary juristic support for options trading, they are nevertheless not identical and each can be utilized for different purposes. I still prefer to utilize the theory of *khiyārāt* (Islamic options) as the juridical premise for validating options. I say this not only because of the unequivocal support that is found for *khiyārāt* in the sunnah, but also because the basic concept of the option of stipulation strikes a closer note with options as a trading formula and a derivative instrument that is associated with an underlying contract.<sup>51</sup>

The present study proposes to utilize *bay' al-'arbūn* as the juridical premise for validating options, while the possibility of accommodating options through *khiyār al-sharṭ* will also be thoroughly investigated. This is because, first, *bay' al-'arbūn* is *khiyār al-sharṭ* plus the permission to buy and sell this option. Second, *bay' al-'arbūn*, as pointed out by Kamālī, closely resembles options, especially in that aspect of options that relates to the payment of a nonrefundable premium and in the sense that both can be used as risk-reduction strategies. Last, despite the fact that the legal foundation of *bay' al-'arbūn* in the

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<sup>51</sup> Ibid., pp. 369–370.

sunnah is weaker than that of *khiyār al-sharṭ*, it could be accommodated under the general theory of freedom of contract. Moreover, it has been accepted by some Companions, including ‘Umar, the second caliph, and the Ḥanbalī School of law. In addition, the Islamic *Fiqh* Academy has given its permission in its resolution no. 72(3/8)<sup>52</sup> about ‘*arbūn*, which eliminates any reluctance about its permissibility and acceptance. But these arguments will be discussed later at the right place.

In conclusion, Kamālī maintained that “there is nothing inherently objectionable in granting an option, exercising it over a period of time, or charging a fee for it, and that options trading (like other varieties of trade) is permissible, (*mubāh*) and as such, it is simply an extension of the basic liberty that the Qur’ān has granted to the individual with respect to civil transactions and contracts (al-Baqarah 2:275; al-Mā’idah, 5:1). Needless to say, options trading, like all other varieties of commerce, can be distorted by malpractice and abuse and the likelihood of this is perhaps widespread in options on futures and, indeed, options over assets that involve high levels of speculative risk-taking. It is, therefore, essential that we adopt a vigilant attitude toward refining our safeguards against malpractice at all levels.<sup>53</sup>

Another scholar who opted for the permissibility of options under *khiyār al-sharṭ* was Aḥmad Yussuf Sulaymān in his article “Ra’y al-Tashrī‘ al-Islāmī fi Masā’il al-Burṣah.”<sup>54</sup> A similar opinion was shared by Mohammad Obaidullah who discussed *khiyār al-sharṭ* in different articles<sup>55</sup> and considered it as the Islamic alternative to conventional options and a tool of risk management. Moreover, in his article “*istijrār*: A Product of Islamic Financial Engineering,”<sup>56</sup> Obaidullah compared *istijrār* with similar products of conventional financial engineering and made a case for its use.

<sup>52</sup> See *Majallat Majamā‘ al-Fiqh al-Islāmī*, no. 8, vol. 1, p. 641.

<sup>53</sup> Mohammad Hāshim Kamālī, *Islamic Commercial Law: An Analysis of Futures and Options*, pp. 270–271.

<sup>54</sup> *Al-Mawsū‘ah ‘al-‘Ilmiyyah wa al-‘Amaliyyah li al-Bunūk al-Islāmiyyah*, Cairo, International Association of Islamic Banks, vol. 5, pp. 4244–457.

<sup>55</sup> Mohammed Obaidullah, “Islamic Options-Engineering Risk Management Solution,” *New Horizon*, Islamic Institute of Islamic Banks, London, May 1998, pp. 6–9 and “Financial Engineering with Options,” *Islamic Economic Studies*, Islamic Development Bank, Jeddah, Saudi Arabia, vol. 6, no. 1, November 1998, pp. 73–103.

<sup>56</sup> Mohammed Obaidullah, “*Istijrār*: A Product of Islamic Financial Engineering,” *New Horizon*, Islamic Institute of Islamic Banks, London, October 1997, pp. 3–8.

On the other hand, Aḥmad Muḥyī al-Dīn in his book, *ʿAmal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah*,<sup>57</sup> claimed that options are illegal because they contradict the general principles of Islamic commercial law. In addition, they do not fall within the purview of *khiyār al-sharṭ* or its objectives. Moreover, they contradict the principle of justice since the option holder will benefit from the loss of the one who provided them. He added that such options are similar to the illegal kind of options (*al-shurūṭ al-fāsidah*) that have been rejected by all schools of law. Finally, these kinds of contract are similar to some contracts prohibited in Islam such as the combination of two contracts in a single transaction (*bayʿataini fi bayʿatin wāḥidah*).

It should be noted that none of these objections is genuine or has a strong link with the validity of options. However, we will discuss them at their proper places later. Aḥmad Ḥassan continued to maintain the same argument in his book, *Aswāq al-Awrāq al-Māliyyah wa ʿAthāruhā al-ʿInmāʿiyyah fi al-Iqtisād al-Islāmī*. Aḥmad Ḥassan was also very critical of speculation, but acknowledged the need for market players who are looking for price differentials to ensure liquidity in the market.<sup>58</sup>

On the other hand, Obiyathullah's paper entitled "Derivative Instruments and Islamic Finance: Thoughts for Reconsideration" addressed the issue of derivative instruments, their evolution, their benefits, and makes a case as to why they are needed. In addition, he discussed *salam* and *istijrār* as Islamic financial instruments with features of derivative instruments. He limited the scope of his article, saying "The objective of this paper is not to reevaluate these instruments in the light of the *Sharīʿah*, nor is it intended as a critical examination of the juridical works of *fuqahāʾ* (Sharīʿah scholars). What is intended here is to provide a deeper understanding and an appreciation of these instruments: how they evolved, why they are needed, their diversity of

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<sup>57</sup> Aḥmad Ḥassan Muḥyī al-Dīn, *ʿAmal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa ʿAthāruhā al-ʿInmāʿiyyah fi al-Iqtisād al-Islāmī*, Dallah al-Barakah, Jeddah, 1996.

<sup>58</sup> Aḥmad Ḥassan Muḥyī al-Dīn, *ʿAmal Sharikāt al-Istithmār al-Islāmiyyah fi al-Sūq al-ʿĀlamiyyah*, Bank al-Barakah al-Islāmī li al-Istithmār, Bahrain, 1986, and *Aswāq al-Awrāq al-Māliyyah wa ʿAthāruhā al-ʿInmāʿiyyah fi al-Iqtisād al-Islāmī*, Dallah al-Barakah, Jeddah, 1996.

use, and the serious handicap that could be posed to Islamic businesses from ignoring them.”<sup>59</sup>

Vogel’s and Hays’ study explored the possibility of options through *khiyār al-sharṭ* and *bayʿ al-ʿarbūn*. It concluded that *khiyār al-sharṭ* or the stipulation of an option has little apparent significance for the creation of Islamically valid derivatives, since the party giving the option cannot be compensated for doing so; thus, the option right itself is not paid for. Its significance is rather a vital analogy, and a background set of rules and principles for *ʿarbūn*.<sup>60</sup> Regarding *ʿarbūn* itself, the study concluded that of all Islamic contracts, *ʿarbūn* offers the closest analogy to options. However, they acknowledged that classical law gives little hope for the approval of the option contract. Rather, it poses a series of objections, of which the following are the most important.

- An option requires payment for something that is an intangible “right,” not property (*māl*) in the usual sense (i.e., tangible goods or a utility taken from a tangible good), for which compensation alone can be demanded. This is one basis for the objection of some scholars that the option price is “unearned.” It is also the position taken by the OIC Academy in declaring the illegality of an option contract.
- An option arguably involves gambling. In practice, only one party can gain from the contract, while the other must lose. Whether a party will gain or lose depends on the unknown futures market price. In most actual option contracts, moreover, the parties have no intention of taking delivery, but only of liquidating their contracts against the price differentials. In every lawful Islamic sale, on the other hand, the parties fix their exchange fully at the time of the conclusion of the contract, and at least one if not all the countervalues are presently owed, even if not immediately paid for.
- An option incorporates the idea of a future sale, which is itself impossible under classical law.
- If the option is in currency, not even forward sales are allowed since currencies may be exchanged only at the spot.

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<sup>59</sup> Obiyathulla Ismath Bacha, “Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration”, Unpublished Paper, International Islamic University, Malaysia, November, 1997, p. 7.

<sup>60</sup> Frank E. Vogel and Samuel Hayes, III, *Islamic Law and Finance Religion, Risk, and Return*, p. 156.

- The price of an option compensates for lost opportunity. Opportunity costs are by definition conjectural, involving sales that do not occur. Damages in Islamic law do not include conjectural losses.
- Options may involve selling what one does not own.

For all these reasons, unless justifiable as *'arbūn* or by analogy with *'arbūn*, the option contract in conventional form is unlikely to be accepted.<sup>61</sup> It should be noted that these objections are mostly those pointed out by the participants in the Islamic *Fiqh* Academy session on options. However, neither Vogel and Hayes's study nor that of the Islamic *Fiqh* Academy went beyond that by discussing the genuine grounds of these objections in Islamic law. Nonetheless, we do believe that many of these objections, if not all of them, could be reversed if a thorough investigation is made.

It should be noted, however, that Vogel and Hayes's study provides some good suggestions as to how to develop Islamic options, the legal grounds of which will be discussed in the relevant chapter.

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<sup>61</sup> Ibid., pp. 264–5.