COMMODITY FUTURES CONTRACT; AN ANALYSIS IN ISLAMIC COMMERCIAL LAW

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ABSTRACT

This thesis is a study on the perspective of Islamic Law of the present commodity futures trading commonly found in commodity futures markets for example those in Britain, United States or Malaysia. The study examines the legal and contractual aspects of commodity futures contracts based on the rules and principles of Islamic Commercial Law with particular emphasis on the concept and mechanism of these contracts some of the trading practices by which such a contract becomes a commercial instrument. Firstly, the basic concept of a commodity futures contract and the fundamental elements of a legally binding contract are discussed. Secondly, the mechanism of such a contract in the commodity futures market is analysed; a discussion of the vital role of the exchange and clearing house is included. Thirdly, the real profitable function of a commodity futures contract is explored where the activities of hedging and speculation become its main concern. Finally, present trading in commodity futures is shown to be generally permissible within the framework of Islamic Law.

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ARABIC TRANSLITERATIONS*

Letters of the Alphabet:

ا	a	ط	ṭ
ب	b	ظ	ẓ
ت	t	ع	ᶜ
ث	th	غ	gh
ج	j	ف	f
ح	ḥ	ق	q
خ	kh	ك	k
د	d	ل	l
ذ	dh	م	m
ر	r	ن	n
ز	z	ه	h
س	s	ة	ah, at (construct state)
ش	sh	و	w
ص	ṣ	ء	ʻ
ض	ḍ	ي	y

Vowels and Diphthongs:

ـَ	a	آ	ā	ـَيْ	ay	ـِيّ	iyy
ـِ	i	ـِي	ī	ـَوْ	aw	ـُوّ	uww
ـُ	u	ـُو	ū				

* This system of transliterations is based on the one that of *Encyclopaedia of Islam* with some modifications.

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INTRODUCTORY CHAPTER

BACKGROUND OF COMMODITY FUTURES CONTRACT AND BASIC CONCEPT OF ANALYSIS IN ISLAMIC COMMERCIAL LAW

A. The commodity futures trading: Past and present

Futures contracts are believed to have evolved in the mid-nineteenth century in Chicago. The farmers used to suffer losses in spot grain transactions due to limited storage for their huge supply of wheat and lack of buyers of the short-term demand, and in the years of crops failures, the dealers or manufacturers suffered big losses due to insufficiency of raw materials for their products. Such problems of supply and demand, storage and transportation led the farmers, together with the dealers, to commit to future exchanges of grain for cash.[1] At first, their agreements appear to be merely an exchange of written contracts stating the amount of grain, the cost and the future date of delivery, with nominal fees representing a guarantee.[2]

It was also reported that for similar reasons, a kind of futures contract was exercised in 1863 in Liverpool, where sales of specific cargoes 'to arrive' of cotton became inadequate to supply the market. To meet the great demand, cotton contracts began to be concluded for much later periods.[3] Such transaction, which were also called 'to arrive' sales, were later developed with a system of inspection and grading.[4]

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[1] Chicago Board of Trade, *Commodity Trading Manual*. Chicago: Chicago Board of Trade, 1994 pp. 3-4.
[2] Oasis Publishing, www.pr-success.com/OASIS/course1 accessed on, 24/02/1998.
[3] Rees, G. L. *Britain's Commodity Market*. London: Paul Elek Books, 1972 p. 90.
[4] Baer, J. B. & Woodruff G. P. *Commodity Exchanges*. London: Harper and Brothers Publishers, 1929 pp. 3-4.

In 1730 in Japan, a 'forward contracting' trading in rice on the Dojima Rice Market was exercised. Such a transaction resembled partly a cash or spot transaction, and partly a futures contract, except that it was not standardised. The contracting parties negotiated on the terms of the contract including the price, quality and quantity of the rice and the future date of delivery.[5]

Similar forward contracts were used in the Chicago Board of Trade during its early years for grain trading. Founded in 1848, the Board of Trade provided a market place for the farmers and grading facilities for the grain upon delivery.[6] Initially, futures contracts were privately negotiated between the traders, then in 1864 such trading was officially recognised by the Board. However, in 1868, as the traders often did not fulfil their commitments, the Board took the initiative of developing a standardised agreement known as a futures contract in which a margining system was also introduced to overcome any default.[7] In other words, the Board had first introduced the modern principles of futures contract in commodity trading as we can see at present, although they had already been applied in the financial market at an earlier date.

The appliance of futures contract practices in commodities markets expanded gradually to different categories of commodities and their respective exchanges and countries. Commodities may be classified into agricultural, metals, tropical and others, such as forest and petroleum. Usually, commodities that are subject to futures markets are tangible and physical, suitable for standardisation and grading, and deliverable. They are generally storable, either for a short time or indefinite.[8] Therefore, commodity futures contracts are defined in many references

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[5] Chicago Board of Trade, *Commodity,* p 2.
[6] Markham, J. W. *The History of Commodity Futures Trading and its Regulation*. New York: Praeger Publishers, 1987 p. 4.
[7] Chicago Board of Trade, *Commodity,* p 5.
[8] Herbst, A. F. *Commodity Futures Markets, Methods of Analysis and Management of Risk.* New York: John Wiley & Sons, 1986 pp 201-202.

as transactions standardised in every aspect except the price which is determined by the parties at the time of the execution of the contract through a process which is known as open outcry auction held on a commodity futures exchange trading floor. For example, Baer and Woodruff[9] define commodity futures contract is defined in a classical but comprehensive manner as a contract for the future delivery of some commodity, without reference to specific lots, made under the rules of some commercial body, in a set form, by which the condition as to the unit of amount and the price is left open to the contracting parties. Although classical, this definition clearly explains the fundamental nature of a commodity futures contract. By entering into such contract, a person is obliged to perform his side of the transaction according to the standard terms under the surveillance of a commercial body.[10]

It is not necessary for commodity futures traders to be the commercial undertakings that actually sell or purchase the underlying commodity, but it is understood that at the expiry date, the traders should perform their duties by whatever means, or if they default they will be subjected to the rules and regulations of the said body. However, it will be shown later that such situations rarely occur.

A commodity futures contract is also defined as an obligation,[11] a binding commitment[12] or a legal agreement[13] to purchase or sell a commodity in which the terms are standardised by type, quantity, quality, delivery time and place, at a price agreed upon when the contract is made. It is worth to note that there is no special emphasis on the terms 'obligation', 'commitment' and 'agreement' are used in this definition even though they are significant and carry distinctive implications in other

[9] Baer & Woodruff, *Commodity*, p. 6.
[10] Practically, it is more appropriate to regard a commercial body as an exchange.
[11] Markham, *The History*, p. 203.
[12] American Bar Association. *Futures and Derivatives: Basics*. Orlando: American Bar Association, 1996 pp. 107 & 144.
[13] Chicago Board of Trade. www.cbot.com/points_of_interest/visitor/news_faq.html accessed on, 04/06/1998. See also, Strauss, D. W. *Handbook of Business Information*. Colorado: Libraries Unlimited, Inc., 1988 p. 376.

legal contexts. Briefly, a commodity futures contract creates an obligation or commitment (or whatever the term is) to deliver or to take the delivery of the underlying commodity according to the terms of the contract (contract specification), which the contracting parties have no legal authority to alter or amend them. Fortunately, the obligation created under a commodity futures contract need not end in delivery made by the seller and payment furnished by the purchaser, for, as such a contract is standardised and uniform, it becomes interchangeable. This interchangeability (or sometimes called fungibility) allows the futures traders to offset their commitments under the contract by entering into an equal but opposite contract before the expiration date that is a stipulated date determined by the exchange.[14] Usually, this date is stated in the contract specification. In other words, a purchaser may offset his position by entering into a contract to sell the same underlying commodity, and the seller may buy an exact amount of the same commodity to offset his obligation.

From a study of the original purpose of a futures contract in commodity trading and its later development, it is clear that initially futures contracts were undertaken by the real traders who owned the physical underlying commodity and the dealers or manufacturers who wished to secure a consistent supply for their products. For example, a farmer who anticipates that the price of his grain would fall in a few months time or during harvest time, would execute a futures contract to secure the current price for the future sale and delivery of his grain, or, a manufacturer who felt that grain prices are likely to rise within the forthcoming months or, who feared a lack of raw material for his products due to certain economic factors, might wish to lock-in the current price or guarantee the flow of supplies for his operations by buying a specified futures contract for a certain amount of grain for a certain month of delivery.

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[14] American Bar Association, *Futures*, p. 107.

As stated earlier, because of the uniformity of the terms the contract becomes fungible. As a result, not only the real futures traders are having benefits from trading in futures, but also public investors and professional speculators can take the opportunity of making a profit from the rise and fall of commodity futures market prices. The interchangeable nature of the contract allows them to come in and go out of the trading at any time as they wish. Furthermore, the mechanism of this contract becomes more complex where a clearing house interposes itself between the seller and the purchaser, and then assumes the role of the counter party for both of them. The futures traders in this latter framework have to pay a margin deposit (known also as initial or original margin) of a small percentage of the total contract value before any initiative of making an order of selling or buying the commodity. This margin is actually paid to the clearing house through their broker as a performance bond or financial guarantee to ensure that they will fulfil the obligation of the futures contract. When the broker receives an order, he transmits the order to other broker/s on the floor of an exchange. When they reached an agreement after the bid and offer of price, the transactions are reported to the clearinghouse to clear. At this moment, the clearing house interposes itself between the parties and guarantees the performance of the contract.

While the traders need to maintain the margin fund at the level of minimum margin (also known as maintenance or variation margin) set by the exchange, the actual price of the underlying commodity has to be paid upon delivery. They must observe this maintenance margin throughout the time or as long as they keep their futures position open until the expiration or maturity of the contract. When they offset their positions before the expiration by taking a futures position opposite but equal to the initial one, their obligations under the initial contract are terminated, which most of the traders prefer.

By terminating the contract prior to its maturity, a trader may make a profit or a loss. Since the market price of the underlying commodity fluctuates between the time of the order was made and the offsetting of position, the trader may either gain or lose by the difference between the initial agreed selling or purchase price and the cost of the offsetting transaction. To illustrate, suppose a customer anticipates a rise in corn prices, he then instructs his broker to buy one corn contract (5000 bushels of corn) in an exchange, to be delivered in September for £3.00 per bushel. He may remain in this position until maturity, or alternatively, during the interval, offset his position by selling the same quantity and delivery month. If the corn market price rises from £3.00 to £3.10 a bushel, he will make a profit of £500.00. But if the price falls below £3.00, certainly he will have made a loss.

B. Basic concept of analysis in Islamic Commercial Law

Theoretically, commodity futures contracts comprise the basic fundamental elements of a forward contract; the prospective buyer and seller, the underlying commodity that will be delivered sometime in future and the price which is paid upon delivery of the commodity. Initial attempts were made to analyse the formation of these contracts by comparing them with commercial instruments used under Islamic Law. It seems that such transactions partly resemble the contract of *bay^c al-salam* (forward sale) and *bay^c al-istiṣna^c* (sale by manufacture) which are generally permissible under Islamic Law. However, further examination needs to be made of other aspects of commodity futures contracts that are still questionable and have become the main subject of discussion among modern Islamic scholars. As discussed in the following chapters, some scholars invalidate this contract totally since its formation is similar to *bay^c al-ma^{c}dūm* (sale of a non-existent object) or *bay^c al-dayn* (sale of debt), which are relatively prohibited in Islamic Law. Supported by a few Quranic verses and some *ḥadīth* of the Prophet (peace be upon

him), they decided further that futures contracts are constituted with an inherent degree of uncertainty which could possibly render the contract as void.

On the other hand, among the Islamic scholars who maintain the permissibility of futures contracts, it had been suggested that the uncertain elements of these contracts have been virtually eliminated by the standardised formation and procedures of futures contracts. In addition, it has been held that these transactions should be treated as a new case and therefore the fundamental maxim of *al-aṣl fī al-ashyā' al-ibāḥah* (the original position of everything is permissible) is applied until it is proved otherwise. So far, they found that there is no element to prove otherwise and the supporting traditions used by the first group lack authenticity, and so could not apply when determining the validity of these contracts.

The above attempts made by the modern Islamic scholars in determining the permissibility of commodity futures contract illustrate the importance of understanding the basic concept of analysis of a new non-regulated subject in Islamic Law. Such a subject or issue that has yet to have its own rules or legal position in the framework of Islamic Law must be carefully examined in order to define its legal status. The Islamic scholars have unanimously agreed that, when examining any new subject or incident that has no rule or legal value, the provisions of the primary bases of Islamic Law must be referred to. These are the Quran and the *Sunnah* that includes the Prophet Muhammad's (peace be upon him) words, deeds and tacit approvals. In a case where there is no equivalent rule provided by these two non-arguable sources, usually Islamic scholars will subsequently resort to the secondary or dependent sources of law, the *Ijmāᶜ* (general public consensus), the *Qiyās* (reasoning by analogy), the *Maṣlaḥah mursalah* or *Istiṣlāḥ* (reasoning by

public interest), the *Istiḥsān* (preference), the *ᶜUrf* (customs or common practice) and *Sadd al-dharā'iᶜ* (blocking the means).[15]

These secondary sources, though disputed among the Islamic scholars, are the most applicable compared to other secondary sources, in determining the (*ḥukm*) legal value of a particular subject in the past and at present. Based on these sources, the classical scholars formulated *Qawāᶜid Fiqhiyyah* (legal maxims) to be a sort of code or guidelines in drawing up legal rules. In addition to the above sources and the legal maxims, the analysis must also adhere to the divine restrictions, especially on commercial dealings. There must be no element of *ribā* (usury or interest)[16], *maysir* (gambling)[17], *gharar* (risk and uncertainty) or any impediments of consent, like *ikrāh* (duress), *ghalaṭ* (mistake) and *tadlīs* (fraud) that will generally lead to unlawful acquisition of property.

B.1. The primary sources of Islamic Law

As mentioned earlier, the primary bases for legislation of the principles and rules of Islamic Law are the Quran and the *Sunnah* of the Prophet Muḥammad (peace be upon him). These two primary sources must both be referred to in order to determine a specific rule for any case or subject.

[15] There are a few other secondary sources that scholars rarely resort to, they are, *Sharᶜ man qablanā* (the divine rules of other Prophets), *Madhhab al-ṣaḥābī* (words and deeds of the companions of the Prophet) and *al-Istiṣḥāb* (ruling on the existence or non-existence of a thing or incident based on its original state).

[16] Literally, ribā means increase or addition, while technically, it refers to usury and interest. In Islamic Law, riba denotes any unjustified increase of capital for which no compensation is given. It covers transactions with a fixed time limit and payment of interest, as well as speculation of all kinds. Ribā is forbidden based on the provisions of the Quran, 3:130 and 2:275. See, Bosworth, C. E. et al (eds.). *The Encyclopaedia of Islam*. Leiden: E. J. Brill, 1995 v. VIII, p. 491, Failaka International, Inc. *Glossary of Islamic Financial Terms*, at, www.failaka.com/Glossary accessed on 12/05/2000.

[17] *Maysir* is a form of *gharar* that denotes any types of risk, uncertainty or ignorance of the contracting party of the subject matter or result of a contract. See, Failaka International, Inc., *Glossary*.

(a) The Quran

The Quran is a compilation of Islamic teachings and rules that were gradually revealed to the Prophet (peace be upon him)[18]. In relation to Islamic Law, the provision of the Quran may, in some instances, be specific and detailed (*tafṣīlī*) in its terminology and meaning. For example, in the provisions on the distribution of an estate, the proportions for the heir have been clearly defined. On the other hand, most of the Quranic provisions pertaining to rules and regulation are revealed in general terms or in summary (*ijmālī*) needing further elaboration, for example, the verse that provides the permissibility of any commercial dealing that is based on mutual consent. For such instances, the *Sunnah* plays an important role in interpreting and accomplishing the rule laid down in the verse.[19]

The flexible provisions of the Quran have, in fact, allowed the principles of Islamic Law to become applicable anywhere, anytime. Except the provisions related to family matters that have been detailed and must be followed strictly, most of the legal provisions of the Quran are open for further interpretation and adaptable in any situation. Thus those principles stated in the verses become extendable and adjustable without affecting the core principles of Islamic Law.[20] For instance, the provision on the permissibility of sale and prohibition of *ribā* is revealed in general without any specification. The Prophet (peace be upon him) in his *Sunnah* had illustrated a few types of permissible sales and a few kinds of merchandise that are subjected to the prohibition of *ribā*. Based on the Quran's general provision and a few specifications given by the *Sunnah*, the Islamic scholars developed the related

[18] Abu Zahrah, Muhammad. *Uṣūl al-Fiqh*. Cairo: Dār al-Fikr al-ᶜArabī, 1958, pp. 70-71, Al-Bughā, Muṣṭafā Dīb. *Āthār al-Adillah al-Mukhtalaf Fīhā fi al-Fiqh al-Islāmī*. Damascus: Dār al-Qalam, 1993 p. 19.
[19] Abu Zahrah, *Uṣūl*, pp. 83-85, Al-Zarqā', Muṣṭafā Aḥmad. *Al-Madkhal al-Fiqh al-Ām*. Damascus: Dār al-Fikr, 1968, v. 1, p. 61.
[20] Al-Zarqā', *Al-Madkhal*, pp. 61-62.

rules to allow a few other transactions and to forbid some more dealings that contain a *ribā* element.

(b) The *Sunnah*

The *Sunnah* of the Prophet Muḥammad (peace be upon him) is legally referred to as the words, deeds and approvals of the Prophet (peace be upon him) that contain Islamic principles on religious, social and legal matters transmitted by his companions. Although the terms *ḥadīth* and *Sunnah* are quite identical, the former is confined to the statements of the Prophet (peace be upon him).[21] Hence, the *Sunnah* is classified into three kinds, *sunnah qauliyyah* (verbal *sunnah*), *sunnah fiᶜliyyah* (practical *sunnah*) and *sunnah taqrīriyyah* (affirmative *sunnah*).[22] The *Sunnah* may also be divided according to its authenticity into *ṣaḥīḥ* (authoritative tradition), the most authentic one followed by *ḥasan* (reliable tradition) and *ḍaᶜīf* (disputable tradition). This classification is significant in determining the strength of the *Sunnah* as a *dalīl* (evidence) in the formation of laws or a ground of judgment.

As mentioned earlier, the *Sunnah* takes an important position next to the Quran as one of the sources of Islamic Law. Since most of the Quranic legal provisions were revealed in general and precise terms, the *Sunnah* becomes the second primary basis of Islamic Law for its role in interpretation and specification of these provisions. In some instances, the *Sunnah* also provides new rules besides the Quran but without overruling any of its general principles. In other words, the *Sunnah* elaborates and illustrates the precise term of the Quran and sometimes came with its own rule where the Quran is silent on that particular matter. Should there be

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21 Al-Zarqā', *Al-Madkhal*, v. 1, p. 63, Aghnides, Nicolas P. *Mohammedan Theories of Finance*. Lahore: The Premier Book House, (No Date), pp. 13-14, Al-Bughā, *Āthār*, p. 21.
22 Abu Zahrah, *Uṣūl*, p. 97.

contradiction between the provisions of the two, both shall be harmonised whenever possible. Otherwise, the provision of the Quran shall prevail.[23]

B.2. The secondary sources of Islamic Law

The secondary sources of Islamic Law are a list of methods for the formation of rules for cases or subjects which have no specific position provided in the Quran and the *Sunnah*. Depending on the provisions of these two primary sources, the companions of the Prophet (peace be upon him) and later Islamic scholars developed a few methods for finding the appropriate rules for such cases.

(a) The ***Ijmā*ᶜ** (general consensus)

Although the *Ijmā*ᶜ is a form of dependent basis of Islamic Law after the Quran and the *Sunnah*, its recognition is actually rooted in the primary sources as the Prophet (peace be upon him) is reported as having said, "My nation shall never unanimously agree on an error." By virtue of this *ḥadīth*, *Ijmā*ᶜ deserves to be a major resource in the determination of legal rules.[24] Legally, the term *Ijmā*ᶜ refers to an agreement or consensus among Islamic scholars of certain era in relation to a legal rule. Such a consensus is attained after due consideration of the two primary sources, the Quran and the *Sunnah*. Conceivably, there can be no *Ijmā*ᶜ without a basis in the Quran or the *Sunnah*.[25] For an example of a valid *Ijmā*ᶜ, the consensus of the Prophet's companions on the allocation of one sixth for a grandfather from the estate of the deceased was based on one-sixth proportion of a father since the grandfather may assume the father's position in the absence of the latter.

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[23] Al-Zarqā', *Al-Madkhal*, pp. 63-64, Abu Zahrah, *Uṣūl*, pp. 103-104, Weeramantry, C. G. *Islamic Jurisprudence; An International Perspective*. London: Macmillan, 1988, pp. 34-35.

[24] Al-Zuḥaylī, Wahbah. *Uṣūl al-Fiqh al-Islāmī*. Beirut: Dār al-Fiqh al-Muᶜāṣir, 1998 v. 1, pp. 542-543.

[25] Al-Zarqā', *Al-Madkhal*, v. 1, pp. 64-65.

*Ijmā*ᶜ may take two forms, *ijmā*ᶜ *qaulī* or *ijmā*ᶜ *ṣarīh* (verbal consensus) and *ijmā*ᶜ *sukūtī* (silent consensus). The former, which is unanimously accepted by Islamic scholars, is the express acceptance of all the scholar involved in the *Ijmā*ᶜ. Each of them expressly accepted the same opinion on a certain legal rule, whereas the latter is a consensus with no refusal but without express acceptance from every scholar. Thus, some of the Islamic scholars do not consider such an *Ijmā*ᶜ to be a legally binding *Ijmā*ᶜ.[26]

The classical Islamic scholars unanimously accepted *Ijmā*ᶜ as a source and a method of legislation, despite their different bases of *Ijmā*ᶜ. The Ḥanafī scholars based their acceptance of *Ijmā*ᶜ on equity and would abide by the *Ijmā*ᶜ of scholars of any age, whereas the Ḥanbalī and Mālikī scholars confined their acceptance on *Ijmā*ᶜ only to the consensus of the companions of the Prophet and of the scholars of Medina respectively.[27] Furthermore, they also differed in accepting an *Ijmā*ᶜ whose basis is *Qiyās* or *Maṣlaḥah*. Basically, there is no *Ijmā*ᶜ based on these two since both *Qiyās* and *Maṣlaḥah* methods are not unanimously accepted and recognised by Islamic scholars. If the opinion or rule was discovered through *Qiyās* or *Maṣlaḥah* based on the Quran or the *Sunnah* provision or the *ᶜillah* (effective cause) is a clear and distinctive (*ẓāhirah*) attribute, then the *Qiyās* may be accepted as the basis of *Ijmā*ᶜ. However, such recognition is actually made to the provision of either the Quran or the *Sunnah* and not the *Qiyās* or the *Maṣlaḥah* per se.[28]

(b) The *Qiyās* (reasoning by analogy)

The *Qiyās* is recognised as the fourth basis of Islamic Law in rank for its strength and significant method for formulating rules. It is an extension of a legal rule from *al-aṣl* (the original case) to *al-far*ᶜ (a subsidiary case) for the existence of

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[26] Abu Zahrah, *Uṣūl*, pp. 191-193, Al- Zuḥaylī, *Uṣūl*, v. 1, pp. 551-553.
[27] Weeramantry, *Islamic*, pp. 39-40.
[28] Abu Zahrah, *Uṣūl*, pp. 195-197.

a similar *ᶜillah* common to both cases. It obtained its recognition as a source of law for it is a reasoning by analogy that is strongly emphasised in a few of Quranic verses[29] and the Prophet (peace be upon him) himself used to decide a case by *taᶜlīl al-ḥukm* (reasoning). For instance, it is reported that the Prophet (peace be upon him) said, "Verily, permission is required (before entering into someone's house) for the sake of eyesight." The Prophet (peace be upon him) had used reasoning in justifying the prohibition of entering into someone's house without permission in order to prevent the visitor from viewing forbidden scene.[30]

In legislation by *Qiyās* methodology, there are always four fundamental elements, the original case, the subsidiary, the rule for the original case and the *ᶜillah*.[31] An attribute that satisfies all the conditions of *ᶜillah* must be discovered between the two cases so as to apply the same legal rule. The *ᶜillah*, which is actually the foundation of *Qiyās*, is a form of a *waṣf* (an attribute) that must be *ẓāhir* (clear) to be the ground for the underlying rule, *munḍabit* (constant), *munāsib* (proper or convenient), *mutaᶜaddī* (transitive) and in conformity with the principle of Islamic Law.[32]

The *ᶜillah* must be an attribute that is obviously causal in nature; meaning that the existence of such an attribute was clearly the reason for the underlying rule, such as an admission of a person should effectively affirm his lineage with someone. The attribute must also be a constant attribute, which is unchanged by different times or persons, for example, the intoxicating effect of alcohol. It is also required that the attribute must be proper and convenient with the rule from Islamic Law, without the need for further elaboration, such as the prohibition on the consumption of alcohol because of its intoxicating effects which can damage human's reasoning.

[29] For instance, in the verse 59:2 that read, "...Learn a lesson then, o you who are endowed with insight."
[30] Abu Zahrah, *Uṣūl*, p. 208.
[31] Abu Zahrah, *Uṣūl*, p. 213.
[32] Abu Zahrah, *Uṣūl*, pp. 221-222.

It is further required that such an attribute can be applied to other cases, for example the intoxicating effects of other substances such as drugs and certain chemicals. Finally, the attribute should not contradict any provision of Islamic Law so that it overrules an existing rule that relies on a *dalīl.*[33]

Relatively, a legal rule may be determined through *Qiyās* methodology once the requirements of *ᶜillah* are fulfilled. However, *Qiyās* is not allowed in matters that are expressly limited to the original case only, like the testimony Khuzaymah, in which a testimony of one witness is admitted as legal evidence contrary to the general requirement of two witnesses. There must be no *Qiyās* too in cases that are contradictory to the concept of reasoning, for instance, the numbers of *rakaᶜāt* (prostrations) in prayers, where the human mind cannot understand the reason for the rule. Despite the status of *Qiyās* as a source of law, a *Qiyās* cannot be practised on a legal rule that is established by another *Qiyās*. It must be based on a legal rule derived from the Quran, the *Sunnah* or the *Ijmāᶜ*. In general, a *Qiyās* is accepted as a source of Islamic Law and a method law-making provided that the requirements are satisfied and the established rule does not contradict any basic principle or any provision of the Quran or the *Sunnah.*[34]

(c) *Maṣlaḥah* or *Istiṣlāḥ* (reasoning by public interest)

Legally, the term *Maṣlaḥah* refers to the protection of the five objectives of the Islamic Law, the preservation and protection of mankind's faith, life, intellect, offspring or lineage and property. It also includes protection of any element that is directly or indirectly related to these five objectives. The consideration given to these interests must be based on Islamic Law, not on the interests of individuals. In other words, in determining the position of a specific subject, the reasoning must be

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[33] Abu Zahrah, *Uṣūl*, pp. 223-225.

[34] Abu Zahrah, *Uṣūl*, pp. 218-220, Aghnides, *Mohammedan*, pp. 61-62.

based on the concept of protection of these interests and the prevention of hazard and loss. Therefore, a case that has no legal rule provided by the primary sources must be evaluated through *Qiyās* methodology. If there is no eligible attribute to be the ᶜ*illah*, then it shall be decided in accordance with *Istiṣlāḥ* methodology.[35]

Maṣlaḥah may be divided into categories. It is classified into three groups according to the strength of their effect, *ḍarūriyyāt* (absolute necessities) such as the protection of life, *ḥājiyyāt* (expedient necessities) such as the legality of a contract of leasing and *taḥsīniyyāt* (accomplished interests), for example the promotion of good morals. *Maṣlaḥah* may either be a specific interest or a general interest that involves the public at large. Finally, it may also be divided according to its recognition in Islamic Law, as interest that is required and allowed, interest that is expressly disregarded and interest that is neither required nor disapproved by the Islamic Law.[36] Based on the classification of *Maṣlaḥah* above, the *Maṣlaḥah* or interests that may be accepted in the legislation by the *Istiṣlāḥ* method are those that are recognised by Islamic Law without contravening a specific provision. Furthermore, they must also be considered as necessities for individuals and people in general.[37]

(d) *Istiḥsān* (preference)

Istiḥsān is the method of legislation that usually overrules an opinion based on *Qiyās*. Literally, *Istiḥsān* means to hold something for its righteousness, but in legal terms, *Istiḥsān* denotes the deviation from a ruling derived from *Qiyās* to another rule ecause there is a stronger reason for such a deviation, or a deviation from *ḥukm kullī* (a general rule) to *ḥukm istithnā'i* (a specific exceptional rule). A

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[35] Al-Zarqā', *Al-Madkhal*, v. 1, p. 90, Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 706-709.
[36] Al-Zarqā', *Al-Madkhal*, v. 1, pp. 92-94, Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 770-773.
[37] Al- Zuḥaylī, *Uṣūl*, v. 2, p. 774.

rule based on *Qiyās* may be abandoned because stronger evidence has been found in the *Sunnah* or the *Ijmāᶜ*, or on the basis of necessity. If the necessity arises, the rule that was discovered through *Qiyās* must be abandoned in preference to common practice, *Maṣlaḥah* or another *Qiyās.*[38]

The departure from the rule or opinion based on *Qiyās* due to evidence found in the *Sunnah* or *ijmāᶜ* shows that the *Sunnah* and *Ijmāᶜ* should prevail when they are contradict *Qiyās*. Similarly, in a case of necessity where something forbidden has to be made permissible to a certain extent, a rule sought through *Qiyās* may be put aside.[39] Furthermore, where a rule derived from *Qiyās* methodology conflicts with another rule based on *Qiyās*, the priority must be given to the one that is easier and more flexibile rather than more difficult and complex.[40] Thus, although the *Qiyās* that has been overruled may be a *Qiyās jalī* (a definite *Qiyās*) than the other, which might be a *Qiyās khafī* (an indirect *Qiyās*), the latter is to be preferred if it increases the benefit and simplicity.

From the above, the basis of legislation by *Istiḥsān* may either be a provision from the Quran or the *Sunnah*, a rule or opinion sought through *Ijmāᶜ*, *Maṣlaḥah* or *Qiyās*, a common practice or a necessity. Any of these may become the evidence for a departure from a legal opinion discovered through *Qiyās* to another opinion or from a general rule to a specific rule, for instance, the legality of a will executed by a *safīh* (a profligate or a spendthrift) for a beneficial cause. A *safīh* is generally impeded from executing any transaction under the Islamic Law in order to protect his rights and interest over his property. However, by *Istiḥsān* methodology, such a will is acceptable since the purpose and effect of the will do not encroach on his rights and property. The will of course, only takes effect upon his death and the

[38] Abu Zahrah, *Uṣūl*, pp. 245-246, Al-Zarqā', *Al-Madkhal*, v. 1, p. 77, Al- Zuḥaylī, *Uṣūl*, v. 2, p. 736.
[39] This principle is based on the maxim, 'Necessities may justify the forbidden things', Al-Zarqā', *Al-Madkhal*, v. 1, p. 81.
[40] Abu Zahrah, *Uṣūl*, p. 247.

reason for this exception is that through his charitable actions he may receive blessings after death.[41]

(e) *'Urf* (public or common practice)

^{c}*Urf*, or in some cases known also as ^{c}*ādah* or *ta*^{c}*āmul*, legally means custom, tradition or common practice[42] that may take two forms, ^{c}*amalī* (practical) and *qaulī* (verbal).[43] Islamic scholars unanimously accept it as a basis of legislation in Islamic Law,[44] provided that all the requirements of a valid ^{c}*Urf* are satisfied. The common practice of the people may be legalised and recognised in Islamic Law when there is no specific provision of the Quran and the *Sunnah* to determine the status of the matter concerned. Public usage has also been referred to by classical scholars, especially the Ḥanafī and Mālikī, in order to clarify ambiguous provisions of the Quran and to specify its general terminology.[45]

The application of ^{c}*Urf* in legislation may sometimes abrogate the rules discovered through *Qiyās* that were based on an ambiguous provision,[46] especially when the issue concerns the public interest, as in the public recognition of *bay*^{c} *al-istiṣnā*^{c}, the interest of the people should be given priority though the contract is forbidden through *Qiyās*. Such a transaction is a void contract in *Qiyās* methodology as there is no capital deposited at the execution of the contract as in the permitted *bay*^{c} *al-salam*. However, as adapted by the Ḥanafī and Mālikī schools, the rule obtained through *Qiyās* is ignored since it is against the public need.[47]

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[41] Al-Zarqā', *Al-Madkhal*, v. 1, pp. 77-78, Al- Zuḥaylī, *Uṣūl*, v. 2, p. 746.
[42] Cowan, J. Milton (ed.). *The Hans Wehr Dictionary of Modern Written Arabic*. New York: Spoken Language Services, Inc. 1976 p. 606.
[43] Al-Zarqā', *Al-Madkhal*, v. 2, pp. 845-846, Al- Zuḥaylī, *Uṣūl*, v. 2, p. 829.
[44] Al-Zarqā', *Al-Madkhal*, v. 1, pp. 132-133, Al- Zuḥaylī, *Uṣūl*, v. 2, p. 838.
[45] Abu Zahrah, *Uṣūl*, p. 254, Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 835-836.
[46] Al-Zarqā', *Al-Madkhal*, v. 1, p. 135.
[47] Abu Zahrah, *Uṣūl*, pp. 255-256.

In order to obtain recognition or to be adaptable in legislation under Islamic Law, a practice must fulfil the requirement of a valid ᶜ*Urf*. The practice must firstly, have been followed continuously and be well known to the people of a certain place or of a certain profession.[48] Secondly, such a practice must have been applied from antiquity and not a recent phenomenon. For instance, in the interpretation of the Quranic term of *ibnu sabīl*, according to the usage during the revelation of the verse, such term refers to the one whose journey is disrupted. At a later period, people also used the term to include a foundling child. In such a case, the earlier interpretation must prevail.[49]

Furthermore, a practice may also become a binding rule in Islamic Law if such a practice has not been expressly refuted by any of the people of the place or profession concerned. If, in any particular case, there is an express statement providing a position different from the common practice, then such a practice should be applied therein. For example, according to common usage, the period for a tenancy agreement is two years. However, if the contracting parties expressly stated in the terms of agreement that the period of tenancy was to be three years, the common usage has no effect on this agreement. The contractual terms must be applied so that they are consistent with the maxim, 'No consideration for inference (*dilālah*) in the existence of express provision.'[50]

Most importantly, a practice needs to be in conformity with any divine provision or definite basis or doctrine of Islamic Law so as to be recognised as a binding practice. Thus, if a practice contravenes any of these provisions, it must not

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[48] Al-Zarqā', *Al-Madkhal*, v. 2, pp. 874-875.
[49] Al-Zarqā', *Al-Madkhal*, v. 2, pp. 876-878, Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 846-848.
[50] Art. 13, The *Mejelle (An Enlish Translation of Majallah al-Aḥkām al-ᶜAdliyyah and A Complete Code on Islamic Civil Law)*, translated by C. R. Tyser, D. G. Demeiriades & Ismail Haqqi Effendi, Lahore: Law Publishing Company (No Date), Al-Zarqā', *Al-Madkhal*, v. 2, pp. 879-880, Al- Zuḥaylī, *Uṣūl*, v. 2, p. 848.

be accepted unless the provision is a general rule, when the practice may be deemed a specific exception to the rule.[51]

(f) *Sadd al-dharāf* (blocking the means)

Literally, the term *al-dharāi*[c] is referred to the means of doing an act that will have a destructive (*ḍarar*) or forbidden (*maḥẓūrah*) result although the act itself may be legal.[52] For instance, it is forbidden for a judge to decide a case based on his personal information or knowledge of the accused since such a decision may cause injustice. Basically, the legality of the conduct or action of a person is determined from the consequences of such conduct. If the consequences are good or in the public interest, the said act is deemed as legally recommended since it establishes what is required in Islamic Law. However, if such an act causes damage or loss, it will be prohibited and must be avoided.[53]

In examining an act to see whether it is forbidden or not according to the concept of *Sadd al- dharāi*[c], an evaluation must be made of either the purpose or reason for such an act, or of the act itself and its effects. In the former approach, consideration is given to the motive of the act, whether it is sinful or against the act's legal purpose and whether such a motive could nullify the whole dealing in which the act was involved. To illustrate, the prohibition of a marriage that is intended to enable the former husband to remarry his ex-wife whom he has divorced three times. Such a marriage will be judicially rendered as void in accordance with the evidence proving such a motive for it is a denial of the legal purpose of a contract of marriage as required in Islamic Law.[54].

[51] Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 849-850.
[52] Abu Zahrah, *Uṣūl*, pp. 268-269, Al-Zarqā', *Al-Madkhal*, v. 1, p. 98, Al- Zuḥaylī, *Uṣūl*, v. 2, p. 902.
[53] Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 906-907.
[54] Al- Zuḥaylī, *Uṣūl*, v. 2, p. 908.

On the other hand, in the second approach of *Sadd al-dharāi^c* methodology in which an evaluation is made of the act and its effect, consideration is given to the result and consequences of the act. Although the act is initially permissible, it must be automatically deemed as void or forbidden if its consequences are illegal, harmful or detrimental to any person or property. If it has had beneficial or permissible effects, whether intended or not, the act maintains its permissibility.[55] For example, bargaining over a price offered by another buyer is prohibited since it contravenes the rights and interests of the buyer. Although offering to buy a goods at a certain price is allowed, in this case such a conduct would result in the denial of the first offerer's right to have a fair trade. Therefore, the act is forbidden based on such consequences.

In determining whether a particular act is permissible or not, al-Shāṭibī classified acts into four types in accordance with the strength of their results. First, a malicious act that will certainly lead to corruption or wickedness (*mafsadah*), second, an act that will be most unlikely to cause detriment or deprivation, third, an act that generally cause detriment or damage and fourth, an act that usually leads to forbidden consequences. Based on this classification, the first and the third categories are generally prohibited, unlike the others where the legality of the act must be determined on an individual basis.[56]

B.3. The *Qawā^{c}id Fiqhiyyah* (legal maxims)

As mentioned earlier, the classical scholars formulated *qawā^{c}id fiqhiyyah* to simplify the course of legislation. These *qawā^{c}id fiqhiyyah* are simply the basic principles derived from the Quran and the *Sunnah*. Literally, the term '*qā^{c}idah*' refers to a universal law that is applicable to almost every related aspect. For

[55] Al- Zuḥaylī, *Uṣūl*, v. 2, p. 909.
[56] Abu Zahrah, *Uṣūl*, pp. 271-272, Al- Zuḥaylī, *Uṣūl*, v. 2, pp. 914-915.

instance, the maxim 'Everything is determined by its purpose' implies that the status of every thing or action may be established by examining its motive and objective. In legal terminology, the term '*qāᶜidah fiqhiyyah*' is defined as the general basic legal principles, which are expressed in precise constitutional terms or simple statements or slogans that consist of certain legal rulings and doctrines applicable to the events or matters concerned.[57]

The numerous *qawāᶜid fiqhiyyah* that still exist were gradually formulated over a long period of time. Classical scholars formed the *qawāᶜid fiqhiyyah* from time to time based on the provisions of the Quran and the *Sunnah* or resulting from their study of the doctrines of Islamic Law, of the effective cause of legal rules and of decisions based on reasoning. Usually, the terms of the *qawāᶜid fiqhiyyah* originate from the *Sunnah*, like the maxim, '*lā ḍarar wa lā ḍirār*' (No damage and no mutual infliction of damage), but many were formed as a consequence of the scholars' study of the derivation of laws, of their reasoning and their interpretation of the primary provision.[58] Thus, it is clear that these *qawāᶜid fiqhiyyah* do not act as a source of Islamic Law but rather corroborative and affirmative evidence for decision-making.[59]

These *qawāᶜid fiqhiyyah* cover every aspect of Islamic Law, from Islamic Family Law to Islamic Criminal Law. They originated in and developed from five major *qawāᶜid fiqhiyyah*, which were rooted in the provision of the Quran and the *Sunnah*. The five original maxims later generated a number of *qawāᶜid farᶜiyyah* (subsidiary maxims).[60] The following are the above-mentioned five major *qawāᶜid fiqhiyyah* and some of the subsidiaries:

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[57] Al-Zarqā', *Al-Madkhal*, v. 2, pp. 946-947, Schacht, *The origins*, p. 188.
[58] Al-Zarqā', *Al-Madkhal*, v. 2, pp. 951-952.
[59] Al-Borno, Sudqi. *Al-Wajīz fī Qawāᶜid al-Fiqh al-Kulliyyah*. Riyadh: Maktabah al-Maᶜārif, 1990 pp. 31-32.
[60] Al- Sayūṭī, Jalaluddin A. Rahman. *Al-Ashbāh wa al-Naẓāir fī Qawāᶜid wa Furūᶜī Fiqh al-Shāfīᶜiyyah*. Egypt: Maktabah al-ᶜUlūm wa al-Ḥikam, 1959 pp. 7-8.

(a) 'The status of everything is determined by its purpose'[61]

This maxim means that the words and conduct of a person, in whatever dealing, are judged individually, as the motive and purpose of similar acts may vary from one person to another.[62] This provision is based on the *ḥadīth*, "Verily, all action shall be judged by their intentions or motives".[63] The application of this maxim is extended to the determination of the legal rule of the dealing involved, where the scholars had composed another maxim that has a similar effect, 'Consideration is given to the purpose and meaning of the contracts, and not to the words and forms'.[64]

(b) 'There shall be no damage and no mutual infliction of damage'[65]

The term *ḍarar* (damage) includes any action that may cause damage or injury to others. This maxim spells out the doctrine of promoting public interest and preventing damage and injury that becomes the basis for *Istiṣlāḥ* methodology. This maxim, which is based on the *ḥadīth*, "No damage and no mutual infliction of damage", also provides that an injury or damage occurred must be compensated with a better alternative rather than inflicting an equal damage since it would cause more damage and give no benefit.[66] Other similar maxims to this maxim are, 'A damage must be prevented as much as possible'[67] and 'The prevention of damage is preferred to the acquisition of benefit',[68] which means, when elements of damage

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[61] Art. 2, The *Mejelle*, Ibn Nujaym, Zainuddin Ibrahim. *Al-Ashbāh wa al-Naẓāir (commentary by Ibn Abidin, Muhammad Amin Umar and Muhammad Muti' al-Hafiz)*. Damascus: Dār al-Fikr, 1983 p. 22, Al-Nadwī, ᶜAli Aḥmad. *Al-Qawāᶜid al-Fiqhiyyah*. Damascus: Dār al-Qalam, 1994 p. 282.
[62] Al-Zarqā', *Al-Madkhal*, v. 2, p. 965, Ibn Nujaym, *Al-Ashbāh*, p. 22, Al-Borno, *Al-Wajīz*, p. 61.
[63] Al- Sayūṭī, *Al-Ashbāh*, p. 8.
[64] Art. 3, The *Mejelle*, Al- Nadwī, *Al-Qawāᶜid*, p. 286, Al-Borno, *Al-Wajīz*, pp. 84-85.
[65] Art. 19, The *Mejelle*, Ibn Nujaym, p. 94, Schacht, *The Origins*, p. 183.
[66] Al-Zarqā', *Al-Madkhal*, v. 2, pp. 977-980, Al- Nadwī, *Al-Qawāᶜid*, p. 287.
[67] Art. 31, The *Mejelle*.
[68] Art. 30, The *Mejelle*.

and benefit meet in a situation, the benefit must be ignored in order to avoid any further infliction of damage.

(c) 'Hardship (*mashāqqah*) causes the giving of facilitation or flexibility (*taysīr*)'[69]

This maxim provides principles on the prevention of hardship, damage or loss. Based on the verse, "...Allah intends every facility for you, He does not want to put you to difficulties",[70] this maxim states that hardships and burdensome actions must be avoided.[71] The term '*mashāqqah* in the maxim refers to those extraordinary hardships that may cause damage, loss or injury.[72] Especially in a case of necessity, an alternative must be provided to overcome the difficulties, such as the legislation of *rukhṣah* (permission or concession) in joining two prayers together. Unless there is no other means, then any prohibition may be lifted, as provided in the maxim, 'Necessities make forbidden things become permissible'.[73] A similar principle is also provided by the maxim 'Where a matter is narrow it becomes wide',[74] meaning whenever there is a necessity, there must be an exception from the general rule of the restriction or prohibition as long as the necessity exists.[75]

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[69] Art. 17, The *Mejelle*, Al- Sayūṭī, *Al-Ashbāh*, p. 76, Al- Nadwī, *Al-Qawāʿid*, p. 302.
[70] The Quran, 2:185.
[71] Al- Sayūṭī, *Al-Ashbāh*, p. 76, Ibn Nujaym, *Al-Ashbāh*, p. 84, Al- Nadwī, *Al-Qawāʿid*, p. 303.
[72] Al- Sayūṭī, *Al-Ashbāh*, p. 77-78, Ibn Nujaym, *Al-Ashbāh*, p. 98, Al-Zarqā', *Al-Madkhal*, v. 2, pp. 991-992.
[73] Art. 21, The *Mejelle*, Al- Sayūṭī, *Al-Ashbāh*, p. 84, Ibn Nujaym, *Al-Ashbāh*, p. 94, Al- Nadwī, *Al-Qawāʿid*, p. 308.
[74] Art. 18, The *Mejelle*, Al- Nadwī, *Al-Qawāʿid*, p. 308.
[75] Al-Zarqā', *Al-Madkhal*, v. 2, p. 994.

(d) 'The custom is of force'[76]

This maxim underlines the recognition of the *ᶜurf* (common practice) as a source of Islamic Law. Another similar maxim, 'A thing known by common practice is like a stipulation that has been made'[77] provides that the common practice among the people shall be binding in the absence of any provision of the superior sources of law.[78] In another subsidiary maxim, 'A thing known among the merchants is as though fixed by stipulation between them'[79] also affirms the precedence of common practice within a group of people working in a certain field or profession. However, such practices are obligatory only on that specific group with no effect on the general public.[80]

(e) 'The original status (*al-aṣl*) of everything is permissible'[81]

The classical Islamic scholars held differing opinions regarding the original rule for every non-regulated thing or subject. Some of the Ḥanafī scholars held that the original rule for everything is that it is forbidden until proven permissible, unlike the majority of Islamic scholar's view that said each thing or action is considered permissible until proven otherwise.[82] The latter view is based on a few verses of the Quran that state that every creature is made for mankind's consumption except those expressly forbidden by the divine provisions. For instance, the verse that reads, "Say, I find not in the *waḥy* (the divined message) revealed to me any food that is forbidden to be eaten by anyone unless it is a dead meat or blood poured forth or the flesh of swine – for it is an abomination – or what is *fisq* (impious) on which a name

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[76] Art. 36, The *Mejelle*, Al-Sayūṭī, *Al-Ashbāh*, p. 89, Ibn Nujaym, *Al-Ashbāh*, p. 101, Al- Nadwī, *Al-Qawāᶜid*, p. 293.
[77] Art. 43, The *Mejelle*.
[78] Ibn Nujaym, *Al-Ashbāh*, p. 101-102, Al-Zarqā', *Al-Madkhal*, v. 2, p. 999.
[79] Art. 44, The *Mejelle*.
[80] Al-Zarqā', *Al-Madkhal*, v. 2, p. 1001.
[81] Ibn Nujaym, *Al-Ashbāh*, p. 73, Al-Sayūṭī, *Al-Ashbāh*, p. 60, Al-Borno, *Al-Wajīz*, p. 129.
[82] Ibn Nujaym, *Al-Ashbāh*, pp. 73-74, Al-Borno, *Al-Wajīz*, pp. 129-132.

has been invoked other than Allah's."[83] Based on this provision, everything should be deemed as permissible as long as there is no proof of it being forbidden.[84]

Significantly, this maxim determines the permissibility of every consumable object and any act or conduct. By this position, anything that has no specific provision or, has not been proven prohibited by any legal methodology is deemed as permissible in Islamic Law. Thus, by virtue of this maxim, should there be an analysis of any particular subject so as to determine its legal rule, the approach is to maintain its permissibility until proof of prohibition of such a subject is discovered.

C. Objective and scope of this study

As explained in section A earlier, it is evident that the use of commodity futures contracts is a method of reducing risk and cost as well as an investment device. Trading in commodity futures contracts implies, in present practice, the placing of an order with a futures broker to buy or sell the commodity futures traded on a specified commodity futures exchange and cleared by its associate or an independent clearing house. The exchange, which provides an organised regulated market place and other trading facilities, trades standardised futures contracts after its designation as a contract market by the local authority. The clearing house, on the other hand, plays an important role in guaranteeing the performance of each traded contract through its clearing process. These two institutions, however, only allow their members to execute the contract and use their trading facilities. These members, as well as the general public who trade through the members, may be futures investors, speculators or pure commercial traders, who are usually known as the hedgers. Certainly, with such different motives for trading in futures, the commodity futures traders, especially the speculators and hedgers, have their own

[83] The Quran, 6:145.
[84] Al-Borno, *Al-Wajīz*, pp. 129-130.

strategies in order to manage their business. Thus, this study will attempt to analyse the contractual aspects of trading in commodity futures with a further examination of the activities and practices of the futures traders.

In order to determine the permissibility of every aspect related to the execution of a commodity futures contract and the activities of the traders, this study is divided into three parts, the first of which deals with the basic concepts of commodity futures contracts, the second is a discussion of their real mechanism. In the first two parts, the components and elements that relate to the contractual aspects of commodity futures trading are examined so as to determine its position in the framework of Islamic Law. Practical alternatives are provided at the end of the chapters whenever the element concerned needs alteration in order to be in conformity with the principles of Islamic Law. In part three, the activities and practices that represent the present function or purpose of trading in commodity futures are analysed. Emphasis is laid on hedging and speculative activities since, at present, most commodity futures are traded with these motives. It is worth mentioning that the concept, mechanism and practices of commodity futures trading are almost the same in every designated commodity futures market, whether it is, for example, Chicago Board of Trade in the United States or the Commodity and Monetary Exchange in Malaysia. Hence, the analysis in this study is based on a general approach towards commodity futures trading with specific reference to certain contract markets where necessary.

PAGE NUMBERING AS ORIGINAL

PART ONE

BASIC CONCEPT OF A COMMODITY FUTURES CONTRACT

CHAPTER ONE

THE COMMODITY FUTURES AND THE CONCEPT OF *AL-MAᶜQŪD ᶜALAYH* (THE CONTRACTUAL OBJECT) IN ISLAMIC LAW

1.1. Traded commodity futures

In the nineteenth century, futures trading was developed due to the need for a system for marketing agricultural products. Beginning with the centralised trade in eggs, butter, vegetables and grain in the United States in the late 1700's, agricultural futures trading was evolved to undertake the problems of the supply and demand of these commodities and eventually to overcome the financial risk and price fluctuation, which accompanied the marketing of these agricultural products.[1] Section 2(a)(1) of the United States Commodity Exchange Act 1968,[2] listed all the actively traded agricultural products including grain, edible oils, cotton, wool, livestock and juice. The definition of commodity futures was later expanded by the United States Commodity Futures Trading Commission Act 1974 to include metals, foreign currencies, stock indexes, bonds and many other goods and articles.[3]

Besides the definition given by the United States commodity regulations above, the regulations of other countries provide a more indefinite meaning of commodity

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[1] American Bar Association. *Futures and Derivatives: Basics*. Orlando: American Bar Association, 1996 pp. 101-102.

[2] Most of the provision of this Act were amended in 1975 by the *Commodity Futures Trading Commission Act* 1974. See, American Bar Association, *Futures*, pp. 100-101.

[3] Johnson, P. M. & Hazen, T. L. *Commodities Regulation*. Boston: Little, Brown & Company, v. 1, 1989 pp. 3-4.

futures, such as, in the Malaysian Futures Industry Act 1993 (amended 1997), futures instrument are defined as,

"Anything that is capable of delivery under an agreement for its delivery, including a commodity or a document creating or evidencing a thing in action, or any other thing that is prescribed to be an instrument..."[4]

By virtue of the above definition as well as the United States Commodity Futures Trading Commission Act provisions, it seems that any type of commodity may be traded as commodity futures on any designated futures market. Most of the futures exchanges at present specialise in trading a certain type of commodity, for instance, the Chicago Board of Trade majors in trading grain while the New York Cocoa Exchange exclusively trades in cocoa futures. However, some exchange may trade only in commodity futures of one type of goods, which may be traded in by other exchanges as well.[5]

Thus, anything may be the subject of a futures contract so long as the item is prescribed by the authority or regulatory body concerned, it becomes a commodity that may be traded on that particular futures market.[6] Usually, a commodity futures contract involves standardised terms of contract pertaining to the type, quantity, delivery time and place of the underlying commodity.[7] Thus, any object that could possibly be standardised according to such specifications is a prospective subject of a futures trading. However, although securities, services, rights and interests may

[4] Sec. 2, *Futures Industry Act* 1993 with the amendment of *Futures Industry (Amendment & Consolidation) Act* 1997.
[5] Hieronymus, Thomas. *Economics of Futures Trading for Commercial and Personal Profit.* New York: Commodity Research Bureau, Inc. 1981 p. 19.
[6] Johnson & Hazen, *Commodities*, v. 1, p. 7.

well become a subject of futures trading, the commodities that are usually subjected to the futures market are those which are tangible and physical in nature, making them deliverable and suitable for standardisation and grading. These commodities may also be storable for a short or indefinite period.[8]

Any type of commodity futures that is traded on any designated futures market must have its own contract specification. This contract specification contains all the standardised terms of a designed commodity futures contract, the quantity, grade, time and place of delivery, price limitations and other related requirements. (For example, see **Figure 1.1**) By this contract specification, a futures trader, either buyer or seller, has no opportunity to negotiate on the terms of the contract. Nevertheless, he is allowed to negotiate on the price of the commodity, which he does in the process of open outcry auction.[9]

As the trading in commodity futures is done through standardised and uniform terms of contract, the contracting parties only need to bid for the best price. Once the parties agree to a price, the seller is obliged to deliver the underlying commodity in accordance with the contract specification. On the other hand, the buyer reserves the right to demand such delivery as well as being responsible for paying the price upon delivery. In addition to these rights and obligations, both parties must deposit an initial margin as a security or financial guarantee for their performance of the futures contract obligations. This margin usually represents a certain percentage of

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[7] American Bar Association, *Futures*, p. 107.
[8] Herbst, A. F. *Commodity Futures Markets, Methods of Analysis and Management of Risk*. New York: John Wiley & Sons, 1986 pp. 201-202.
[9] Johnson & Hazen, *Commodities*, v. 1, p. 11.

the total value of the traded commodity futures in the contract they have executed, but it does not necessarily form a part of the commodity's price.[10]

CRUDE PALM OIL (CPO) FUTURES CONTRACT SPECIFICATIONS

Contract Size:
25 metric tans

Delivery Months:
Current and the next 5 succeeding months, and thereafter, alternate months up to 12 months forward

Price Quotation:
Malaysian Ringgit (RM) per metric ton

Minimum Price Fluctuation:
RM1.00 per metric ton

Daily Price Limits:
RM1000 per metric ton above or below the Settlement Prices of the preceding day for all months, except current month. Limits are expanded when the Settlement Prices of all three quoted months immediately following the current month, in any day are at limits as follows:

Day	Limit (RM)
First	100
Second	150
Third	200

Daily price limits will remain at RM200 when the preceding day's settlement prices of all the three quoted months immediately following the current settles at limit of RM200. Otherwise it shall revert to the basic limit of Rm100

Reportable Position:
100 or more open contracts, either long or short, in any one delivery month

Speculative Position Limit:
500 contracts net long or net short for any delivery month or all delivery months combined

Transaction Limit: Each single floor transaction shall hot exceed 20 lots

Last Trading Day:
A contract month expires at noon on the 15th of the month, if the 15th is a non-market day, the preceding business day

Tender Period:
First business day to the 20th day of the delivery month, if the 20th is a non-market day, the preceding business day

Contract Grade and Delivery:
Crude Palm oil of good merchantable quality, in bulk, unbleached, in Port Tank Installations located at the option of the seller
Free Fatty Acids (FFA) of palm oil delivered into Port Tank Installations shall not exceed 4% and from Port Tank Installations shall not exceed 5%
Moisture and impurities shall not exceed o.25%

Deliverable Unit:
25 metric tons, plus or minus not more than 2%
Settlement of weight differences shall be based on the simple average of the daily Settlement Prices of the delivery month from the 1st business day of the delivery month to the day of tender, if the tender is made before the last trading day of the delivery month, or the 1st business day of the delivery month to the business day immediately preceding the last day of trading, if the tender is made on the last trading day or thereafter

Figure 1.1. Contract specifications of crude palm oil (CPO) futures as traded on the Commodity and Monetary Exchange Malaysia, Kuala Lumpur.

[10] New York Institute of Finance. *Futures; A Personal Seminar*. New York: New York Institute of Finance Corp. 1989 p. 52.

1.2. The commodity futures in the perspective of Islamic Law

As mentioned above, a commodity futures contract is formed by an agreement between the original seller and the original purchaser who are accordingly making and taking delivery of an underlying commodity sometime in future. The seller, initially, does not have the said commodity in his possession, but he agrees to produce the exact amount and grade of the commodity as specified in the terms of the contract upon the maturity date. In fact, there is no exchange of goods and price at all between the contracting parties, only an exchange of promises to sell and to buy a specified commodity that must be delivered on a specified date. Normally, the purchaser pays a certain percentage of the whole value of the commodity at the time of contract. Thus, in this chapter, the discussion will be based mainly on the concept of *bay^c al –ma^{c}dūm* (sale of non-existent) in order to determine the permissibility of commodity futures to be an object of a contract within the purview of Islamic Law.

Before any further discussion, it is worth noting briefly the basic elements, which constitute a valid contract of sale[11] in Islamic Law. According to the Ḥanafī School, a valid contract of sale must have an offer[12] and an acceptance[13]. In fact, the offer and acceptance are the foundations of the other elements of a sale[14] that are

[11] A contract of sale or *bay^c* literally means an exchange of a thing for another, and legally means an exchange of ownership of a property for another, namely a consideration. See, Al-Jazīrī, ^{c}Abdul Raḥmān. *Al-Fiqh ^{c}alā al-Madhāhib al-Arba^{c}ah*, v.2, Beirut: Dar al-Kitab al-'Ilmiyyah, (no date) p. 147.

[12] In Arabic term, it is *al-ījāb*, made by the seller, which includes pronunciation of any words that may mean 'I sell to you' or 'I make you the owner of' and conducts that infer the same meaning thereof.

[13] It is called as *al-qabūl*, made by the purchaser that includes any pronunciation or act that indicates the meaning of 'I buy' or 'I accept the ownership'.

[14] Al- Jazīrī, *Al-Fiqh*, p. 155.

enumerated by Islamic scholars other than the Ḥanafī as the famous four elements; the congruence of offer and acceptance (*al-ṣīghah*), the contracting parties (*al-muta^cāqidān*), the object of sale (*al-ma^cqūd ^calayh*) and the consideration or the price (*al-badal*).[15] Specific stringent requirements are attached to these elements. For example, the contracting parties must be of full contractual capacity (*ahliyyah adā' al-kāmilah*) when entering into such an agreement.

As the main focus of this chapter is the object of the contract of sale, it is worth mentioning its major requirements as prescribed by most scholars. There are various conditions imposed on the object of sale, and the most important ones are that the object must be existent,[16] valuable,[17] capable of delivery[18] and determinably known[19] to both parties. Impliedly, the sale of a commodity which does not exist or which cannot be delivered at the time of the contract will generally be rendered as void ab initio.[20] Different opinions and analyses have been made concerning this matter, i.e. the validity of a sale in the absence of the subject matter, either the object or the price or both. Most of the views that mitigate the strict requirement of the existence of the object rely on the recognition of certain exceptional transactions in which the object of the sale does not exist at the time of the contract, despite of the opinions that held that exceptional cases is not analogous. It is worthwhile to

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[15] Al-Khafīf, ^cAlī. *Aḥkām al-Mu^cāmalāt al-Shar'iyyah*, (No Place): Dar al-Fiqh al-Arabi, (No Date) p. 369.
[16] Art. 197, *The Mejelle* (An English Translation of *Majallah al-Aḥkām al-^cAdliyyah* and A Complete Code on Islamic Civil Law), translated by C. R. Tyser, D. G. Demeiriades & Ismail Haqqi Effendi, Lahore: Law Publishing Company, (No Date).
[17] Art. 199, *The Mejelle*.
[18] Art. 198, *The Mejelle*.
[19] Art. 200-201, *The Mejelle*, Usmani, Muhammad Taqi. *An Introduction to Islamic Finance*. Karachi: Idaratul Ma'arif, 1999 pp. 97-100.

have a clear picture of the exceptional transactions that are legal under the Islamic Law even though the object does not in exist.

1.2.1. The principles of the non-existence of a contractual object in Islamic Law

There are varieties of contracts, which are invalidated under the Islamic Law framework due to the non-existence of the contractual object or the uncertainty of its existence in the future. This rule is generally based on the tradition in which the Prophet (peace be upon him) was reported to say,

"Do not sell what you do not own (what is not in your possession)."[21]

The above tradition however, does not actually infer that the sale of a non-existent is totally prohibited. Instead, it implies the prohibition of the sale of an object that is uncertain in terms of its existence in the future or upon the settlement of the sale. Therefore, a few contracts of sale, which involve a non-existent object, were made permissible in Islamic Law since the element of uncertainty is carefully avoided though the object does not exist at the execution of the contract. Some of the relevant exceptional contracts are, *bay[c] al-salam* (forward sale), *bay[c] al-istiṣna'* (sale of manufacture), *bay[c] al-[c]arayā* (sale of fresh dates by estimation), *bay[c] al-istijrār* (continuous sale), *bay[c] a-mu'ajjal* (deferred sale), and *bay[c] al- dayn* (sale of debt).

[20] It is also treated as *ghayr mun[c]aqid*, means, that there is no contract at all. See, Ibn Mufliḥ, Abī Isḥāq Burhānuddīn. *Al-Mubdi[c] fī Sharḥ al-Muqni[c]*. (No Place): Al-Maktab al-Islāmī, 1980 v. 4, p. 18, Al-Khafīf, *Aḥkām*, p. 372.

(i) *Bay^c al-Salam* (the forward sale)[22]

This is a contract of sale in which the price is paid in advance for specified goods that to be delivered at a fixed date and place. This contract is formed by an agreement between a buyer who pays the cash price (*ra's al-māl*), and a seller who will make the delivery of the contractual object at a later date agreed by the parties. Thus, the cash price must be paid at the time of contract, otherwise it becomes a void contract of sale.[23] The majority of Islamic scholars laid down such a requirement for a valid *bay^c al-salam* contract, but some scholars of the Malikī school ruled that the price might be paid at a later date with no condition. There is however, no indication given by these scholars as to whether the price had to be paid in full or whether it might be paid in part.[24]

It is further required in this contract of sale that the object of the contract or the goods must be measurable, weighable or quantifiable in nature,[25] so that the terms of the contract can be specific and certain. Thus, anything, which cannot be determined by these specifications, is not allowed to be an object of a *bay^c al-salam*

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[21] Quoted in, Al-Ḍarīr, al-Ṣiddīq Muḥammad al-Amīn. *Al-Gharar wa Atharuhu fī al-Fiqh al-Islāmī*. Beirut: Dār al-Jīl, 1990 p. 355.

[22] It is also known as *al-salaf*, which carries the same meaning, to advance payment in a contract without any immediate consideration. See, Al-Yusufī, M. H. *Zād al-Muslim*. Beirut: Dār Ehyā' al-Turāth al-^cArabī, (No Date) p.71.

[23] Al-Shāfi^cī, Abū Abdullāh Muḥammad Idrīs. *Al-Umm* (with commentary by Mahmūd Maṭrājī). Beirut: Darul Kitab al-'Ilmiyyah, 1993 v. 3, p. 116, Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ ^calā Matn Minhāj al-Ṭālibīn*. Damascus: Dār al-Fikr, (No Date) v. 2, p. 102, Ibn ^cĀbidīn, Muḥammad Amīn. *Radd al-Muḥtār ^calā Durr al-Mukhtār Ḥāshiyah Ibn ^cĀbidīn*. Pakistan: Maktabah Majīdiyah, 1399H v. 4, p. 226, Al-Zarkashī, Shamsuddīn Muḥammad. *Sharḥ al-Zarkashī ^calā Mukhtaṣar al-Kharqī*. Riyadh: Maktabah al-^cAbikān, 1993 v. 4, pp. 3, 4 & 13, Ibn Mufliḥ, v. 4, p. 177.

[24] Al-Jazīrī, *Al-Fiqh*, v. 2, pp. 305-306.

[25] Al- Sharbīnī, *Mughnī*, v. 2, p. 105, Ibn ^cĀbidīn, *Radd*, v. 4, p. 226, Al-Zarkashī, *Sharḥ*, v. 4, pp. 8-9, Al-Zuḥaylī, Wahbah. *Al-Fiqh al-Islāmī wa Adillatuh*. Damsyik: Dār al-Fikr, v.4, 1989 p.603.

contract. Briefly, the object must be made known by its specifications and be deliverable at the contractual maturity date.[26] On the other hand, the deferment must also be specific[27] for the finalisation of the contract, i.e. the delivery of goods. To illustrate, A, the purchaser, pays B the seller, £50 for 200 kilos of unbleached wheat flour, which is to be delivered in three months, which means that A paid £50 as the price for the said flour which B is willingly to deliver three months after the date of the contract.

This contract of sale had been legalised by virtue of the Quranic verse that reads as follow,

> "O you who believe, when you deal with each other in any dealing involving future obligation in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties, let not the scribe refuse to write as Allah has taught him, so let him write. Let him who incurs the liability dictate, but let him fear Allah, and not diminish aught (anything) of what he owes... And get two witnesses out of your own men, and if there are not two men, then a man and two women such as you choose for witnesses, so that if one of them errs, the other can remind her.[28]

The above verse, which is known as *āyah mudāyanah* (the loans and credits verse) clearly authorised transactions involving future obligation in a fixed period of

[26] Ibn Mufliḥ, v. 4, pp. 178, Al- Sharbīnī, *Mughnī,* v. 2, pp. 106-109, Ibn ᶜĀbidīn, *Radd,* v. 4, p. 230, Al-Zarkashi, v. 4, pp. 9-10, Al-Būṭī, Muḥammad Taufīq Ramaḍān. *Al-Buyūᶜ al-Shāiᶜah wa Athar Ḍawābiṭ al-Mabīᶜ ᶜalā Sharᶜiyyatihā.* Damsyik: Dār al-Fikr, 1998 p. 145.
[27] Al-Qurṭubī, Abū ᶜAbdullāh Muḥammad. *Al-Jāmiᶜ li Aḥkām al-Qurān.* Cairo: Matba'ah Dār al-Kutūb al-Miṣriyyah, 1935 p. 377, Al- Sharbīnī, *Mughnī,* v. 2, p. 105, Al-Zarkashī, *Sharḥ,* v. 4, p. 12, Al-Zuḥaylī, *Al-Fiqh,* v. 4, p. 607.

time as long as it was recorded or witnessed. As Al-Qurṭubī says in interpreting this verse, some of the Maliki scholars had gone further by saying that this verse includes all types of transactions involving *mudāyanah* (loan and credit),[29] although its cause of revelation (*sabab al-nuzūl*) is to approve the practice of *bay*ᶜ *al-salam*.

This contract is further recognised by the Prophet (peace be upon him) where he is reported to have said,

> "Whoever pays money in advance for something (to be delivered later) should pay it for a known specified measure, weight and time (to be delivered).[30]

From the above verse and tradition, it may be summed up that such a speculative transaction is legal if the object of contract is known and guaranteed, and the seller is able to fulfil his obligation in time, since this transaction is permitted in consideration of some traders who are unable to deliver the goods immediately. In addition, the specification of time of delivery, weight and measure of goods is regarded as evidence for the existence of the goods.[31] In other words, the specifications act as the main factor in removing the elements of risk and uncertainty in *bay*ᶜ *al-salam*.

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[28] Translation of the Quran, 2:282.
[29] Al-Qurṭubī, *al-Jāmi*ᶜ, v. 3, p.377.
[30] Al-Yusufī, *Zād al-Muslim*, p.71. For other traditions, see, Hasan, Ahmad. *Sunan Abu Dawud English Translation.* India: Al-Madina Publication (P) Ltd., 1985 v. 3, p.275-276.
[31] Hasan, Abdullah Alwi. *Sales and Contracts in Early Islamic Commercial Law*. Islamabad: Islamic Research Institute, 1994 p.67.

(ii) *Bay^c al-Istiṣnā^c* (sale of manufacture)

This transaction is another contract of sale involving non-existent objects in which the seller agrees to produce or manufactures something according to the detailed specification given by the buyer. The raw material may be provided by the buyer or from the seller's property,[32] and the price may be paid at any time, totally or partially, or even in instalments.[33] For example, a baker asks a flour manufacturer to produce for him 200 kilos of wholemeal flour for a total cost of £100. The buyer may advance a deposit of £50 and pay the rest in instalments or pay the whole sum at the time of contract or at the delivery time.

In this transaction, there is no requirement to fix a period or date of delivery, which makes it different from *bay^c al-salam*. In fact, according to Ḥanafī scholars, both parties may set aside their respective obligations at any time before the delivery is made.[34] However, it is required for the validity of this contract, just as for a *bay^c al-salam* contract, that the underlying contractual object must be fully specified by its measure, quality, quantity or any other relevant attribute. Furthermore, the object must also be a property that conforms to common usage. In addition, there should be no specification of date of delivery since, if there is one, the contract will become a *bay^c al-salam* contract. According to Ḥanafī scholars, if the last two requirements are not fulfilled, then the rules of *bay^c al-salam* contract shall apply thereto.[35]

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[32] Ibn ^cĀbidīn, *Radd*, v. 4, p. 236, Al-Zuḥaylī, *Al-Fiqh*, v.4, p.631.
[33] Ibn ^cĀbidīn, *Radd*, v. 4, p. 236, Al-Ashqar, Shabīr *et al. Buhūth Fiqhiyyah fī Qaḍāyā Iqtiṣādiyyah Mu^cāṣirah*. Amman: Dār al-Nafā'is, v.1, 1998 p.227 & 232.
[34] Ibn ^cĀbidīn, *Radd*, v. 4, p. 237, Al-Ashqar, *Buhūth*, v.1, p.235. See also, Al-Sālūs, *Al-Iqtiṣād*, v.2, p.973.
[35] Ibn ^cĀbidīn, *Radd*, v. 4, pp. 236-237, Al-Khafīf, *Al-Aḥkām*, p. 398.

The majority of scholars did not allow this contract on the ground that it is a sale of non-existent goods whose formation is different from that of *bay^c al-salam* and it therefore contravenes the concept of *Qiyās*. However, if the contract observes all the requirements of *bay^c al-salam*, then it is legal and considered as a *bay^c al-salam* transaction in manufacturing.[36]In a *bay^c al-salam* contract of manufacture, both the price and the object must be made known by stipulating their grade, type, quantity and criteria. Furthermore, the money must be deposited at the execution of the contract. Upon its conclusion, the seller is entitled to the money and the buyer to the forward delivery of the goods.[37]

On the other hand, the Ḥanafī scholars considered that *bay^c al-istiṣnā^c* is not a type of *bay^c al-salam* and should not therefore be restricted to the requirements of *bay^c al-salam*. In other words, it is a legal transaction on its own by virtue of the concept of *Istiḥsān* (preference).[38] The Ḥanafī only differed on the nature of this transaction, whether it is a promise or a contract of sale. It appears that the stronger view between the two is that it is a contract,[39] which is not obligatory on the contracting parties[40] so that the parties may waive their rights and duties at any time before delivery.

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[36] Al-Sālūs, *Al-Iqtiṣād*, v. 2, p.942-948.
[37] Al-Būṭī, *Al-Buyū^c*, p.170.
[38] *Istiḥsān* consists of two types; a preference of *qiyās khafī* than *qiyās jalī* and an emergence from a general rule for a *dalīl* (proof) which may be in the form of tradition, *ijmā^c* (consensus) or necessity. Pertaining to *bay^c al-istiṣnā^c*, the *dalīl* of its legality is *ijmā^c al-ta^cāmul* (customary consensus). See, Al-Sālūs, *Al-Iqtiṣād*, v.2, p.959.
[39] Al-Sālūs, *Al-Iqtiṣād*, v.2, p.956.
[40] Ibn ^cĀbidīn, *Radd*, v. 4, p. 236, Al-Zuḥaylī, *Al-Fiqh*, v.4, p.633.

Generally, it seems that this non-obligatory contract, though speculative in nature, establishes a perfect model of a *bay^c al-ma^{c}dūm* in order to analyse the commodity futures contract as this is also speculative and non-obligatory in nature. The detailed specification of the object to be produced or manufactured serves as evidence for its existence in future. This, of course, makes the transaction more certain and less risky.

(iii) *Bay^c al-^{c}Arayā* (contract of barter in dates or sale of fresh dates by estimation)

This contract of *bay^c al-^{c}arayā* may be considered as a type of *bay^c al-gharar* (aleatory sale) rather than *bay^c al-ma^{c}dūm* (sale of non-existent) group. Such a contract involves the sale of an existent object, the fresh dates which are yet to be harvested with no specific weight. It is made permissible as an exception to the forbidden *bay^c al-muzābanah* (sale of non-estimated fruit on the tree for a specified measure of fruit). The latter is forbidden[41] as it consists of an uncertain amount of object of sale for a determined price, whereas in *bay^c al-^{c}arayā*, a person is allowed to sell his fresh dates while they are still on the palms, by means of estimation as dried harvested dates. Its legality is based on the tradition in which the Prophet (peace be upon him) is reported to have approved this sale since it is made upon a calculated amount; in fact, the buyer may have the fruit while they are fresh.[42]

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[41] The prohibition was laid down in a tradition reported by Ibn ^{c}Umar, saying that the Prophet (peace be upon him) forbade the sale of fruit on the tree for fruit by measure, and sale of grapes for raisins by measure, and sale of harvest for wheat by measure. See, Ḥasan, *Sunan*, v. 2, p. 955.

[42] Ḥasan, *Sunan*, p. 955-956. See also, Ḥasan, *Sales*, p. 74.

It is noted that as long as the invalidating elements of uncertainty in the object of sale are carefully removed, like the estimation of non-specified dates in a *bay^{c} al-^{c}arayā*, a prohibitory contract may be made permissible under Islamic Law. In other words, a contract which is initially regarded as a type of *bay^{c} al-gharar* or *bay^{c} al-ma^{c}dūm* can be legalised if the elements of risk and uncertainty attached to such contracts are carefully removed from its formation through standard rules and conditions.

(iv) *Bay^{c} al-istijrār* (continuous contract of sale)[43]

This transaction is called a continuing sale as the buyer, in most cases, continuously takes goods from the seller where the prices are calculated later and paid at the expiry of an agreed time, for example a week or a month. In other cases, the buyer may pay a sum of money in advance and spend it accordingly. For a simple illustration, X needs a kilo of sugar and a kilo of flour to fulfil his weekly requirement. He then enters into an agreement with Y, the seller, in which X will take his needs from Y every week and pay the total price at the end of the month.

Most Islamic scholars, including the Ḥanafī and the Ḥanbalī, allow this transaction although there is no prior agreement on the specific price of each good taken, since in most cases both buyer and seller know the exact price of the goods.[44] Furthermore, if the goods taken are ones which have no consistent market price the

[43] Some scholars categorised this contract as a loan transaction (*qarḍ al-a^{c}yān*) while others classified it as a guarantee or security agreement (*ḍamān al-mutlafāt*). See, Shalabī, Muḥammad Muṣṭafā. *Al-Madkhal fī al-Fiqh al-Islāmī*. Egypt: Al-Dār al-Jam'iyyah, 1985 p. 502.
[44] Ibn ^{c}Ābidīn, *Radd*, v. 4, p. 14.

seller is allowed to calculate the price of the goods according to the most recent market price.[45]

In addition, the scholars upheld that even though this contract is a type of *bay^c al-ma^cdūm*, it is exempted from the general prohibition as they found that the public's need of this sale had attained the degree of necessity.[46] To fulfil public necessity is preferable to strictly enforcing the general stringent requirement of a valid contract. This view meets the meaning of the legal maxim that says, "Necessities justify the forbidden things"(*al-ḍarūrāt tubīḥ al-maḥzūrāt*).[47]

(v) *Bay' al-muajjal* (deferred sale)

Technically, this contract of sale is formed in the opposite way to *bay^c al-salam* in terms that the price is deferred in this contract, while in *bay^c al-salam* the object of sale is deferred to a fixed date. In terminology, this sale includes several types of deferred sales. The most commonly practised are *bay^c bi thaman ajil* (deferred payment sale) and *bay^c al-^cinah* (cash sale for a deferred payment sale).

Bay^c bi thaman ajil is a type of sale where the buyer has the possession of the goods while paying the price at a later date. For instance, nowadays, a buyer who purchased a car may effectively possess the car and make the payment in

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[45] Shalabī, *Al-Madkhal*, p. 502. See also, Ibn Qayyim, Abū ^cAbdullāh Bakr. *I^clām al-Muwaqqi^cīn*. Beirut: (No Publisher), 1970 v. 3, p. 302.
[46] Shalabī, *Al-Madkhal*, p. 503.
[47] This legal maxim had been derived from a few Quranic verses, among others, "...But if any one is forced by hunger, with no inclination to transgression, Allah is indeed oft-forgiving, most merciful, the Quran, 5:3. See, Al-Nadwī, ^cAlī Aḥmad. *Al-Qawā^cid al-Fiqhiyyah*. Damsyik: Dār al-Qalam, 1994 p. 308.

instalments to the seller. On the other hand, *bay^c al-^cinah* is not a solid contract of sale but is formed by two different sales, the first sale (immediate cash sale) and the second sale (deferred payment sale, i.e. *bay^c bi thaman ajil*). It is worth noting that the intention of this contract is to create a sum price difference between the two sales.[48] To illustrate, a prospective vehicle purchaser goes to a financier asking him to purchase a car on his behalf. The financier later, buys a car from a dealer for say £10,000 cash. He then sells the car to the real purchaser for £12,000 on credit. The purchaser may advance a deposit and pay the instalments for a fixed period, depending on their terms of contract.

The majority of Islamic scholars disapprove of such transactions and declared them void and sinful. They consider that the formation of this contract is nothing but a *ḥilah* (legal device or stratagem)[49] to legalise a *ribā* transaction in the face of a sale and purchase agreement.[50] They further argue the legality of *bay^c al-^cinah* by quoting a few traditions that forbid such transaction on the basis of *sadd al-dharā'i^c* (blocking the means) since the ultimate purpose of this contract is to give a loan with interest. However, according to Imām Al-Shāfi^cī, this transaction is a valid contract as it fulfils all the requirements of a valid contract. In addition, the intention of the contacting parties behind the agreement is a matter belonging to Allah and is not considered in determining its legality in Islamic Law.[51] It seems that Imām Al-

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[48] Ibn ^cĀbidīn, *Radd*, v. 4, p. 272, Al- Zuḥaylī, *Al-Fiqh*, pp. 466-467, Wan Ibrahim, Wan Ismail. " *Bay^c al-^cinah* as a useful Islamic Instrument" presented in, *International Islamic Capital Market Conference '97* at Kuala Lumpur, p. 5 (1997).

[49] Ḥīlah is a practice of accommodating the existing law or principles to fit the changes in the society and its usage. Most of the classical scholars recognised this concept based on its practicability but to a certain limited extent in that it must not be immoral in terms of it permits a forbidden subject. See, Rayner, S. E. *The Theory of Contracts in Islamic Law*. London: Graham & Trotman, 1991 pp. 23-25.

[50] Ibn ^cĀbidīn, *Radd*, v. 4, p. 272, Wan Ibrahim, "*Bay^c*", p. 6.

[51] Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 469.

Shāfi^c^ī's view is preferable when considering the apparent mechanism of *bay^c^ al-^c^inah* in terms of its validity because this approach is similar to the precedent taken by civil courts at present. In other words, it may be inferred that if the formation of *bay^c^ al-^c^inah* complies with its standard rules that can eliminate risk and uncertainty, there is no reason why it should not be allowed.

(vi) *Bay^c^ al-dayn* (sale of debt, either for another debt or cash)

Bay^c^ al- dayn may be classified into two, *bay^c^ al-dayn nasī'ah*[52] (sale of debt for another debt) and *bay^c^ al-dayn naqdan fī al-hāl* (sale of debt for cash on spot). Islamic scholars are unanimously agreed that the former is totally forbidden, although they differ in the basis of the prohibition. Most refer to the tradition in which the Prophet (peace be upon him) clearly forbade such transactions[53] while others who allege the weakness of this tradition consider that the prohibition is based on public or general consensus (*ijmā^c^*).[54] The prohibition is applied in both cases, either the sale is made between the creditor and the debtor or between the creditor and a third person. For instance, P owes Q 100 kilos sugar returnable in four months. Prior to the expiry, Q sells the sugar to P or a third person for £50 payable in two months. This sale is unlawful since it involves exchange of debt for debt in which a risk of unavailability for delivery at the completion of the contract arises.

[52] This transaction is also termed as *bay^c^ al-dayn bi al-dayn* or *bay^c^ al-kāli' bi al- kāli'*.
[53] Al-Shawkānī, Muḥammad ^c^Alī Muḥammad. *Nayl al-Awṭār Sharḥ Muntaqā al-Akhbār*. (No Place): Maktabah al-Aymān, (No Date) v. 5, p. 156.
[54] Al-Zuḥaylī, *Al-Fiqh*, v. 4, p. 432.

Unlike *bay^c^ al-dayn nasī'ah*, *bay^c^ al-dayn naqdan* does not leave room for such a risk, especially if the sale is made between the creditor and the debtor. For example, Q agrees to sell the 100 kilos sugar, which P owes to P himself for a price of £50 that Q has borrowed from P. This contract does not involve any risk, as there is no need of delivery or exchange of goods and price. However, Ḥanafī and Ẓāhirī scholars disallow such transactions if the sale is made to a third party, because it involves the risk of delivery whereas other scholars still approve provided that the debtor has guaranteed to pay his debt.[55]

Having considered these different opinions, it may be concluded that the sale of debt is regarded as unlawful until it is devoid of any risk and uncertainty by means of a guarantee on behalf of the debtor but it seems that this transaction is not really analogous to the discussion concerning the object of contract in a commodity futures contract as there is no debt owed by the original seller and the ultimate buyer or vice versa.

1.2.2. The position of commodity futures in Islamic Law

Generally, the above-mentioned contracts of sale are among the transactions that have been categorised as *bay^c^ al-ma^c^dūm* which are legal although there are a few juristic opinions that oppose to the legality of some of them. While the other categories of *bay^c^ al-ma^c^dūm* are not permissible due to the existence of *gharar fāḥish* (excessive risk), for example, sale of flying birds and *bay^c^ al-muwāṣafah*

[55] Al- Zuḥaylī, *Al-Fiqh*, p 433-435.

(sale of goods by description without inspection or possession). Furthermore, the prohibition is extended to those contracts which carry the possibility of *ghubn* (fraud) that deter one or the other of the contracting parties from having a fair trade, for instance, sale of prospective inheritance and *bay^c al-kālī' bi al- kālī'* (sale of credit for credit).[56]

Muslim jurists have unanimously agreed that sanction is only given to the above-mentioned exceptional transactions after the inherent factor of prohibition is lifted, i.e. the element of *gharar* is avoided by forming various standard conditions and rules. These conditions and rules are outlined in order to establish some sort of guarantee or evidence of the existence of the object of sale. Referring to al-Sanhūrī's analysis in his work (*Maṣadir al-Ḥaq*), the yardstick to determine whether a non-existent object could constitute a valid contract or not is that assurance must have been given of the object's existence in the future (*muḥaqqaq al-wujūd fī al-mustaqbal*). This concept covers also the object which most probably will exist, such as the sale of flour which is still in the form of wheat grain.[57]

It has been agreed by past and present scholars that the *^cillah* (effective cause)[58] of forbidding the sale of a non-existent object is the risk of producing the object upon the maturity date, and not its non-existence at the time of contract per se. This was clearly shown in the legality of a *bay^c al-salam* contract, though it is a sale of a non-existent object, it was approved by the Prophet (peace be upon him)

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[56] Ḥasan, *Sales*, pp. 50-65.
[57] Al-Sanhūrī, ^cAbdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī*. Beirut: Dār Ehya' al-Turāth al-'Arabī, (No Date) v. 3, p.31-33.
[58] For further explanation, please refer to the preceding introductory chapter.

for the assurance that the object of sale will exist in future by a full description of the object concerned and by fixing a date for its delivery. Based on this, it is shown that some scholars invalidate other types of *bayᶜ al-maᶜdūm* as they find that the conditions attached to those contracts do not actually remove the risk.

Therefore, if there is any factor in the formation of a contract that can primarily eliminate the risk by adducing evidence or establishing a guarantee or assurance for the existence of the object, such a contract is then legal and valid under Islamic Law. For instance, the above *bayᶜ al-salam* was approved by the Prophet (peace be upon him) as the seller agreed to produce the specified goods using the capital which had been advanced by the purchaser as the price of the goods. It does not render a *bayᶜ al-salam* contract a risk-free transaction since the seller might turn up with a different object, which is not in accordance with the specification. Pertaining to this matter, the Prophet (peace be upon him) is reported to have ordered a seller to return the buyer's money, as he was incapable of producing the goods in a *bayᶜ al-salam* contract.[59] However, the probability of risk is insignificant to the transaction and should not render the contract void.

Similarly, in other speculative transactions that fall within the ambit of the exception from the general prohibition, the remaining slight risk (*gharar yasīr*), which cannot be avoided, can be dealt with by providing certain conditions and rules. For example, in a *bayᶜ al-istiṣnāᶜ* transaction, the parties are entitled to set aside their obligations, or reserve the right of option or *khiyār*, in case of default in

[59] Ḥasan, *Sunan*, v.3, p. 276.

payment of the price or in the event that the object of sale fails to meet with the agreed specifications.

Applying the above principles to non-existent contractual objects, the underlying commodity in an agricultural commodity futures contract is more or less the same as the objects of *bay^c al-salam* and *bay^c al-istiṣnā^c*. The traded commodity futures is comparable to these two transactions rather than the other types of contract mentioned earlier, since the underlying commodity in a commodity futures contract has been specified in standard terms in the contract. The future delivery of the commodity must be made according to the specification and the commodity delivered at a pre-determined time and place.

Comparing the object of a commodity futures contract with a *bay^c al-salam* transaction, it seems that a commodity futures contract could not be considered legal as a *bay' al-salam* contract according to Islamic Law, because there is no requirement of paying the whole price of the commodity at the contracting time in a commodity futures contract as required in a *bay^c al-salam* contract. Although one of the Malikī scholars allow such a payment to be made at a later time, the deferment is approved only for three days after the contract, because the original purpose of advancing the price in the beginning is to provide capital for the seller in producing the goods. Therefore, it is believed that a *bay^c al-salam* contract is not sufficiently analogous a commodity futures contract. Even if it could be established that the initial margin paid by the buyer at the time of contract forms a small percentage of the price of the commodity, it still could not serve the purpose as intended in a *bay^c*

al-salam contract. Furthermore, an additional margin is paid by the buyer based on the current market value or price of the commodity, and not as an instalment for the fixed price as agreed in the contract. However, it may be established here that the specified commodity in a commodity futures contract could form a valid contract under Islamic Law although it does not exist at the time of contract.

If the formation of a commodity futures contract does not conform to the rules of a *bay^c al-salam* contract pertaining to the requirement to pay the price of the commodity, a *bay^c al-istiṣnā^c* transaction could be an alternative. There is no such requirement in a *bay^c al-istiṣnā^c* contract according to Ḥanafī scholars, who legalise it based on the concept of *Istiḥsān* (preference) on the ground that the public in those days was agreed on the practice of *bay^c al-istiṣnā^c*. Similarly, if there is public consensus and need for a commodity futures contract, it is possible to legalise such a transaction under Islamic Law based on the same grounds as a *bay^c al-istiṣnā^c* contract.

1.3. Conclusion and Summary

A commodity futures contract is a modern version of a *bay^c al-istiṣnā^c* contract despite of its technical procedures stardardised by the respective authorities. The underlying commodity is definitely specified and a particular date and place determined for its delivery. Although it is not necessary to specify the time and place of delivery in a *bay^c al-istiṣnā^c* contract, it is preferable in order to have a more convincing transaction. In addition to this feature, it is also required

that an initial margin should be paid at the time of contract. Theoretically, this margin forms about ten percent of the whole value of the commodity, but in reality, this money is treated as a deposit, which is forfeitable in the event of default or failure to maintain the margin account. It seems unjust to the one who pays the margin.

The issue on payment of a forfeitable deposit had been dealt with by the Islamic scholars in their discussion on *bay^c al-^{c}urbūn* (sale by deposit).[60] They finally annulled this practice as it causes injustice to the buyer. However, modern scholars prefer to legalise this transaction since it is currently necessary to have a conclusive obligatory contract so as to minimise losses or possible default cases, or at least, on the ground that this practice has become customary.[61] Thus, by virtue of the latter view, it is deemed that there is no need for any modification to the present design of commodity futures contracts in order for them to be legal contracts under Islamic Law. In addition, a few studies organised by some contemporary scholars have found that the standardised commodity futures contract is permissible within Islamic Law based on the reduction of risk elements and added guarantee for the performance of futures contract obligations.[62]

Generally, in the above discussion on the subject matter of a commodity futures contract, it is hard to find any inherent factor in its fundamental structure

[60] For further explanation on this transaction, please refer to chapter four, 4.2.1(ii).
[61] Al-Zuḥaylī, *Al-Fiqh*, v. 4, p. 448-450.
[62] Bakar, Mohd Daud. "Pasaran Hadapan Komiditi Minyak Sawit Mentah: Perspektif Shari'ah", (in Malaysian language) presented in, *Seminar Pakar Shari'ah Ketiga, 1998* organised by Securities Commission at Melaka, Malaysia on October 30, 1998 pp. 1-7. See also, Kamali, Mohd Hashim. "The Futures Contact: A Shariah Perspective" presented in, *International Islamic Capital Market Conference '97* organised by Securities Commission at Kuala Lumpur on July 15-16, 1997 pp. 4-10.

that may render it void under the framework of Islamic Law. The specifications of the underlying commodity have been carefully standardised in the terms of the contract issued by the authorities and there is a further conducive guarantee for the performance of the contract given by the clearing house by interposing itself between the buyer and seller. Even though this legality is not established through an analogy on a *bay^c al-salam* contract, nor that this commodity futures contract is considered as a modern version of *bay^c al-istiṣnā^c* due to certain technical differences, it is safe to conclude that the position of a commodity futures as an object in a futures contract falls under the basic principle of permissibility (*al-aṣl fī al-ashyā' al-ibāḥah*) as long as there is no element of excessive risk, fraud or *ribā* (usury).

CHAPTER TWO

THE CONTRACTUAL PARTICIPANTS OF A COMMODITY FUTURES CONTRACT AND THE CONCEPT OF *AL-MUTAᶜĀQIDĀN* (THE CONTRACTING PARTIES) IN ISLAMIC LAW

2.1. An Overview of the Futures Contract Participants

A distinctive feature of a commodity futures contract is that the real buyer or seller does not need to know his counterpart. Normally, in making a contract, a buyer or seller will place an order[1] to buy or sell a specified commodity at a pre-determined month through his brokerage firm. The broker will transmit the order to the floor broker, who executes it according to the procedures. The contract is executed when the floor broker gets the best price for the order through the open outcry auction, which is held on the trading floor of a commodity exchange. After the matched order is recorded in the exchange, it is then reported to the brokerage firm who confirms the execution with his client as well as the clearing house.[2]

Before this entire event takes place, a commodity futures trader, either an individual or a company firm, who is not a member of the commodity exchange, must first of all open an account with a brokerage firm, who is a member of the said

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[1] There are various types of order in the commodity trading. The most common order, named as market order, contains all the particulars except the price. Such order will direct the floor broker to sell or buy at the best available price.

[2] Gould, Bruce G. *The Dow Jones-Irwin Guide to Commodity Trading*. Illinois: Dow Jones-Irwin, 1981 p.116.

exchange.[3] A member may either be an individual, association, corporation or trust. In other words, a prospective futures trader may participate in commodity futures trading by opening an account with a brokerage firm, or he may deal indirectly in such trading by becoming a shareholder of a company or investor in an investment trust which trades in commodity futures.[4]

Upon opening an account, a client (the futures trader) of a brokerage firm must deposit a margin and sign a few documents to protect the interest of the parties, the client and the brokerage firm. The margin is paid as a guarantee that the client will meet his obligations in the futures trading.[5] While the documents that he has to sign, inter alia, the risk disclosure statement, will ensure that the client is aware of the risk of dealing in futures as well as the rights of the brokerage firm as his agent and/or principal and his consequent duties (See **Appendix 1**). Among the duties that are stated in many agreements are that the client is bound to abide by the rules of the commodity exchange and to pay the margin call and any brokerage fee, clearing house fee and taxes incurred. The client is also responsible for bearing any losses and ultimately, to make or take delivery of the underlying commodity. The broker on the other hand, is only made responsible for any losses that result from an error on his part or from a trade which was not executed in accordance with the client's order.[6] These terms of agreement basically outline the legal relationship

[3] This requirement is common to every exchange. So as to be eligible to trade on its trading floor, any individual, firm or trust must be the exchange member.
[4] US Feed Grains Council. "Trade Partners in Feed Grains Risk Management", at, www.grains.org accessed on 01/08/1998.
[5] Gold, Gerald. *Modern Commodity Futures Trading*. New Jersey: Commodity Research Bureau, Inc. 1975 p. 18.
[6] US Feed Grains Council. "Futures Market Orders", at, www.grains.org accessed on 01/08/1998.

between the dealer and the client and the degree of their exposure to any futures trading risk.[7] (See **Appendix 2** for a sample of a customer agreement)

A trader may also participate in commodity futures trading by contributing capital to a trust, investment fund or finance institution which deals in commodity futures. Usually, these bodies do not carry on business in commodity futures trading themselves, but rather appoint an asset management or fund management company[8], which specialises in the futures industry. This fund management company, which is licensed or registered as a dealer, would normally open a portfolio account for any trust or institution that is interested in investment in commodity futures trading. In contrast to a brokerage firm's client account, the money that has been deposited in this account will act as the capital for the said investment.[9]

After opening a client's account, the dealer, either a brokerage firm or a fund manager, will accept any order to buy or sell from the client. The order must be specific without any ambiguity as to the quantity, delivery month and price in order to be properly executed in the open outcry auction.[10] However, such acceptance is always subject to the terms of the agreement. Among the common ingredients of the client's agreement is that the dealer may refuse to accept the client's order at any

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[7] Futures Industry Association. *Financial Integrity Recommendation for Futures and Options Markets and Market Participants*. Washington: Futures Industry Association Global Task Force, 1995 p. 17.
[8] These terms are a few names for companies, which are recognised as fund managers.
[9] For instance, sec. 83(2)(a) of the British *Financial Services Act* 1986 provides that a fund management company may either be a unit trust scheme or a collective investment scheme which invests the contribution of its participants and pays them the resulted profits accordingly.
[10] US Feed Grains Council. "Futures Market Orders", at, www.grains.org accessed on August 1, 1998.

reasonable time depending on the client's position and the dealer's interest.[11] Any accepted order is then transmitted to a floor broker who will execute it, whenever possible, on the trading floor. Once the order is matched, the floor broker confirms the execution with the dealer.[12] (See **Figure 2.1**) Thus, a floor broker in this case not only a represents the dealer but also ultimately executes the order on behalf of the client.

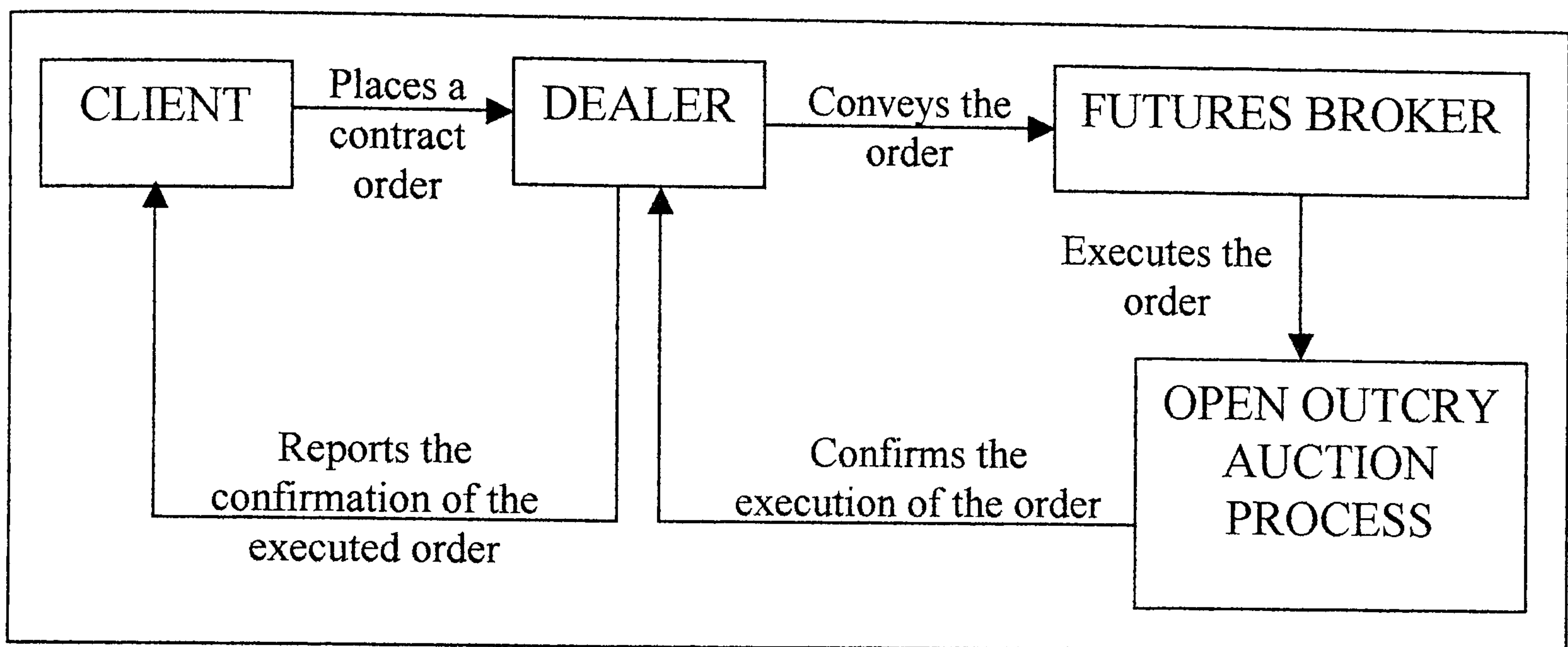

Figure 2.2 The sequence of the execution of a contract order of a commodity futures contract

It is worth mentioning here that the dealer also may transmit orders for his own margin account. Even the floor broker may sometimes execute the trade for himself. Such an individual is usually known as floor trader. In practice, at present it is possible for the dealer or the floor broker to become the counter party for a client's order, but, as required by any exchange's rule, any execution must be made through the open outcry auction process.

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[11] For instance, item 4 of the customer agreement of Robbins Futures, Inc., a commodity futures brokerage firm, provides that the broker has an absolute discretion in accepting or declining the customer order for the purposes of limiting the customer's positions. See, Robbins Trading Company at, www.robbinstrading.com/71.htm

[12] Gold, *Modern*, pp. 24-27.

Beyond this process, a client may find that it is appropriate to seek advice and information regarding his trading from a commodity trading advisor. Such services could be a necessity for any trader, prior to or after his agreement with dealer, in order to protect his interest and position as well as possibly maximise his profit and minimise any losses. In other words, a trader may get information and assistance in his effort to reduce any risk in his trading.

2.2. Role of the Participants of Commodity Futures Market in the Perspective of Islamic Law

It seems that any individual, association or company wishing to trade in commodity futures must first participate in a few deals prior to trading. Briefly, he must be a competent contracting party in the agreements with the dealer, the commodity trading advisor and their representatives. Since these individuals perform a major role in the execution of the commodity futures contract, their functions should be examined under the purview of Islamic Law as well as the competency of the real futures trader. Therefore, the issues that should be dealt with are the basic requirements of a contacting party, the relationship between a client (a futures trader or an investor) and a dealer (a brokerage firm or a fund manager), the position of a floor broker and the relationship between a trader and a commodity trading advisor.

2.2.1. Islamic Law Principles Regarding the Basic Requirements of a Contracting Party

In general, issues pertaining to contractual capacity are governed by the law of contract. For example, as provided by the Malaysian Contracts Act 1950, a person who attains the age of majority and is of sound mind is said to be competent to contract.[13] Furthermore, he must be of free will in order to make an enforceable contract.[14] This general provision, like any other Common Law provision, is deemed to be applied over any contracts made within its jurisdiction. Therefore, unless provided otherwise, most of a client's agreements presume the natural competency of the client according to Contract Law. In other words, these agreements imply the application of the legal capacity requirement as provided by the governing law of contract.

Similarly, under the provisions of Islamic Law (but subject to a difference of opinion among the scholars), a party to a contract must satisfy the requirements that he has attained *ahliyyah al-adā' al-kāmilah* (a full contractual capacity) and given his free consent with no element of mistake, fraud or undue influence.[15] In addition, he must also have the *al-wilāyah 'alā al-māl* (absolute power of disposal) to dispose of the subject matter of the contract. As long as there is no legal interdiction in the interest of a third party, a fully competent person has absolute right over the

[13] According to the Malaysian *Age of Majority Act* 1971, the age of majority is 18.
[14] Sec. 10-11, Malaysian *Contract Act* 1950.
[15] Al-Sanhūrī, ᶜAbdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī.* Beirut: Dār Ehyā' al-Turāth al-'Arabī, (No Date) v. 5, p. 97.

contract.[16] Therefore, any contract entered into by a person who lacks contractual capacity, is generally rendered as void *ab initio*. However, some Islamic scholars do allow transactions carried out by a person who is lacking the said capacity. Thus, it is better to look into the rulings on legal contractual capacity and the right to disposal for further details.

(i) The principles on *al-ahliyyah* (contractual capacity)

Briefly, there are two types of *al-ahliyyah, ahliyyah al-wujūb* (eligibility for duty) and *ahliyyah al-adā'* (executive capacity or capacity to act on one's own behalf). The former category literally means the competency of a person to have rights and duties. This capacity is effective on every living person.[17] Unless he has an unfinished dealing with another, no rights or duties can be imposed on him upon his death. [18]For example, in the case of a deceased debtor, his heir will administer his property and pay of his debt to the creditor. Though any living person is eligible to have rights and duties, such entitlement, however, does not give him the right to make any statement or action that may bind him to perform any duties,[19] such as executing a contract of sale or purchase. But according to the Ḥanbalī schools, a *ṣabiy ghayr mumayyiz* (a non-discerning minor) or a *safīh* (spendthrift) who is under this category, may enter into any petty transaction, while a *ṣabiy mumayyiz* (a

[16] Al-Khafīf, ᶜAlī. *Aḥkām al-Muᶜāmalāt al-Shar'iyyah*. (No Place): Dār al- Fiqh al-'Arabī, (No Date) p. 273.
[17] Abū Zahrah, Muḥammad. *Al-Milkiyyah wa Naẓariyyah al-ᶜAqd fī al-Sharīᶜah al-Islāmiyyah*. Cairo: Darul Fikr al-'Arabi, 1977 p. 273, Zaidān, ᶜAbdul Karīm. Al-Wajīz fī Uṣūl al-Fiqh. Cairo: Dār al-Tauzīᶜ wa al-Nashr al-Islāmiyyah, 1993 p. 95.
[18] Al-Khafīf, *Aḥkām*, p. 236.
[19] Al-Khafīf, *Aḥkām*, p. 239.

discerning minor) is entitled to deal in any contract that may be beneficial to him with the permission of his *waliy* (guardian).[20]

On the other hand, *ahliyyah al- adā'* is meant for a person who has absolute control over himself and his property. This entitles him to bind himself to any duties or responsibilities through his statement and action. Vice versa, he may claim any right resulting from such obligations. Therefore, only those who are of sound mind and attain the age of majority can be regarded to have achieved this category.[21] Islamic scholars have a thorough discussion of what should be the age of majority. Finally, they agreed on two factors which would determine the attainment of the age of majority having reached puberty and the manifestation of prudence.[22]

(ii) *Al-wilāyah ᶜalā al-māl* (power to dispose of property)

As mentioned above, a person who achieves the full contractual capacity automatically has absolute right over his property. As for those who lack such capacity, such as a *ṣabiy* and a *safīh*,[23] their property will be administered by their *waliyy* (guardian). A *waliyy* used to be the father or grandfather or those who were judicially appointed. In addition, a fully competent person may also delegate such powers to his agent or representative.[24] The agent may exercise these powers as

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[20] Al-Jazīrī, ᶜAbdul Raḥmān. *Al-Fiqh ᶜalā al-Madhāhib al-Arbaᶜah*. Beirut: Dār al-Kitāb al-'Ilmiyyah, (No Date) v. 2, p. 160, Zaidān, Al-Wajīz, p. 101.
[21] Zaidān, Al-Wajīz, p. 96, Al-Khafīf, *Aḥkām*, p. 239.
[22] Rayner, S. E. *The Theory of Contracts in Islamic Law*. London: Graham & Trotman, 1992 p. 122.
[23] A *safīh* is an example of self-interdiction. Majority of scholars had also regarded, among others, an insane person, an intoxicant and a sleeping person as being interdicted from making any contract. See, Al-Khafīf, *Aḥkām*, p. 245-247.
[24] Abū Zahrah, *Al-Milkiyyah*, p. 341.

prescribed by the principal. However, if the agent exceeds the limitation, the transaction is considered as *ᶜaqd al-fuḍūlī* (officious contract). Generally, such a contract is not enforceable or is deemed as void *ab initio* until the principal ratifies it.

(iii) Legal interdictions in the interest of third parties

There are some cases where Islamic Law imposed an interdiction on a fully competent person preventing them making contract. Such cases, which must be judicially enforced, are ruled to allow the third parties to reserve their rights in the underlying property. Therefore, any contract entered into by such a person will be either regarded as void or suspended until further ratification or annulment by the third parties concerned. Those who are restrained from any commercial dealing may be enumerated as follow:

a. *Al-marīḍ maraḍ al-maut* (a person suffering from a terminal illness)[25]

   Although such a person deserves the rights to dispose of his property as he has full capacity to contract, because of the illness that may cause his death, the interests of his creditors and heirs must be taken into account.[26] In case he exhausts his property while he is incapable of acquiring any, he is prohibited

[25] There is no conclusive definition for an illness. However, it used to be linked to any sickness which commonly causes death. This category may also include a person who is doing a very dangerous work that puts him close to death.
[26] Abū Zahrah, *al-Milkiyyah*, p. 320.

from disposing of the property in order to cover his debt and protect the rights of his heirs vested in his estate.[27]

b. *Al-madīn al-muflis* (a bankrupt debtor):

In contrast of the majority's opinion, Ḥanafī scholars do not recognise the interdiction imposed on a bankrupt debtor. They prefer to imprison such a debtor upon the request of his creditors until selling his property satisfies the debts. The majority of Islamic scholars consider that such a debtor should be prevented from disposing of his property by a court order. This prohibition is enforced to secure the interests of the creditors in recovery their loans, fully or partially.[28]

Briefly, these basic principles concerning to the competency of a contracting party are comprehensive enough to be applied in determining the contractual capacity of the actual trader in a commodity futures contract. Although a trader in such a contract may be an association, partnership or corporate body, the concepts of *al-ahliyyah* and *al-wilāyah ᶜalā al-māl* could still be applicable since these institutions have their own entities which allow themn to have rights and owe duties towards others.[29] This legal entity *(shakhṣiyyah ḥukmiyyah/ iᶜtibāriyyah/ maᶜnawiyyah)* has been recognised in Islamic Law especially on the issues pertaining to *baitul māl* (public treasury), *waqf* (endowment fund) and government responsibilities. Any dealing involving these institutions is valid and enforceable, just as the *baitul māl* is eligible to receive property and to provide others with such

[27] Al-Khafīf, *Aḥkām*, p. 257-258.
[28] Al-Sanhūrī, *Maṣādir*, v. 5, p. 99-128.

property. These transactions are executed by the management board on behalf of the *baitul māl*.[30] Thus, any institution or corporation may have its own entity provided that it has the mutual interest of certain persons (*maṣlaḥah mushtarikah*) and distinctive financial liabilities (*dhimmah māliyyah*).[31]

Furthermore, it is better to state expressly the representation of the contracting party in the customer agreement. Presuming the general application of the contract law requirement of legal capacity will only provide loopholes for those who would like to take advantage of a trader's ignorance. This may cause injustice to the trader concerned who has solemnly signed such an agreement. Therefore, a clause should be included in a customer agreement to ensure the legal capacity of the contracting parties.

2.2.2. The Islamic Law approach towards the relationship between a client (the original trader) and a dealer (a brokerage firm or a fund manager)

In any event, no person or firm will carry out a commodity futures contract unless he is a member of the commodity exchange. This makes the existence of a dealer a necessity in the structure of commodity trading. A member may not be a dealer, but a dealer must be a member in order to obtain the privilege of trading in the exchange as well as being a license holder to carry on business in commodity

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[29] Al-Khayyāt, ^{c}Abdul ^{c}Azīz. *Al-Sharikāt fī al-Sharī'ah al-Islāmiyyah*. Beirut: Muassasah al-Risālah, v. 1, 1994 pp. 208-210.
[30] Al-Zarqā', Muṣṭafā Aḥmad. *Al-Madkhal al-Fiqh al-Ām*. Damascus: Dār al-Fikr, 1968 v. 3, pp. 256-259.
[31] Al-Zarqā', *Al-Madkhal*, v. 3, pp. 281-282.

futures trading as required by the authority concerned.[32] It is a time-honoured practice that a dealer offers the public an opportunity to trade in commodity futures by opening accounts for those who interested. Since such offers are competitive in nature, any dealer is supposed to be an expert in commodity futures trading so as to be a better dealer than others.

The public, either individually or collectively, may need to trade in commodity futures for hedging the commodity price risk in order to protect their business but many of them are only interested in investing in such trading. This group speculates on the commodity price movement that may result in profit from buying and selling the commodity futures. Whether the trader is a hedger or speculator, he must open an account with a dealer to handle his trading.

An individual trader must be the sole owner of the account. Once he has signed the client agreement, he will act most of the time as a principal and will be liable for any costs incurred throughout his trading. If there is any profit, it will be directly credited to his account. Similarly, if the client is an organisation, it bears the same responsibility and has the same rights as any individual client. Obviously, the only difference between the two is that the latter is mainly meant for collective investment. Most of these accounts are handled by fund managers.

In many cases, a dealer may delegate his work to his representatives to act on his behalf and, while handling a client's order, sometimes it may turn out that the

[32] For example, in the Malaysian *Futures Industry Act* 1993, section 16(1) provides that no business in commodity futures contract shall be carried by anybody unless he is a licensed futures broker.

dealer himself is the opposite party for the order. As long as there is no dispute between the client and the dealer, such an incident is treated as an ordinary conduct. As the dealer acts as an agent, with established brokerage and commission fees, for the client (either a real trader or an investor), it is necessary, to study certain principles of Islamic Law pertaining to these concepts namely, *ᶜaqd al-wakālah* (the contract of agency) and the conduct of a *wakīl* (an agent), *ᶜaqd al-isti'jār* (the contract of lease, hire or services) and *ᶜaqd al-shirkah al-muḍārabah* (the contract of partnership of profit sharing or dormant partnership).

(i) *ᶜAqd al-wakālah* (the contract of agency)

The most distinctive features in this concept of representation (*al-niyābah*) of *ᶜaqd al-wakālah* in Islamic Law are that the principal is always entitled to the final outcomes of the contract (*ḥukm al-ᶜaqd*) while his agent or representative enjoys the rights as well as duties of the execution of such contract (*ḥuqūq al-ᶜaqd*).[33] To illustrate, in a contract of sale, the principal is entitled to the ownership of the price and in the mean time, his agent has the right to enforce the contract by demanding the price and submitting the object of contract. If this transaction is not executed in accordance with the principal's order, the legal consequences will differ, depending on the circumstances. However, if the principal subsequently ratifies the transaction, his agent will not bear any outcoming responsibility.[34]

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[33] Ibn Mufliḥ, Abī Isḥāq Burhānuddīn. *Al-Mubdiᶜ fī Sharḥ al-Muqniᶜ*. (No Place): Al-Maktab al-Islāmī, 1980 v. 4, p. 355, Al-Sanhūrī, *Maṣādir*, v. 5, p. 209.

[34] Ibn Qudāmah, ᶜAbdullāh Aḥmad Muḥammad. *Al-Mughnī*. Cairo: Maktabah al-Jumhūriyyah al-ᶜArabiyyah, (No Date) v. 5, p. 125, Al-Zarkashī, Shamsuddīn Muḥammad. *Sharḥ al-Zarkashī ᶜalā*

Based on the above ruling, it is clear that a principal must have *ahliyyah al-adā' al-kāmilah* (a full contractual capacity) and be free from any interdictions. Although his agent is the one who executes the contract, the agent's actions always rely on the principal's capacity. Therefore, unlike the principal, an agent must be a person who is at least a *ṣabiy mumayyiz* (a discerning minor) since he is supposed not to act beyond the principal's instruction.[35] As long as he can understand the statement of the transaction as well as being understood by the other party, the majority of scholars found that he is eligible to be an agent.[36] On the contrary, the Shāfiᶜī scholars always keep to the general principle that a minor is not allowed to contract for himself or on behalf of others.[37]

An agent is supposed to abide by the order and instruction of his principal. Unless he is a *wakīl ᶜāmm* (a general agent), he has the right to transact in any dealing that is permitted for the principal except, as provided by some of Ḥanafī scholars, in matters pertaining to divorce, freeing slaves and *waqf* (endowment). The Shāfiᶜī scholars on the other hand did not recognise such universal agency as it would cause *gharar* (uncertainty).[38] However, if it is a *wakālah khāṣṣah* (a special agency), the agent is bound by any prescription and limitation ordered by the principal. Otherwise, his execution of a contract is regarded as a *ᶜaqd al-fuḍūlī* (officious contract).

Mukhtaṣar al-Kharqī. Riyadh: Maktabah al-ᶜAbikān, 1993 v. 4, 143, Al-Sanhūrī, *Maṣādir*, v. 5, pp. 219-220.

[35] ᶜAbdul Waḥīd, Kamāluddīn Muḥammad. *Fatḥ al-Qādir*. Pakistan: Maktabah al-Rashīdiyyah, (No Date) v. 7, p. 3.

[36] ᶜAbdul Waḥīd, *Fatḥ*, v. 7, pp. 12-13, Ibn Qudāmah, *Al-Mughnī*, v. 5, p. 202, Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, pp. 356-357.

[37] Abū Zahrah, *Al-Milkiyyah*, p. 346.

[38] Al-Khafīf, *Aḥkām*, p. 276.

'Aqd al- fuḍūlī is a transaction executed by a person who has no authority or right over the object of the transaction, either by *al-wilāyah* or through *al-wakālah.* The majority opinion on this particular transaction is that it is suspended until the one who has the right ratifies or annuls it.[39] In contradiction to this view, Shāfiᶜī scholars held that such a contract is void *ab initio* since it resembles the forbidden contract of sale of something that the seller does not possess.[40] In their view, any subsequent ratification made by the real owner will have no effect, as there is no suspended contract. Therefore, if an agent who is specified to deal in certain transactions has dealt beyond the limitation or contradicted the principal's instruction, such a transaction is regarded as void or suspended unless the principal subsequently ratifies it. If he annuls it, the agent will be responsible for all the legal consequences.[41]

Similarly, an agent is not entitled to appoint another to be his agent or representative in carrying out the principal's instructions. However, this is not a stringent rule. As long as the principal permits or consents, an agent may at any time appoint another person to be his agent to perform the said task whenever necessary.[42] It is also permissible to state a specific fee for any work done for the principal in a contract of agency. In a commonly remunerated contract of agency,

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[39] Ibn ᶜĀbidīn, Muḥammad Amīn. *Radd al-Muḥtār ᶜalā Durr al-Mukhtār Ḥāshiyah Ibn ᶜĀbidīn.* Pakistan: Maktabah Majīdiyah, 1399H v. 4, p. 151.
[40] Abū Zahrah, *Al-Milkiyyah*, pp. 356-357.
[41] ᶜAbdul Waḥīd, *Fatḥ*, v. 7, p. 43, Ibn ᶜĀbidīn, *Radd*, v. 4, pp. 151-152, Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, p. 346, Al-Zuḥaylī, Wahbah. *Al-Fiqh al-Islāmī wa Adillatuh.* Damsyik: Dār al-Fikr, 1989 v. 5, pp.110-111.
[42] Ibn Qudāmah, *Al-Mughnī*, v. 5, p. 215, Al-Zarkashī, *Sharḥ*, v. 4, p. 142, Al-Jazīrī, *Al-Fiqh*, v. 3, pp. 204-205, Al-Khafīf, *Aḥkām*, p. 277.

such as appointing a legal practitioner for a lawsuit, the fee may be specified at the time of contract or else the standard fee (*al-ujr al-mithlī*) will be applied.[43]

In addition, it is also possible for an agent to act on behalf of both contracting parties. Although it was originally forbidden,[44] according to majority opinion an agent may execute a contract for the principal as well as for himself or other person as the counterpart, provided that he has first obtained the principal's permission.[45] As long as there is no conflict of interest, such a case remains permissible.

Therefore a dealer (either a brokerage firm or a fund manager) who acts as an agent for his client, the real trader, must observe the client's order while executing the transaction so as to avoid any inconsistency or mistake. In present practice, the agreement between a dealer and his client may be regarded as a contract of *wakālah khāṣṣah* (specific agency), which is specifically for trading in commodity futures. The dealer, on the other hand is allowed to have his agent/s or representative/s to serve the said client. Unless there is a mistake in the execution of the client's order, all costs incurred are borne by the client.

The costs that result from the client's contract also include, among other things, the brokerage fee. Since these brokerage services have always been paid for the dealer's expertise, there should be no objection under the Islamic Law

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[43] Al-Khafīf, *Aḥkām*, p. 279.
[44] Al-Sanhūrī, *Maṣādir*, v. 5, p. 251.
[45] Al-Zarkashī, *Sharḥ*, v. 4, p. 146, Al-Khafīf, *Aḥkām*, pp. 296-299, Abū Zahrah, *Al-Milkiyyah*, pp.362-363.

framework as to its permissibility. However, the dealer should avoid executing the client's order for his own advantage. As some Islamic scholars are unlikely to recognise such a transaction, it should be avoided to prevent any unnecessary conflict of interests. But, if such an execution offers a better deal for the client, it is permissible.

In short, a dealer always has absolute discretion in the execution of the client's order as long as the execution is made in accordance with the client's request. In particular issues as mentioned above, the prior consent of the client is necessary. Thus, it is better to obtain his consent by including in the agreement an express provision stating the necessity of such consent.

(ii) *ᶜAqd al-isti'jār or ijārah*(the contract of lease or hire)

A dealer is not solely an agent, since he is paid by his client for his brokerage, as if he were an employee of the client. There is no doubt that, by signing the client agreement, the client is appointing the dealer as his agent to carry out his trading in commodity futures, but this agency is performed in exchange for brokerage fees. Thus, it would be appropriate to regard the agreement between a dealer and his client as a contract of agency with remuneration (*ᶜaqd al-wakālah al-ma'jūrah*).

This type of agency resembles an ordinary *ᶜaqd al-isti'jār* (a contract of hire and services). Basically, there are two types of *ᶜaqd al- isti'jār*, *isti'jār ᶜalā al-*

manfa^cah or *al-^cayn* (the contract of leasing) and *isti'jār ^calā al-māl* or *al-dhimmah* (the contract of service).[46] As the dealer providing for the client with services in trading, it would be sufficed to look further into the latter category of *isti'jār*.

In a contract of *isti'jār ^calā al-māl*, the *ajīr* (person who provides the service) may be of two kinds, *ajīr khāṣ* who serves one person or one party only, and *ajīr mushtarak*, a person who is providing services for the general public. According to the majority of Islamic scholars, neither of them should be held liable for any losses incurred in the course of the transaction. This ruling is based on the general principle that there is no indemnity (*ḍamān*) except in a case of encroachment (*lā yajib al- ḍamān illā bi al-ta^caddī*).[47] Therefore, if the *ajir* or any of his representative or subordinate encroached any right of the *musta'jir* (the person who is hiring the service), only the *ajīr* will be made liable since he is the original party of the contract.[48]

As regards the legal conditions of this contract, precisely, the contracting parties must have full contractual capacity and the subject matter of the contract, the service and the payment, must be determined. As long as such a contract does not contain any forbidden or *gharar* elements, each party is responsible for fulfilling his respective obligations.[49] In addition to these rules, in a case where dispute arises

46 Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ ^calā Matn Minhāj al-Ṭālibīn*. Damascus: Dār al-Fikr, (No Date) v. 2, pp. 333-334, Al-Zarkashī, *Sharḥ*, v. 4, p. 219, Ibn Mufliḥ, *Al-Mubdi^c*, v. 5, p. 62, Al-Jazīrī, *Al-Fiqh*, v. 3, pp. 95-99, Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 759.
47 Al- Sharbīnī, *Mughnī*, v. 2, p. 351, Ibn Mufliḥ, *Al-Mubdi^c*, v. 5, pp.108-109, Al-Zarkashī, *Sharḥ*, v. 4, p. 244, Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 768.
48 Ibn Mufliḥ, *Al-Mubdi^c*, v. 5, 108-109, Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 771.
49 Al- Sharbīnī, *Mughnī*, v. 2, p.337, Ibn Mufliḥ, *Al-Mubdi^c*, v. 5, pp. 63-64, Al-Khafīf, *Aḥkām*, p. 404.

during the course of service or after the service is completed, the decision may be either rescission of the contract or indemnity paid by the *ajīr*, if it involved any encroachment on his behalf.[50] However, such an indemnity does not affect his right to his service fee, because, he is entitled to the payment upon any work done as his service.[51]

Therefore, as a dealer is more likely to be an *ajīr mushtarak*, he is responsible for providing his expert services in commodity futures trading as well as being liable for any losses which are caused by his mistake or those of any of his representatives, while the client must pay any brokerage fees determined by the dealer upon the execution of transaction. Nevertheless, most dealers charge a client an inactive monthly maintenance fee if he has not made any contracts for thirty days. For whatever reason, such a charge can encroach on the client's right and freedom. Furthermore, such a charge for maintaining the account is not part of what is intended by the client in the agreement. Other proper alternatives must be provided by the dealer for the client to choose, rather than penalising him for a cessation in trading.

(iii) The contract of *al-muḍārabah* (silent or dormant partnership)

A dealer may be an individual or an organisation including a member or non-member of the commodity exchange, as well as a brokerage firm or a fund manager. Most fund managers manage the futures account of joint ownership funds, such as

[50] Al- Sharbīnī, *Mughnī*, v. 2, p. 354, Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 780.
[51] Al-Khafīf, *Aḥkām*, p. 410.

trust and pension funds. Initially, these funds are set up on the basis of a collective investment scheme. Then, these funds are used as capital for investment in futures trading administered by a fund manager. In other words, at the initial stage, there is the formation of a partnership for investment, while later it is merely an appointment of an investment agent, the fund manager.

The contract of *al-muḍārabah* has been categorised as a partnership agreement as the contracting parties are sharing the profits, but not the capital. One party, known as *rabb al-māl* (the capital provider) provides the investment capital for the other party, the *muḍārib* (the one who carry the business for such investment or the agent manager).[52] As long as the former permits, the latter may delegate the investment tasks to others, either his partner or even his own appointed *muḍārib*.[53] In return, both parties will share the resulting profits according to a mutually agreed proportion. The losses, however, are borne by the *rabb al-mal*.[54]

From the structure of *al- muḍārabah* partnership as described above, it is clear that such a contract only exists between the original investors and the trust or whatever type of fund it is, because the profits are to be shared only among them. As for the fund manager, he is always entitled to the brokerage fee for any trading executed, regardless of whether it resulting profits or losses.

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[52] Ibn Mufliḥ, *Al-Mubdi*ᶜ, v. 5, p. 17, ᶜAbdul Waḥīd, *Fatḥ*, v. 7, p. 414, Al-Zarkashī, *Sharḥ*, v. 4, p. 131.

[53] Ibn Mufliḥ, *Al-Mubdi*ᶜ, v. 5, p. 18, Al-Shirāzī, Abū Isḥāq Ibrāhīm. *Al-Fiqh*. Beirut: Dār al- ᶜUlūm, v. 53, 1988 p. 322.

[54] ᶜAbdul Waḥīd, *Fatḥ*, v. 7, pp. 415-416, Ibn Mufliḥ, *Al-Mubdi*ᶜ, v. 5, p. 19, Al-Zarkashī, *Sharḥ*, v. 4, pp. 135-136, Al-Khayyāt, *Al-Sharikāt*, v. 2, p.50.

Therefore, it could be summed up that a fund manager, like any other dealer, is only an investment *wakīl* (agent) since he represents his client, the investors, in managing their account for investment in futures trading. His services are made in exchange for brokerage fees. The agreement between a fund manager and his client is not very different from an agreement with a brokerage firm. Since they share the same basic features of a remunerated agent, the same rules are applicable.

2.2.3. The position of a floor broker

As mentioned earlier, any client's order will be executed on the commodity exchange's trading floor via a floor broker. The order that is transmitted to him by a dealer contains all the necessary particulars for its execution. The specification provided in this order should be accurate so that the floor broker can execute it in the course of the open outcry auction. Depending on the order's instruction, the floor broker may sometimes be unable to match such an order with another. Since there is naturally no guarantee made by the dealer or the floor broker that every order will be fulfilled, the floor broker only reports to the dealer regarding an unexecuted order, if there is any.

Nowadays, a floor broker may be an individual employed by a dealer to be his representative on the trading floor,[55] and, in certain cases, he may directly handle a client's account. In such cases, he certainly acts as an agent for his client. In addition, a floor broker may also be a floor trader since, while fulfilling his client's

[55] Gould, *The Dow Jones*, pp. 123-124.

order, he may also trade on his own account.[56] The latter position represents the fact that most floor trader are self-employed but they execute the orders from various brokerage firms or dealers for a floor brokerage fee.[57] They may also be termed locals or scalpers. A local or scalper is usually an independent floor broker, who trades for different firms as well as the general public.[58]

As regards a floor broker employed by a dealer, he is merely the dealer's representative in executing any order from the accounts handled by the dealer. Obviously, he has no dealings at all with the dealer's client. Similarly, it seems that an independent floor broker also has no specific relationship with the clients of the firms for which he acts.

Therefore, in determining the position of a floor broker under the purview of Islamic Law, certain issues must be taken into consideration. If the floor broker is an agent for his own client or an employee who acts as a representative for a dealer, the rules on contract *al-wakālah* may be applied but, if he is an independent floor broker who accepts order from various firms, there are two possibilities: either he receives a commission for each order or he routinely fills the orders with no commission or fee. For the former, the general rules on contract of services could be applicable if there is prior agreement between him and the said firms. As for the latter, the rules on agency may apply as if he executes the orders for the firm. It is worth noting here that he might be a member of the exchange and the firms are not

[56] Chicago Board of Trade. *Commodity Trading Manual*. Chicago: Board of Trade 1994, p. 52.
[57] Gold, *Modern*, p. 27.
[58] Chicago Board of Trade, *Commodity*, p. 37.

members of the exchange, but are taking an advantage of the floor broker's position since only members are allowed to trade on the trading floor.

In any event where a mistake occurs in the course of fulfilling the orders, a floor broker may or may not be made liable for any losses, depending on his capacity, whether he is an employee of a dealer or an independent floor broker. To resolve this, a client can always bring the matter to the exchange arbitration procedure. If he is a dealer's representative and his mistake causes losses, the dealer must pay the client a sum equal to the amount lost.[59] However, if it was caused by an independent floor broker, in practice, the dealer is not responsible.

On the other hand, under the provisions of Islamic Law, the procedure on contractual mistake is quite lengthy. It must be determined whether such a mistake is substantial to the contract or not. Whether substantive or not, such an element of mistake may either invalidate the contract or entitle the injured party the right of *khiyār* (option).[60] Although it is almost impossible to exercise a right of *khiyār* or retraction in commodity futures trading because of its volatility, they are still preferable to burden any party with the losses. Therefore, such remedies should be made available, whenever possible, in the arbitration procedure.

[59] Gould, *The Dow Jones*, p. 124.
[60] Rayner, *The Theory*, pp. 180-183.

2.4. The position of the relationship between a trader and a commodity trading adviser

A commodity trading adviser is usually defined as an individual or firm that advises another as to the advisability of trading in commodity futures or options as well as issuing such advice, analyses and reports in written publications, in exchange for payment.[61] Such services may be necessary for a trader, especially a beginner or a newly qualified trader, in order to obtain advice that will be beneficial to his trade or investment. For a direct remuneration, a commodity futures trading adviser usually provides expert advice as well as reports and analyses concerning commodities.[62]

Seemingly, the agreement between a commodity trading adviser and the trader (or his client) is no more than a contract of *al-isti'jār* (contract of service). Usually, in a commodity trading advisory contract a futures trading adviser agrees to act as a commodity adviser for the futures trader about such trading and by such a position he may release to the trader any relevant information pertaining to trading in futures.[63] In such a contract, the client pays the commodity trading adviser according to the services he provides. The payment must not be a proportion of the profit gained by the client, as this contract is not a partnership where the partners share the profits as well as liabilities.

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[61] Chicago Board of Trade, *Commodity*, p. 54.
[62] Sec. 2, Malaysian *Futures Industry Act* 1993.
[63] Sec. 17, Malaysian *Futures Industry Act* 1993.

Even though the contractual terms of commodity trading advisers may differ from one to another, they commonly appear as agreements of providing the services as mentioned earlier. Clearly they resemble a contract of *al- isti'jār*. As discussed earlier, the underlying services in such a contract must be specific, including the time or period and place. As long as there is no contravention of any Islamic Law provision, such contracts remain valid.[64]

In summary, a commodity trading advisory contract is basically a contract of hire or service whereby the commodity trading adviser, who is the *ajīr*, promises to provide his expert services for his client, the *musta'jir*. So long as neither the adviser nor his client becomes bankrupt, the contract between them remains enforceable.[65]

2.3. Conclusion and Summary

After examining various agreements and procedures for trading in commodity futures, one might say that to enter into a commodity futures contract is not as simple as it sounds. A trader needs to satisfy a variety of requirements under the present rules and practices as well as under the Islamic Law provisions for such trading. He must observe his duties that arise from every agreement and at the same time must be entitled to his stipulated rights in the respective agreements. Like the trader, a dealer is bound by the rules and regulations of the relevant legislation and of the exchange and clearing house. Whether he is a brokerage firm or a fund manager, as a dealer he must fulfil his obligations towards his clients.

[64] Al-Khafīf, *Aḥkām*, p. 404.
[65] Al-Sanhūrī, *Maṣādir*, v. 5, pp. 99-128.

As the client agreement appears to be a mixture of contract of agency and contract of hire or service, the rules of both contracts can be applied concurrently. Although scholars differ over certain issues, the basic formation of these contracts under Islamic Law is flexible enough to cover the client agreements, both those of a dealer and those of a commodity trading adviser. As long as the services offered are free from any forbidden and *gharar* elements, and the parties are at all time eligible to contract, the existing client agreement could remain valid and permissible under the Islamic Law provision.

The floor broker also has the same rights as well as the same liabilities as the dealer if he is officially the representative of the dealer. Similarly, a commodity trading adviser also has the same rights and obligations as a dealer since the commodity trading advisory contract resembles a contract of *al-ijārah* as well as a contract of *al-wakālah*. As a whole, the relationship between the trading partners in commodity futures trading remains legal under the principles of Islamic Law provided there are no elements contradictory to any of its rules.

CHAPTER THREE

THE FORMS AND EXECUTION OF A COMMODITY FUTURES CONTRACT AND THE PRINCIPLES OF *AL-ṢĪGHAH* (THE FORMS OF OFFER AND ACCCEPTANCE) IN ISLAMIC LAW

3.1. The actual process of the execution of a commodity futures contract

A commodity futures contract is a contract standardised by the type, quantity and quality of the underlying commodity with pre-determined delivery date and place. The price is determined and agreed upon by the contracting parties at the time the contract is made. Although every futures contract specification sets out the minimum price for the commodity, the price at which the contract is concluded must be determined in the open outcry auction process that takes place on the exchange trading floor.[1] Thus, no dealing is allowed beyond this process.[2] By this open outcry auction process, the exchange or the futures market is able to perform one of its important economic function[3] namely, discovering the future price of the underlying commodity as well as its actual cash value (this function is known as the price discovery role of the futures market).[4]

After considering relatively all relevant information or data, market factors and conditions[5] that affect the supply and demand of a particular commodity,[6] the

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[1] Most commodity futures are traded through the open outcry auction (or, in the London Metal Exchange, the auction is known as ring dealing), unlike financial futures, which are traded mostly through a computer network system or over-the-counter trading.
[2] Gould, Bruce G. *The Dow Jones-Irwin Guide to Commodity Trading*. Illinois: Dow Jones-Irwin, 1981 p. 119.
[3] Commodity and Monetary Exchange Malaysia. www.klce.com.my/htm/ak.htm accessed on, 15.03.1999.
[4] Chicago Board of Trade. *Commodity Trading Manual*. Chicago: Board of Trade, 1994 p.40.
[5] To give examples, some of these factors in relation to crops are: weather, general economic trends and large transactions between two nations. See, American Bar Association, *Futures and Derivatives: Basics*, Orlando: American Bar Association, 1996 p.97.

futures traders, buyers and sellers make a bid and an offer to sell or to buy commodity futures at a particular price through the process of open outcry auction. Whether the trader on the trading floor is executing orders on behalf of his client or for his own account, the procedure is always the same, the one that is provided by the respective exchange.

The open outcry auction is a trading system in which the buyer offers his bid while the seller calls out his offer in a loud and audible manner, assisted by hand signals, in the pit of an exchange trading floor.[7] Unlike any other ordinary contract of sale, in a commodity futures contract an offer may be either an offer to sell (offer) or offer to buy (bid) a specific commodity. The offering and bidding are commonly made in the open outcry auction by shouting out prices and types of commodity on the trading floor.[8] In addition to this verbal offer, the traders also use hands and fingers signals to represent a bid or an offer, especially when the market is active when the use of signals is more appropriate.[9] Usually, an offer is a proposal to sell a certain commodity at a specific price, whereas a bid is a proposal to buy a certain commodity for a specific price. The difference in vocalising the offer and bid is necessary in order to avoid any confusion especially in an active market.[10]

The contract is concluded when a bid and an offer are matched at a certain price. The first trader who accepts the bid or the offer has the right to conclude the contract. However, if two or more traders accept such a bid or offer simultaneously, the contract is shared among them. So, if two buyers accept an offer to sell four lots

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[6] In theory, the market price of a commodity is reached when the forces of demand and supply are just in balance (technically, the price is at the equilibrium of supply and demand). See, Samuelson P.A., *Economic, An Introductory Analysis*, New York: Mc Graw-Hill Book Co., 1958 pp.370-380.
[7] Commodity and Monetary Exchange Malaysia, www.klce.com.my/htm/ak.htm, accessed on 15.03.1999.
[8] Duffie, Darrell. *Futures Markets*. New Jersey: Prentice-Hall, Inc. 1989 pp. 21-22.
[9] The method of verbal and hand signals of bids and offers vary from one exchange to another. It is usually detailed in the exchange rules and regulations. See, Chicago Board of Trade, *Commodity*, p.38.
[10] Duffie, *Futures*, p. 23.

of a certain commodity, each has two lots of the commodity offered by the seller.[11] In other words, the buyer, who makes bid, has agreed to buy a specific commodity at the same price offered by the seller or vice versa. Consequently, after this bidding and offering, they may agree upon a price and then conclude the transaction to be recorded by the exchange and cleared by the clearing house.[12]

As mentioned above, the price of the underlying commodity is determined through the open outcry auction process, and the buyer and seller can only agree to the price that is discovered through this process. When the buyer or the seller agrees to a particular price after the bidding and offering, they are deemed to have been trading in a futures contract. In other words, once they entered into an agreement to buy or to sell, they are regarded as traders in futures[13] and should therefore being subjected to its contractual obligations. The contractual obligations of the commodity futures contract must be performed according to the rules and regulations provided by the exchange and the clearing house. Thus futures traders are legally bound by such futures contract terms or specifications notwithstanding their rights to offset at any later date before the closing date of a particular futures contract.[14]

In addition to the requirements of having a lawful object and consideration, and competent contracting parties, it is necessary that both parties have given their consent freely. In practice, in a commodity futures contract, there is no doubt in the lawfulness of its subject matter and the competency of the traders as the transaction is standardised and the exchange has a standard procedure in allowing any person to trade on its floor. Should the futures trader find that there is any error or mistake made by his futures broker in the execution of the contract, he may have recourse to

[11] Duffie, *Futures*, p. 24.
[12] Gould, *The Dow Jones*, p. 120.
[13] Sec. 2c(1)(a), Malaysian *Futures Industry Act* 1993.
[14] A closing date of a futures contract is the end of the trading session during which the traders who wish to liquidate or discharge the obligations under a future contact do so.

the exchange arbitration procedure. If it were proved as alleged, the trader would be entitled to compensation equal to the loss incurred by the mistake.[15] Obviously the traders have to consent to the process of open outcry auction in order to determine the sale or purchase price of the traded commodity futures. In general, there is nothing in the formation of this transaction that contradicts the general requirements of a valid legal agreement under the provision of the Common Law of Contract.

3.2. The formation of a commodity futures contract in the perspectives of Islamic Law

Basically, a commodity futures contract is concluded when both buyer and seller agreed to sell or to buy the commodity futures at a specific price. But, in order to find the counterparty or to get a match for his buying or selling order, the futures trader must make a clear offer to sell or a bid to buy the commodity futures at a certain price. This offering and bidding that illustrates the open outcry auction process implies that no commodity futures can be traded outside the exchange trading floor where each contract is standardised by the terms in the contract specification. In such an execution of a contract, there are four main issues that need to be examined. Firstly, do the offers and bids in the open outcry auction constitute valid offers and acceptances in Islamic Law? Secondly, what is the position of the open outcry process itself in the frameworks of Islamic Law? Furthermore, as the futures traders must adhere to the business rules and procedures of the exchange and the clearing house, have they validly given their consent to the execution of the contract? Finally, are the standardised contract specifications and other limitations and requirements in the said auction process in compliance with the principles of Islamic Law?

[15] Gould, *The Dow Jones*, p. 124.

3.2.1. The Islamic Law principles on the communication of offer and acceptance in a contract of sale

In Islamic Law, the *ṣīghah* (forms of offer and acceptance) is considered to be one of the basic elements of a contract. It is defined as anything that proves the consent of the contracting parties to enter into the contract, either by verbal, written, signs or conduct of giving and taking the merchandise.[16] On this particular issue, the Islamic Law recognises several methods of making an offer and acceptance. There are different views among Islamic scholars about these methods, and the only method that has been unanimously agreed by them is the verbal declaration. In addition, for the verbal method, it is preferable to use past tenses.[17]

Unlike the majority of Islamic scholars, the Shāfiᶜī scholars refused to allow any method other than verbal offer and acceptance, except in a case of necessity or where a contracting party is mute or voiceless,[18] whereas the majority, such as the Mālikī and Ḥanbalī scholars, generally recognised other ways of concluding a contract, by writing[19], conduct or gesture[20], as long as these methods indicate the consent of the party to enter into such a contract.[21] Furthermore, they favoured having the forms of offer and acceptance in writing rather than the verbal method

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[16] Ibn ᶜĀbidīn, Muḥammad Amīn. *Radd al-Muḥtār ᶜalā Durr al-Mukhtār Ḥāshiyah Ibn ᶜĀbidīn.* Pakistan: Maktabah Majidiyah, 1399H v. 4, p. 7, Al-Kāsānī, ᶜAlā Eddin Abīi Bakr Masᶜūd. *Kitāb Badāiᶜ al-Ṣanāiᶜ fī Tartīb al-Sharāiᶜ*. Beirut: Dār al-Kutub al-Ilmiyyah, 1986 v. 5, p. 134, Al-Jazīrī, ᶜAbdul Raḥmān. *Al-Fiqh ᶜalā al-Madhāhib al-Arbaᶜah.* Beirut: Dār al-Kitāb al-'Ilmiyyah, (No Date) v. 2, p. 155-156.

[17] Ibn ᶜĀbidīn, *Radd,* v. 4, p. 7, Al-Kāsānī, Kitāb Badāiᶜ, v. 5, p. 133, Ibn Mufliḥ, Abī Isḥāq Burhānuddīn. *Al-Mubdiᶜ fī Sharḥ al-Muqniᶜ*. (No Place): Al-Maktab al-Islami, 1980 v. 4, p. 4, Al-Sanhūrī, ᶜAbdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī.* Beirut: Dār Ehyā' al-Turāth al-'Arabi, (No Date) v.1, p.84-85.

[18] Al-Shīrāzī, Abī Isḥāq Ibrāhīm. *Al-Muhadhdhib fī Fiqh al-Imām al-Shāfiᶜī.* Beirut: Dār Ehyā' al-Turāth al-Arabi, 1994 v. 1, p. 342.

[19] Art. 173, The *Mejelle (An Enlish Translation of Majallah al-Aḥkām al-ᶜAdliyyah and A Complete Code on Islamic Civil Law),* translated by C. R. Tyser, D. G. Demeiriades & Ismail Haqqi Effendi, Lahore: Law Publishing Company (No Date).

[20] Art. 174, The *Mejelle.*

[21] Art. 175, The *Mejelle,* Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, p. 6, Al-Sanhūrī, *Maṣādir,* v.1, pp.99-126, Al-Būṭī, Muḥammad Taufīq Ramaḍān. *Al-Buyūᶜ al-Shāiᶜah wa Athar Ḍawābiṭ al-Mabīᶜ ᶜalā Sharᶜiyyatihā.* Damsyik: Dār al-Fikr, 1998 p. 34.

alone, since written documents can be produced as evidence at later time. It is worth mentioning that a contract may be constituted by offer or by acceptance, as long as the offer and acceptance corespond with each other.[22] Therefore, whenever an offer is made, the acceptance must be correctly matched with the terms of the offer. Both must agree on the type of object, the price and the stipulation of *khiyār* (option) if any. The buyer has no right to alter or amend the terms of the offer, otherwise the contract is deemed unexecuted (*ghayr munᶜaqid*).[23]

Usually, the futures traders in the open outcry auction communicate with each other by verbal offer or bid. However, under certain circumstances, this method must be aided by hand signals as the opposite side could hardly hear the verbal offer. Even though the Shāfiᶜī School's view is quite stringent, the communication of the offer and acceptance by hand signal is a necessity in such a situation. Therefore, the commodity futures contract may be concluded by using hand signals. In order to avoid any uncertainty or dispute, the concluded contract is recorded immediately, stating all essential particulars of the contract and the parties.[24] Certainly, the majority of Islamic scholars apart from the Shāfiᶜī scholars have no doubt as to the validity of such a contract since they permit other methods of executing a valid contract.

3.2.2. The Islamic Law approach towards the open outcry auction process

The process of open outcry auction in which the futures traders make a bid and an offer to buy and to sell the commodity futures resembles the sale of *al-muzāyadah* or, *bayᶜ man yazīd* (sale by auction).[25] In this contract, the prospective

[22] Al-Kāsānī, *Kitāb Badāiᶜ*, v. 5, p. 134, Al- Jazīrī, *Al-Fiqh*, v. 2, p. 156.
[23] Art. 177, The *Mejelle*, Al-Kāsānī, *Kitāb Badāiᶜ*, v. 5, p. 136, Haidar, ᶜAlī. *Durar al-Hukkām Sharḥ Majallah al-Aḥkām*. Beirut: Dār al-Jīl, 1991 v. 1, p. 147.
[24] Chicago Board of Trade, *Commodity*, p.38.
[25] This contract is also known as *bayᶜ fī al-dilālah* (sale executed through brokerage). See, Al-Sanhūrī, *Maṣādir*, v. 2, p. 64.

buyers are allowed to bid for a higher price competitively in order to buy the item.[26] This contract may be defined as a contract of sale that is made publicly in which the price for the specified item is subjected to increment by offers from the prospective buyers. Such sale may be carried out by the owner of the property himself or assigned to a *dallāl* or *simsār* (auctioneer or broker).[27]

This contract of *bay^c al- muzāyadah* is permissible in Islamic Law based on the *ḥadīth* of the Prophet (peace be upon him) and *ijmā^c* of the Muslims (public consensus) where everyone approves the practice of *bay^c al- muzāyadah* in their marketplace.[28] The said tradition read as,

> It is reported by Anas that the Prophet (peace be upon him) had sold a saddle blanket (*ḥils*) and a drinking bowl (*qadaḥ*) by asking, "Who wants to buy this saddle blanket and drinking bowl?" Someone said, "I shall buy them for one dirham," The Prophet (peace be upon him) asked again and repeated it two or three times, "Does anyone would like to pay higher than a dirham?" Then a man paid two dirhams and the property was sold to him.[29]

In the above tradition, the Prophet (peace be upon him) was actually acting for a man of al-Anṣār tribe. He (peace be upon him) sold the property on behalf of its owner through *bay^c al-muzāyadah* and later gave the two dirhams to the owner.[30] This tradition clearly shows that *bay^c al-muzāyadah* is a legal transaction that differs from the prohibited practice of bargaining over a price offered by another trader (*al-*

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[26] Al-Salamī, Muḥammad Mukhtār. "Bay^c al-Muzāyadah". in, *Majallah Majma^c al-Fiqh al-Islāmī*, Jeddah, issue 8, v. 2, 1994 p. 11.
[27] Abū Sulaymān, ^cAbdul Wahhāb Ibrāhīm. "^cAqd al-Muzāyadah baina al-Sharī^cah al-Islāmiyyah wa al-Qanūn", *Majallah Majma^c al-Fiqh al-Islāmī*, Jeddah, issue 8, v. 2, 1994 p. 11.
[28] Al- Salamī, "Bay^c al- Muzāyadah", p. 13.
[29] Ibn Ḥajar (Al-^cAsqalānī), Aḥmad ^cAlī. *Fatḥ al-Bārī*. Beirut: Darul Kutub al-Ilmiyyah, 1997, v. 4, p. 446, Al-Ṣan^cānī, Muḥammad Ismā^cīl. *Subul al-Salām Sharḥ Bulūgh al-Marām*. Beirut: Dār al-Fikr, 1988, v. 3, pp. 42-43.
[30] Al-Sanhūrī, *Maṣādir*, v. 2, p. 64.

saum 'alā saum akhīh).[31] Unlike the former transaction, in the latter, the second trader who had bargained over the first price had unethically ignored the interest of the first trader. Such a practice deprives the first trader's right to have a fair trade, but, in the former, each of the traders consents to any other bid higher than his offer since the sale is opened to the general public. Every member of the public has the right to bid for a higher price.

In addition, *bay*[c] *al-muzāyadah* also resembles *bay*[c] *al-najash*, a practice of a conspired bidding of a higher price with the intention to cause other bidder to bid for a high price and conclude the contract at the said price. This practice is prohibited due to the fraudulent conduct of the seller or his agent in inducing other participants to buy the property at a higher price.[32] However, although such a practice is likely to occur in a sale of *al-muzāyadah*, it does not mean that *bay*[c] *al-muzāyadah* should be forbidden in Islamic Law. According to the majority of Islamic scholars, such a contract remains permissible and valid as long as there is no element of fraud and it is executed as prescribed by Islamic Law.[33]

Bay[c] *al-muzāyadah* is formed by an offer or proposal to sell by putting the property on auction or public sale. The owner of the property or the auctioneer has a right to knock down to or accept a bid of a buyer. He may also hold the property on sale, even though there is a bid, and wait for another bid for a higher price. Once the seller or the auctioneer has agreed on a price, the contract is deemed as concluded. In other words, a bid is considered as an offer and the consent of the auctioneer to a price becomes the acceptance. Therefore, when there are two or more offers to buy, the subsequent one will replace or annul the previous offer. Furthermore, if the

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[31] This sale practice is prohibited based on the *ḥadīth* reported by Abi Hurairah that the prophet (peace be upon him) had said, "A man should bargain over an offer of another". Ibn Ḥajar (Al-[c]Asqalānī), *Fatḥ al-Bārī*, v. 4, p. 444.
[32] For further explanation, please refer to chapter 7, notes 51-56.
[33] Abū Sulaymān, "[c]Aqd al- Muzāyadah", p. 75.

auctioneer does not agree to any of the bidding price until the close of the auction, all the offers are consequently dropped.[34]

In the course of the auction, the auctioneer who is not the owner of the property should not participate in the bidding since it may be regarded as a breach of trust. By participating in the auction, conceivably he is buying the property for himself, whereas he is entrusted by the owner to sell the property at the best price through the auction.[35] Furthermore, upon such assignment, he is actually acting as a *wakīl* (an agent) for the owner as well as an *ajīr mushtarak* (a hired person who servers for two or more principals)[36] if he receives remuneration. In this position, he is liable to guarantee the safety of the property to a certain extent in accordance with common practice. Similarly, the amount of his commission is also determined by common practice.[37]

Based on the principles of *bay^c al-muzāyadah* above, it seems that the open outcry auction almost resembles the contract of *bay^c al-muzāyadah*. The forms of offer and acceptance are represented by the offer (proposal to sell) or the bid (proposal to buy) of a trader, and the acceptance of his counterparty. If there is no acceptance for the offer or the bid, the trader must be silent. In other words, his offer or bid must be dropped. Likewise, if the auctioneer in *bay^c al-muzāyadah* does not accept bid, the sale does not conclude. As long as the auction is still on, the traders or market participants in both open outcry auction and sale of *al-muzāyadah* retain the right to make an offer or a bid at a higher price (or lower, if it is an offer in the open outcry auction) than the earlier bid or offer. Such practice is allowed in common practice and the competition between the traders clearly shows that they have assented to the practice. Unless there is a proof of conspiracy or fraud, like the

[34] Al-Sanhūrī, *Maṣādir*, v. 2, p. 66.
[35] Abū Sulaymān, "'Aqd al- Muzāyadah", p. 97.
[36] For further information, please refer to chapter 2.
[37] Abū Sulaymān, "'Aqd al- Muzāyadah", pp. 98-100.

practice of *al-najash*, occurring in the auction, the defrauded party shall has the right to rescind the said contract.

The trader in the open outcry auction may be either a floor trader who executes the futures contract for his own trade or a floor broker who trades for his clients from the individual futures traders or brokerage firms. The traders of the first category may be regarded as the same as the auctioneer in the sale of *bay^c al-muzāyadah* who is the owner of the sale property, while the traders in the second category and the auctioneer who is not the owner of the property are almost alike. They act on behalf of the principals and therefore should adhere to any instruction given by the principals. As stated above, the floor broker and assigned auctioneer must not interfere in the offering and bidding of the price of the property or commodity other than as instructed or ordered by the principals. Interfering in such a bidding or offering is equivalent to breach of trust, except that if the principals or the clients authorised them to do so, they may act at their discretion. The auctioneer and the floor broker can even execute the sale or the order by which they become its counterparty upon given consent of the principal or the client.

Relatively, the only difference between sale of *al-muzāyadah* and the open outcry auction is that the object of the transaction in the former is existent at the time of sale, while in the latter, the commodity is not present except for its detailed specification. Islamic scholars have no doubt as to the legality of *bay^c al-muzāyadah* since there is consent of the contracting parties and there is no uncertainty in matters pertaining to the sale property. With these two essentials, this contract is deemed legal in Islamic Law. However, in the open outcry auction, although each trader has given his or her full consent, the object of the contract does not exist. Based on these criteria, some contemporary scholars consider that the commodity futures contract is not permissible in Islamic Law. Further, the execution of such a contract through the open outcry auction is not comparable with *bay^c al-muzāyadah* and therefore an

analogy is not possible between the two.[38] Adding to their argument, the traders do not own the commodity and there is no exchange of object or price at the execution of the contract.[39]

Despite the above disapproval, the contract specification that is attached to each commodity futures contract may stand as a proof that the traded commodity futures is deliverable sometime in the future, thus reducing the element of *gharar* or risk of non-delivery. As the futures trader must produce and deliver the commodity at a certain date like the object of *istiṣnā*ᶜ and *bay*ᶜ *al-salam* contracts, the commodity is therefore eligible to be traded. In other words, the execution of a commodity futures contract through the open outcry auction may be legalised based on its resemblance to *bay*ᶜ *al-muzāyadah*. If *Qiyās* could ever be established between the two, certainly the ᶜ*illah* (effective cause) is not the existence of the contractual object but may be the fair competitive nature of the transaction.[40] Thus, the open outcry auction process may be recognised in Islamic Law.

3.2.3. The presumed consent of the futures traders and the rules of consent in Islamic Law

In determining the validity of a contract, the consent of the contracting parties at the execution of the contract is a necessity since consent forms one of the pillars of a contract. Generally, in order to regard a consent as validly given, it must be legally established through the terms of offer and acceptance. To establish that the consent of both contracting parties exists in the offer and acceptance of a particular agreement, the offer must rightfully correspond with the acceptance.[41] But

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[38] Riḍwān, Samīr ᶜAbdul Ḥamīd. *Aswāq al-Awrāq al-Māliyyah*. Cairo: Ma'ahad al-'Alamī li al-Fikr al-Islāmī, 1996 p. 317.

[39] For further explanation, please refer to chapter 1.

[40] For further explanation on *Qiyās* methodology, please refer to introductory chapter.

[41] Al-Kāsānī, Kitāb Badāiᶜ, v. 5, p. 136, Al-Sanhūrī, *Maṣādir*, v. 2, p. 41.

in order to be a valid legal consent, it must be free from any impediment and the person who makes such a consent must be a competent contracting party who is eligible to receive any contractual obligation. A party of a contract who believes that he has given an impeded consent, can plead on three grounds: *ghalaṭ* (mistake), *tadlīs* (fraud) and *ikrāh* (undue influence or duress).[42]

In a commodity futures contract nowadays, there is no doubt at all that the offer and acceptance between the buyer and the seller rightfully correspond with each other as they are made verbally. But sometimes the offer and acceptance are also made through a set of hand and finger signals that are recognised and specified by the exchange in its business rules. In addition, each exchange has its own specific rules relating to these verbal and hand signals that represent a bid or an offer, number of the contract and which commodity and delivery month.

In determining the validity of the consent given in this trading, it is required that there should be no impediment that may vitiate the validity of the consent given by the contracting parties at the execution of the contract. Through the currently practised open outcry auction, there is a very little room for any element of mistake, fraud or duress to occur. This is because this time-honoured trading system allows the traders to transact in an open free market atmosphere. For this reason, the process is still in use in the present commodity futures exchanges. If there is any conduct that falls within the ambit of the above said impediments, for example, an act to create a false or misleading trading which could be categorised as a fraud, the offender will certainly subjected to a disciplinary or arbitration proceeding handled by the exchange. He may also being brought to a legal hearing if such fraudulent conduct has violated any provision of the local relevant law.

[42] Al-Sanhūrī, *Maṣādir*, v. 2, pp. 97-98, Al-Qurrah Dāghī, ᶜAlī Muḥyiddīn. *Mabda' al-Riḍā fī al-ᶜUqūd.* Beirut: Dār al-Bashāir al-Islāmiyyah, v. 1, 1985 p. 600. For further explanation, please refer to introductory chapter.

Thus, at this point, any consent given in the execution of a commodity futures contract through the open outcry auction may be considered to be a valid one and the only thing that matters to the traders during the auction is whether they are willing or not to buy the commodity futures at a higher price or to sell at lower price than they had anticipated.

3.2.4. The position of the common stipulated conditions in the open outcry auction and contract specifications of a commodity futures contract in Islamic Law

Inasmuch as traders are willing to trade in futures contracts for whatever purpose,[43] they have to comply with the traditional requirement of all commodity futures exchanges that the price of the underlying commodity must be determined through the process of open outcry auction. In other words, unlike any other simple contract, the market price in a commodity futures contract is not fixed by the owner but is determined in the open outcry auction. Admittedly, it is the generally necessary in this technological age, for exchanges to be made responsible for disseminating the commodity prices which are set out on the trading floor in the open outcry auction.[44] Therefore, the traders have to adhere to whatever rules and conditions that are outlined by the exchange so as to provide a fair market and just execution of the commodity futures contract in accordance with its contract specification.

Approaching the limitation in the contract specification and various other conditions required in the open outcry auction, it is necessary to have a clear-cut guideline as to what type of condition and requirement would ensure that the contract remains valid. To begin with, there are three types of conditions, as

[43] Besides trading in commodity futures for commercial purposes, a number of futures traders trade in futures contracts for their investment, hedging and speculation purposes.
[44] Chicago Board of Trade, *Commodity*, p.35.

formulated by the majority of Islamic scholars; *sahīh* (valid), *bāṭil* (void) and *fāsid* (voidable).[45] A *fāsid* condition is the condition that upsets the balance of equality and fairness between the contracting parties. The existence of such a condition in any contract renders the contract as voidable.[46] A *bāṭil* condition that contravenes the rights of the contracting parties[47] may also result in a voidable or even void contract. Usually, a condition that does not confer any advantage on both parties or deny the original purposes of the contract and is detrimental to the parties' right and interest, shall be regarded as a *bāṭil* condition.[48] On the other hand, a condition that in effect, enhances advantages and benefits for both parties may be recognised as a *sahīh* condition. However, such a condition is only permitted to be stipulated in a contract if it satisfies one of these characteristics:

(a) it is implied in the nature of the contract, such as the condition that requires that the object of the contract must be delivered to the buyer or, the object must be returned to the seller if there is any defect, or,

(b) it is intimately connected with the contract, such as the requirement that the guarantor must be present at the time of contract in a pledge contract, or,

(c) it has been established or practised by custom or common tradition.[49]

Therefore, whenever a condition meets one of the above criteria, it becomes obligatory on the contracting parties.[50] They are bound to perform the specified duty and should adhere to any outcome of the said condition. Unless the condition is contradictory to any legal provision of Islamic Law, then it is considered as a *bāṭil*

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[45] Al-Sanhūrī, *Maṣādir*, v. 3, p.105.

[46] Rayner, S. E. *The Theory of Contracts in Islamic Law*. London: Graham & Trotman, 1991 p.353.

[47] According to Ḥanafī school, a *fāsid* condition may either makes the contract void or voidable, depending on its features. For further explanation, see, Al-Sanhūrī, *Maṣādir*, v. 3, p.121.

[48] Al-Shīrāzī, *Al-Muhadhdhib*, v. 1, pp. 356-357, Muḥammad, Yūsuf Kamāl. *Al-Maṣrafiyyah al-Islāmiyyah al-Azmah*. Egypt: Dār al-Nashr li al-Jāmi'āt al-Miṣriyyah, 1996 p. 206.

[49] Al-Shīrāzī, *Al-Muhadhdhib*, v. 1, p. 356, Al-Sanhūrī, *Maṣādir*, v. 3, p.106-118.

[50] According to Ibn Taimiyyah, stipulating a condition concerning legal characteristic of the subject matter that is ordinarily expected from the contracts shall also be admissable. See, Al-Jundī, Muḥammad al-Shaḥāt. *Muᶜāmalāt al-Burṣah fi al-Sharīᶜah al-Islāmiyyah*. Cairo: Dār al-Nahḍah al-'Arabiyyah, 1988 p. 159.

condition and should be disregarded. This principle is based on the *ḥadīth* of the Prophet (peace be upon him) who had said,

> "... The one who had stipulated a condition that is not stated in the Book of Allah shall receive nothing though he had stipulated a hundred conditions."[51]

Having regard to the above principles of Islamic Law on the stipulated conditions, the specification of the commodity futures contract and the required process of open outcry auction in determining the price of the commodity are supposed to be the most appropriate trading system for executing a commodity futures contract. Although such a process does not seem to be a part of the commodity futures contract nor does it imply the nature of the contract, the process is strongly connected to the concluding of the contract. The governing local law and the exchange's rules do not recognise any trade which is made beyond the trading floor where the auction takes place, while the limitation and requirement stated in the contract specification too, such as the limitation of price and quantity of the underlying commodity, do provide a few benefits for the traders. These limits and specifications are designed in such a way as to avoid any confusion or mistake in the execution of the contract.

Furthermore, the process of open outcry auction has been practised for centuries and has long been recognised by commodity futures traders. It has traditionally been a necessity for every exchange which is designated to trade in commodity futures contracts. The process, in fact, becomes a part of the exchange economic function in order to reduce price fluctuation. This phenomenon shows that the determination of commodity futures price through the auction is not only advantageous for the traders but also beneficial for the nation. Similarly, the specification of each commodity futures contract is always acceptable to every

[51]Ibn Ḥajar (Al-ᶜAsqalānī), *Fatḥ al-Bārī*, v. 5, pp. 443-444.

futures trader since it standardises the contract. By such standardisation, each trader can easily execute the contract and offset it if he does not wish to perform the contractual obligations. Based on the legal maxim, 'The common practice among the traders shall have the same effect as the stipulated condition between them'[52] and the concept of *al-maṣlaḥah* (public interest), this process should be permissible in Islamic Law. By virtue of the maxim above, any common practice among the traders can be a valid condition so long as it does not contravene any express provision of Islamic Law and it is not objectionable.[53]

3.3. Conclusion and Summary

Although the rules and regulations of the exchanges vary from one to another, the open outcry auction process is among the common features that any commodity futures exchange has. The process plays a vital role in determining the prices of commodity futures as well as the actual cash commodity. Throughout this process buyers and sellers discover the market value of their specific commodity. They are free to offer to sell, or bid to buy the commodity at any reasonable price provided that the transaction is concluded through the process and in accordance with the limitations stated in the contract specification. In other words, any agreement on a commodity futures contract is subject to the process, and any relevant rules and procedures apply accordingly.

Legally, any transaction, which is formed through the open outcry auction process is valid as long as every trader abides by the law and specified rules and regulations of the respective exchange. Any violation of any legal provision or exchange rule will consequently upset the original purposes of the process. Therefore, in such cases, the local law has imposed fines and penalties as well as

[52] Al-Zarqā', Aḥmad Muḥammad. *Sharḥ al-Qawā'id al-Fiqhiyyah*. Damascus: Dār al-Qalam, 4th edition, 1996 p. 239.
[53] Al- Zarqā', *Sharḥ*, p. 239.

empowering the exchanges to deal with any violation of the rules through its arbitration proceeding.

On the other hand, such a trading process does not primarily affect the validity of the commodity futures contract under Islamic Law. This process, which is similar to the execution of *bay^{c} al-muzāyadah,* is also operated by the exchange under strict regulation in order to provide fair competitive trading for the futures traders. So far, the formation of this transaction satisfies the basic structure of a valid legal contract. All the elements of a valid contract are satisfied and the traders give their consent in the execution of the contract. If there is proof showing that an element of *ikrāh*, *ghalaṭ* or *tadlīs* has occurred in the process, the traders are entitled to rescind the contract or be eligible to compensation if such rescission is not possible.

Although the futures traders are subjected to certain conditions, especially those conditions which are stipulated in the contract specification, these conditions are obviously valid and enforceable. They are actually designed to reduce the uncertainty associated with the contract as well as to avoid any possibility of confuse or mistake. Certainly, with such criteria, these conditions should be permissible in Islamic Law. In support of this view, it is evident that the commodity futures traders accept the execution of commodity futures contracts through the open outcry auction process together with the universal requirements and limitations. Thus, it is possible to consider such a formation of commodity futures contracts as part of common practice with no rejection from the futures traders. Therefore, the process of open outcry auction should be permissible in Islamic Law at least on the ground that it is a custom or common practice among the futures traders.

PART TWO

THE ACTUAL MECHANISM OF A COMMODITY FUTURES CONTRACT

CHAPTER FOUR

THE REQUIREMENT OF MARGINS AND THE POSITION OF THE MARGINS SYSTEM

4.1. The margins system in practice

A transaction on commodity futures is actually a margin transaction.[1] The system of margins is intended to reduce default risk as well as being a means of settling the losses and gains on any futures contract.[2] For these reasons, futures trader deposits a mutually acceptable amount of money or its equivalent with his brokerage firm before he begins to trade. If a default occurs, this margin deposit is used to compensate the other party's financial losses arising from the default.[3] This shows that the margin deposit in a futures contract is paid as a good faith deposit[4] or performance bond and not as a part payment of the value of the underlying commodity such as the similarly requisite margin deposit in capital trading.

The margin system is commonly formed by the clearing margins[5] and customer margins[6] that serve as a contractual performance security (See Figure 4.1).

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[1] New York Institute of Finance (NYIF). *Futures; A Personal Seminar*. New York: NYIF Corp. 1989 p. 52.
[2] Duffie, Darrell. *Futures Markets*. New Jersey: Prentice-Hall, Inc. 1989 p. 58.
[3] Belveal, L. D. *Commodity Speculation with profits in mind*. Illinois: Commodities Press, Belveal & Co, Inc. 1967 p. 19.
[4] NYIF, *Futures*, p. 52
[5] The clearing margin is usually known as the clearing house margin since its minimum amount is determined by the clearing house.
[6] The customer margin is sometimes being called as exchange margin as the minimum of such margin is fixed by the exchange. See, Fink, Robert E. *Futures Trading*. New York: New York Institute of Finance, 1988 pp. 135-136.

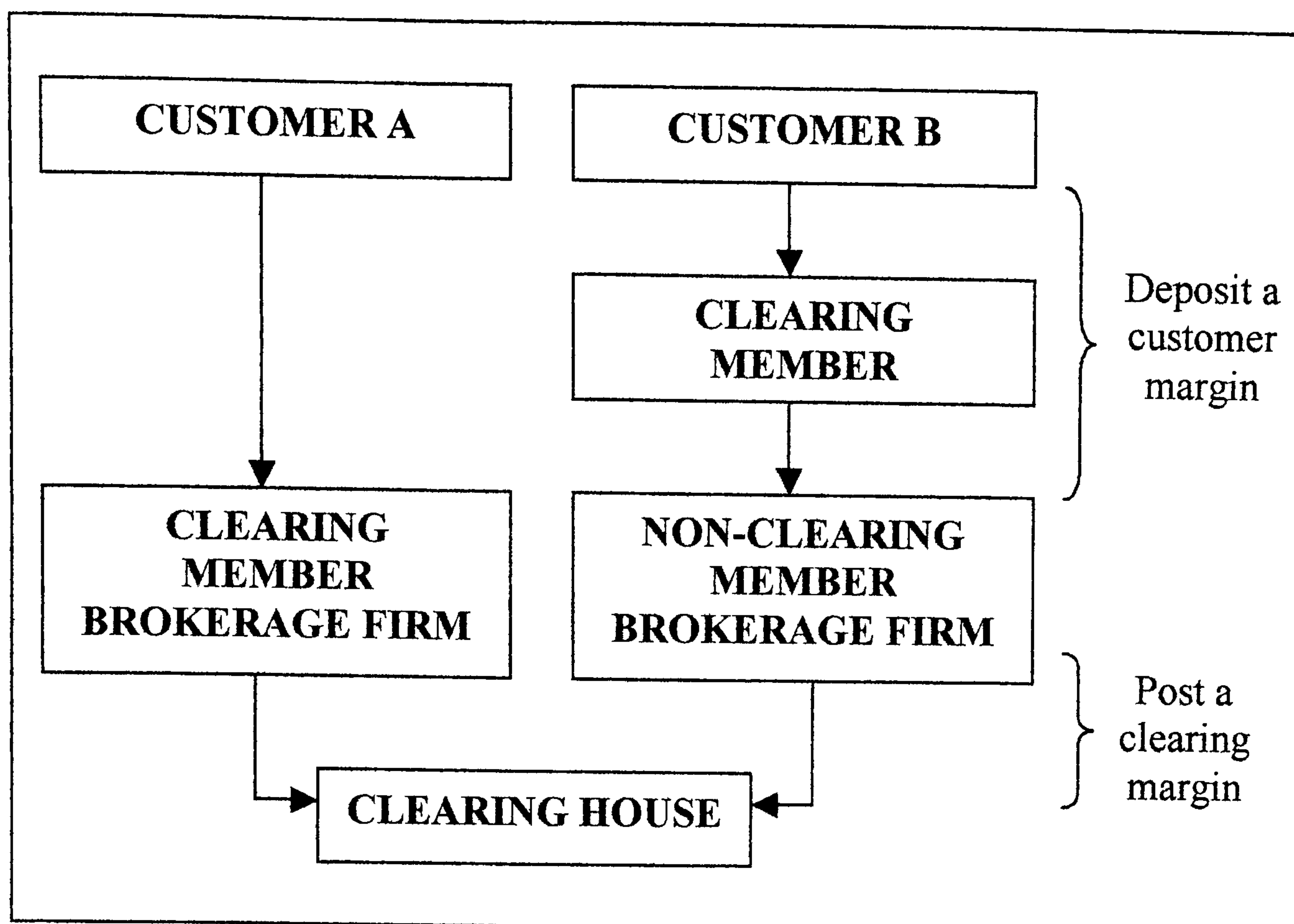

Figure 4.1. A typical flow of margins system

The clearing margin is deposited by a clearing member (in most cases a broker firm) with a clearing house for every open position. This margin is designed to guarantee the performance of a clearing member's obligations and to compensate in case of default. It consists of two parts, the initial margin, which has to be deposited whenever the clearing member wishes to open or increased a position, and the variation margin that may be regarded as a daily resettlement payment. Both these margins must be paid based on the clearing member's trade during the day, and must be made in accordance with the adverse price movements on all positions.[7]

The amount of the original clearing margin varies from clearing house to clearing house. Typically, the clearing houses set a margin based on the volatility of

[7] Duffie, *Futures*, p. 60.

the contract, approximately at five to ten per cent of the contract's underlying cash value.[8] Inevitably, the amount of the original margin will be higher during periods of rapid price changes (high volatility). The clearing houses are empowered to revise their margins and change the amount accordingly. If there is any change, the clearing member will be given notice, requiring him to deposit an additional sum in addition to the original margin.[9]

Likewise, the variation clearing margin will be required whenever the clearing member's outstanding contracts incur gains or losses due to price fluctuations. If the price is in his favour, the clearing house pays him the variation margin and if the price is against him he has to deposit a variation margin. This daily settlement process allows all open positions to be 'marked-to-market'[10] at the end of each business day.[11] Briefly, this means that the old contract is cancelled and a new one is written at the current price. The appropriate compensation or the variation margin will be paid accordingly.[12]

The customer margin is commonly determined by the exchange,[13] which sets the minimum amount for the customer margin, which is not less than the clearing margin. This margin is maintained by the client of the clearing member who is

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[8] Kuala Lumpur Commodity Exchange (KLCE). *The Kuala Lumpur Commodity Exchange*. Kuala Lumpur: KLCE (No Date) p. 12.
[9] Duffie, *Futures*, p. 60.
[10] This phrase means to debit or credit a margin account on a daily basis based on the close of that day's trading session. In this way, buyers and sellers are protected against the possibility of contract default. See, Chicago Board of Trade (CBOT). *Commodity Trading Manual*. Chicago: Board of Trade, 1994 pp. 353-354.
[11] KLCE, *The Kuala Lumpur*, p. 12.
[12] Kohn, Meir. *Money, Banking and Financial Markets*. Orlando: The Dryden Press, 1993 p. 326.
[13] Fink, *Futures*, p. 157.

acting as his futures broker.[14] The customer margin also comprises an original or initial margin and a variation margin.

The initial customer margin is deposited with a broker firm by the client of the firm before he can begin trading. It may be in the form of cash, letters of credit or securities.[15] Although every exchange has a minimum margin requirement for a brokerage firm's client, the firm usually charges its client more than this minimum margin. For instance, at the Malaysian Commodity and Monetary Exchange (COMMEX Malaysia), the broker is required to collect and maintain a margin from each client for an amount which is not less than the margin calculated by the clearing house for all open contracts.[16]

As the minimum amount of the customer margin varies in different exchanges so, it also differs according to the type of underlying commodity,[17] the volatility of the contract and the nature of the client's account.[18] There are two considerations in determining the appropriate level for such margin: the margin must be low enough to allow the broad participation that provides market liquidity and the level must be high enough to ensure the financial integrity of the contracts.[19]

Similarly, the exchange also sets the maintenance margin level (also called the maintenance balance) for the customer margin. Should the client's account fall

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[14] Duffie, *Futures*, p. 64.
[15] To give an example, Rule 312 of *COMMEX Malaysia Business Rules* (as at July, 1999) provides that a broker may accept cash, letters of credit, bank guarantee and other approved securities as margin deposits.
[16] R311, *Business Rules of COMMEX Malaysia.*
[17] Oster, Merrill J. *Commodity Futures for Profit.* Iowa: Investors Publications, 1979 p. 3 /4.
[18] Duffie, *Futures*, p. 64.
[19] NYIF, *Futures*, p. 52.

below this maintenance level, he will receive a margin call.[20] This indicates that he has insufficient money in his account to support his position due to price fluctuation and that he needs to deposit additional margin money. Failure to do so will commonly lead to the closing out[21] of all the client's positions.[22] In this event, the brokerage firm retains the right to liquidate or close out the client's account after due notification.[23]

Like the clearing margin, the customer positions are 'marked-to-market' based on the new settlement price at the end of each trading session. In other words, the customer account is in effect credited with favourable price changes and debited with unfavourable price changes. Therefore, if his account drops below the maintenance level, he then receives a margin call.[24]

In summary, the clearing margin system is more rigid compared with the system for customer margins. Though both margins are marked-to-market daily, there is no maintenance level with regard to clearing margins. Furthermore, the variation call for clearing accounts can be issued by the clearing house on a single day since the clearing house is empowered to issue such intra day margin call. Therefore, in an event of unanswered margin calls, a clearing member could expect disciplinary proceedings,[25] while his customers may have some alternatives at his discretion before their positions are finally closed out.

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[20] It simply means a request by a brokerage firm that the client must add capital to his commodity account to cover an unrealised loss, which has occurred in his position decreasing his initial margin below the maintenance level due to the mark-to-market process. See, Gould, Bruce G. *The Dow Jones-Irwin Guide to Commodity Trading*. Illinois: Dow Jones-Irwin, 1981 p. 340.
[21] To close out means to sell or to buy in, whichever appropriate.
[22] Oster, *Commodity*, p. 3 /4.
[23] NYIF, *Futures*, p. 54.
[24] Duffie, *Futures*, p. 65.
[25] Fink, *Futures*, p. 158-159.

From consideration of the whole margins systems and its related procedures, it could be implied that each clearing house as well as the exchange has an absolute discretionary power to determine the margins' levels, and to decide any remedies for non-compliance or a violation of its rules and recognised practices. Any action would appropriately be taken solely to protect financial integrity of the clearing house and the exchange.

4.2. The Islamic Law Approach on the Requirement of Margin and the Margins System

As the commodity futures contract binds the trader to putting up and maintaining a set amount of money in reserve in the margin account,[26] inevitably the trader needs to be wary of price fluctuations since they may cause him to deposit more cash to top up his margin account, otherwise all his positions will be in effect closed out. Obviously, the issues to be examined are generally covering the positions of margin deposits and the 'mark-to-market' process.

4.2.1. The Position of Margins in Islamic Law

A request for deposit as a guarantee or security is common in a daily transaction permitted under the Islamic Law principles. The concepts concerning deposit, guarantee and security agreements have always been discussed and, to certain extent, recognised by Islamic scholars. Among those contracts that have been legally recognised in relation to deposits, guarantee and security are the contract of

[26] Oster, *Commodity*, p. 3 /4.

al-kafālah or *al-ḍamān* (suretyship or collateral security), the contract of *bay*[c] *al-*[c]*urbūn* (sale by deposits) and the contract of *al-rahn* (pledge).

(i) Contract of *al-kafālah* or *al-ḍamān*[27] (Suretyship or Collateral Security)

Al-kafālah literally means responsibility or suretyship, and legally it means a guarantee or pledge given by the *kafīl* (guarantor) to the *makfūl lah* (creditor) on behalf of the *aṣīl* or *makfūl anh* (the debtor) to ensure that the *makfūl bih* (the guaranteed object) will be performed at a definite time.[28] Al-Jazīrī, however, suggests a more comprehensive definition given by the Ḥanafī scholars, that *al-kafālah* means to add or associate a liability (*dhimmah*) with another upon a claim, either for the person, debt or corporeal property.[29]

The fundamental elements for a contract of *al-kafālah* are simply the declaration of offer and acceptance as prescribed by the Ḥanafī scholars.[30] This connotes that the formation of a legal contract of *al-kafālah*[31] is by agreement between the guarantor and the creditor. The contract is not restricted by the consent

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[27] It is also known as *al-za*[c]*āmah*, *al-qabālah* and *al-ḥamālah*.
[28] Ibn Qudāmah, [c]Abdullāh Aḥmad Muḥammad. *Al-Mughnī*. Cairo: Maktabah al-Jumhuriyyah al-Arabiyyah, (No Date) v. 5, p. 70, Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ* [c]*alā Matn Minhāj al-Ṭālibīn*. Damascus: Dār al-Fikr, (No Date) v. 2, p. 198, Al-Zarkashī, Shamsuddīn Muḥammad. *Sharḥ al-Zarkashī* [c]*alā Mukhtaṣar al-Kharqī*. Riyadh: Maktabah al-Abikan, 1993 v. 4, p. 114, Hasan, Abdullah Alwi. *Sales and Contracts in Early Islamic Commercial Law*. Islamabad: Islamic Research Institute, 1994 p. 142. For more definitions, see, Al-Zuḥaylī, Wahbah. *Al-Fiqh al-Islāmī wa Adillatuh*. Damascus: Dār al-Fikr, 1989 v. 5, p. 132.
[29] Ibn [c]Ābidīn, Muḥammad Amīn. *Radd al-Muḥtār* [c]*alā Durr al-Mukhtār Ḥāshiyah Ibn* [c]*Ābidīn*. Pakistan: Maktabah Majīdiyah, 1399H v. 4, 277-278, Al-Jazīrī, [c]Abdul Raḥmān. *Al-Fiqh* [c]*alā al-Madhāhib al-Arba*[c]*ah*. Beirut: Dār al-Kitāb al-'Ilmiyyah, (No Date) v. 3, p. 221.
[30] Al-Khafīf, [c]Alī. *Aḥkām al-Mu*[c]*āmalāt al-Shar'iyyah*. (No Place): Dār al-Fiqh al-[c]Arabī, (No Date) p. 443.
[31] This contract is legalised by a few Quranic verses, (3:37), (12:66) and (12:72).

of the principal debtor. *Al-kafālah* may also occur in guaranteeing the presence of the *makfūl* *ᶜanh* for an execution of punishment. In addition, a corporeal property or capital asset (*ᶜayn*) can also be a form of *makfūl bih* (the guaranteed object).[32] However, the latter category of *kafālah* is confined to the 'self-guaranteed' property or asset (*al-aᶜyān al-maḍmūnah bi nafsiha*) only, such as stolen property (*al-maghsūb*), and assets guaranteed by others (*al-aᶜyān al-maḍmūnah bi ghayriha*), such as a pledged property.[33]

In general, a contract of *al-kafālah* may be unconditional (*muṭlaqah*) or stipulated (*muqayyadah*) with restrictions and conditions that are closely related to the contract. For instance, the period of the guarantee can be pre-determined to a certain date, but the contracting parties must first of all fulfil the basic requirements of the contractual capacity as well as be known to each other. Furthermore, the guarantor must be capable of satisfying the debt or the guaranteed object.[34]

The above-mentioned principles of *al-kafālah* could, at least, show that additional liability may be created as a security for the performance of an obligation. Comparing this contract of *al-kafālah* with the margins system, it seems that no clear *ᶜillah* (effective cause) could be established between the two in order to apply the principles of *al-kafālah*. However, as the purpose of both *al-kafālah* contract and margins is the same, that is, to guarantee the performance of an obligation, the

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[32] Ibn ᶜĀbidīn, *Radd,* v. 4, pp. 280-281, Ibn Qudāmah, *Al-Mughnī,* v. 5, pp.70-71, Al-Zarkashī, *Sharḥ*, v. 4, p. 120.
[33] Al- Jazīrī, *Al-Fiqh*, v. 3, pp. 221-223.
[34] Ibn ᶜĀbidīn, *Radd,* v. 4, pp. 281-282, Ibn Qudāmah, *Al-Mughnī,* v. 5, pp.74-75, Al-Zarkashī, *Sharḥ*, v. 4, p. 117, Al- Zuḥaylī, *Al-Fiqh*, v. 5, pp. 136-145.

principles of *al-kafālah* can be utilised as guidelines in a further examination of the margins system.

(ii) The contract of *bay^{c} al-^{c}urbūn*[35] (sale by deposit)

Bay^{c} al-^{c}urbūn is a contract of sale in which the buyer deposits a certain amount of money as a part-payment of the price of the object on the condition that the outstanding money will be seized by the seller if the buyer does not wish to conclude the contract.[36] However, if he would like to proceed with the contract, the deposit money will be calculated as part of the whole value of the object of the contract.

Originally, this contract of sale was forbidden by the Prophet (peace be upon him). It is reported that He (peace be upon him) had prohibited *bay^{c} al-^{c}urbūn*.[37] The rationale of this prohibition is the presence of *gharar* elements because, among other things, the position of the deposit money may either be part of the price upon completion of the contract or become the seller's property if the outstanding contract fails. Furthermore, if the contract is not concluded, the seller will automatically forfeit the deposit money without any consideration in return. This is equivalent to false acquisition of property.[38]

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[35] The word *'urbūn* may also being pronounced as *'arabūn* and *'urbān*.
[36] Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 448.
[37] The tradition was quoted in, Al-Sanhūrī, ^{c}Abdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī*. Beirut: Dar Ehya' al-Thurath al-'Arabi, (No Date) v. 2, p. 91.
[38] Al-Sanhūrī, *Maṣādir*, v. 2, pp. 91-93.

The classical scholars tried to recognise the contract of *bay^c al-^{c}urbūn*. By stipulating that the deposit money must be returned to the buyer upon non-execution of the contract, the contract could be made permissible.[39] But, according to Imām Aḥmad ibn Ḥanbal, the deposit may remain with the seller if the buyer gives his consent.[40] However, as Al-Sanhūrī prefers, the seller is entitled to own the deposit in return for missing the opportunity of selling the goods to other person.[41]

In addition, some of modern scholars insist on the permissibility of *bay^c al-^{c}urbūn* based on customary practices, since the traditions prohibiting such sales are not authentic traditions.[42] Although many of them consider that *bay^c al-^{c}urbūn* is legal, the elements of *gharar* and injustice still exist. Therefore, it is wise to legalise the contract of *bay^c al-^{c}urbūn* with a redeemable deposit. Though the seller loses the opportunity of selling the goods to others, this loss cannot be valued and cannot be counted as a loss that makes the seller eligible to be compensated with the deposit money.

Though the formation of contract is similar, the margin money is, however, deposited with the brokerage firm, or for the broker, the margin is deposited with the clearing house. Apparently, the margins are not deposited with the counterparts, as in the contract of *bay^c al-^{c}urbūn*. Nevertheless, as the entire futures contract ends at the clearing house where the clearing house interposes itself as the buyer for all

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[39] Al-Sanhūrī, *Maṣādir*, v. 2, p. 93.
[40] Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 449.
[41] Al-Sanhūrī, *Maṣādir*, v. 2, p. 95.
[42] Al- Zuḥaylī, *Al-Fiqh*, v. 4, p. 450.

sellers as well as seller for all buyers,[43] it is safe to say that all margin is, in fact, deposited with the clearing house, who is the counterpart for every futures trader, in the form of individual or corporate margin account. In other words, every trader must deposit margin money in order to buy or sell commodity futures. This margin must be maintained until the contract is settled.

Settlement of a futures contract may be either by offsetting[44] or contract maturity,[45] i.e. by making and taking delivery of the underlying commodity. At this point, the *al-ᶜurbūn* and margin differ. If the contract is settled by offsetting, the margin remains property of the trader, as in *al-ᶜurbūn*, provided that any loss or cost incurred is paid therein, but if the contract is settled by maturity, the margin may or may not be used as part payment of the price of the commodity. This is because firstly, the margin is paid as a form of guarantee for the performance of contractual obligations and secondly, margin money is deposited, deducted and added (if any) for as long as the contract is open. Once the contract is closed or settled, by offsetting or maturity, technically, no margin is required while the deposited margin (initial margin) still belongs to the trader.

The difference between the *al-ᶜurbūn* and margin materialised at the settlement of contract is due to the different purposes for which they are paid. However, for the sake of enhancing fair trades, the deposit money, be it *al-ᶜurbūn* or margin, should not be affected by any factors other than default of its depositor.

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[43] This process is known as "novation".
[44] Offsetting means closing out a futures contract position by selling or purchasing an equal futures contract of the same delivery month but opposite to the existing futures contract position.
[45] A futures contract reaches its maturity when it is no longer permitted to be traded on the exchange trading floor, usually it is determined a few days before the specified date for the delivery of the commodity.

(iii) The contract of *al-rahn* (the pledge)

Al-rahn is a form of security for the payment of a debt or for the performance of a pecuniary obligation. Undoubtedly the contract of *al-rahn* has been recognised under Islamic Law[46] as a contract in which a property is pledged for its material value so as to make it possible to regain the debt from the property or part of it.[47]

The formation of this contract is quite simple. As portrayed by the Quranic verse (2:283), a person may pledge any of his property to guarantee his debt as an alternative to documentary evidence. The verse reads as follow:

> "And if you are on a journey and cannot find a scribe, pledges (may be taken) in hand, but if you trust one another, then let him who is trusted fulfil his trust, and let him be conscious of Allah, his Sustainer. And do not conceal what you have witnessed for, verily, he who conceals it is sinful at heart, and Allah has full knowledge of all that you do."[48]

Therefore, if such a person defaults in paying his debt, besides being a proof of his obligation, the pledged property could also be used as a resource to satisfy the debt.

A contract of *al-rahn* is similar to any other ordinary contract that consists of three elements, namely, the parties, the subject matter and the terms of offer and

[46] The legality of the contract of *al-rahn* was found in the Quranic verse (2:283) and in a few traditions; for instance, the Prophet (peace be upon him) was reported to have bought some foodstuff on credit for a limited period and to have given his armour as a security for it.

[47] Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ ᶜalā Matn Minhāj al-Ṭālibīn*. Damascus: Dār al-Fikr, (No Date) v. 2, p. 121, Al-Zarkashī, *Sharḥ*, v. 4, p. 25, Al-Jazīrī, *Al-Fiqh*, v. 2, p. 319.

[48] Translation of Quranic verse (2:283) in, Asad, Muhammad. *The Message of The Quran* (Translation and Explanation). Gibraltar: Dar al-Andalus, 1984 pp. 63-64.

acceptance, while Ḥanafī scholars, as usual, regarded the terms as the only element of any contract.[49] The parties need to be in full contractual capacity and the subject matter, either the *marhūn* (the pledged property) or the *marhūn bih* (the debt) must be certain.[50] The *rāhin* (pledgor) must be the rightful owner of the *marhūn* which must be free from any attachment of other's interest (however, this does not include joint ownership property) whereas the *marhūn bih* should be in the form of an obligatory right that needs to be returned to its rightful owner,[51] for instance, a debt that needs to be paid to the creditor. Furthermore, the *marhun bih* must be an obligation that is capable of being performed or fulfilled by the *rāhin.*[52]

This contract is executed by submitting the *marhūn* to the *murtahin* (pledgee). He will keep the property in his possession for a specified period as stipulated in the contract. However, by entering into this contract, the *murtahin's* right to claim (*ḥaqq al-muṭālabah*) for his debt does not cease, especially when there is no specific time stipulated in the contract.[53]

In such a contract, the pledged property will be kept in the *murtahin's* possession and neither the *rāhin* nor the *murtahin* may exploit or utilise it. Nevertheless, depending on the type of property and the consents of both parties, either of them may utilise or enjoy any usufruct of the pledged property. For instance, if the pledged property is a riding animal, the *murtahin* may ride this

[49] Al-Jazīrī, *Al-Fiqh*, v. 2, p. 320.
[50] Al-Sharbīnī, *Mughnī*, v. 2, pp. 122-123, Al-Zarkashī, *Sharḥ*, v. 4, p. 81, Al-Khafīf, *Aḥkām*, p. 435.
[51] Al-Sharbīnī, *Mughnī*, v. 2, p. 126, Al- Zuḥaylī, *Al-Fiqh*, v. 5, p. 193.
[52] Al-Sharbīnī, *Mughnī*, v. 2, pp. 127-128, Al- Zuḥaylī, *Al-Fiqh*, v. 5, p. 198.
[53] Al-Zarkashī, *Sharḥ*, v. 4, p. 26, Al-Khafīf, *Aḥkām*, p. 437.

animal upon given consent of the *rāhin*.[54] In fact, the Prophet (peace be upon him) was reported to have allowed such utilisation.[55]

In an event of destruction or loss of the pledged property, the *murtahin* should not be held liable if such destruction or loss is not due to his negligence or misconduct. As the pledge is held on trust (*amānah*) for the *rāhin*, the majority of scholars consider that his debt should not be affected by such an incident.[56] In other words, if the pledged property is damaged by itself, the *rāhin* loses his right of security and no liability will be incurred on the *murtahin*. In such case, both parties should withdraw the contract and settle any remaining obligation. However, if the damage was caused by the *murtahin*, his right to claim the debt is lost and he has to compensate the *rāhin* if the value of the property is more or higher than the debt.[57]

Most scholars allow the *murtahin* to keep the pledged property for as long as it takes the *rāhin* to pay the debt. Even if the debt is due, the *murtahin* may retain the property, unless his debt is paid off or the contract of *al-rahn* itself had ended. A contract of *al-rahn* may end by payment or remission of the debt, or by rescission of the contract.[58] Although the *murtahin* reserves the right to hold the pledged property until his debt is paid or the contract ended, he is not entitled to forfeit the said property in a case of default.[59] In such an event, the pledged property will be

[54] Al-Sharbīnī, *Mughnī*, v. 2, p. 130, Al-Zarkashī, *Sharḥ*, v. 4, pp. 48-49, Al- Jazīrī, *Al-Fiqh*, v. 2, pp. 332-335.
[55] The tradition is quoted in, Hasan,*Sales*, p. 148.
[56] Al-Sharbīnī, *Mughnī*, v. 2, p. 136, Al-Zarkashī, *Sharḥ*, v. 4, p. 46, Al- Zuḥaylī, *Al-Fiqh*, v. 5, pp. 266-268.
[57] Al-Sharbīnī, *Mughnī*, v. 2, p. 137, Hasan, *Sales*, pp. 150-152.
[58] Al- Zuḥaylī, *Al-Fiqh*, v. 5, pp. 280-281.
[59] Hasan, *Sales*, p. 154.

judicially put on sale (*al-bay^c al-ijbārī*) unless the *rāhin* voluntarily makes such a sale (*al-bay^c al-ikhtiyārī*) upon the *murtahin's* claim.[60]

Basically, this contract of *al-rahn* is established in order to guarantee the payment of debt to the creditor, like the contract of *al-kafālah*. Nevertheless, this form of guarantee may also be extended to secure other types of monetary payment that result from a contractual obligation. For instance, a buyer may pledge a piece of land belonging to him for the execution of his hire-purchase contract with a financier. Among the contemporary versions of contract of *al-rahn* is the contract of mortgage. The margins system, in fact, greatly resembles the contract of *al-rahn*.

The *rāhin* in a contract of *al-rahn* needs to pledge part of his property, either monetary, movable or immovable, with the *murtahin* in order to guarantee the *marhūn bih*, his future perform contractual obligation, such as the payment of a debt or the price of a sale on credit. Likewise, a futures trader, either a buyer or seller, deposits a margin money with his brokerage firm as a means of ensuring his contractual performance arising from the futures contract. It is worth noting here that the brokerage firm is only an agent whose duty is to enter into a futures transaction and execute any futures dealings on behalf of the trader. This means that margin money is not paid to guarantee a contractual performance towards the broker firm, but to guarantee an obligation owed to the clearing house, that is, to make or to take the delivery of the underlying commodity.

[60] Al-Sharbīnī, *Mughnī*, v. 2, p. 134, Al-Zarkashī, *Sharḥ*, v. 4, pp. 60-61, Al- Zuḥaylī, *Al-Fiqh*, v. 5, pp. 273-275.

Although the *marhūn bih* was initially a simple form of debt or a price in a sale on credit as illustrated in the Quranic verse and a few traditions, the principles of *al-rahn* contract are meant to be general (*ḥukm ᶜām*) and not specific (*ḥukm khāṣ*) for securing payment of a debt or price on credit. In the absence of any provision that specifies the contract of *al-rahn* for matters concerning debts and credits, the recognition of this contract should be interpreted and applied generally. In support to this concept, the distinctive maxim of ' *al-ᵉibrah fi al-ᵉuqūd li al-maqāṣid wa al-maᶜānī* ' (the consideration or recognition in contracts is made for their aims and meanings) gives the idea of applying the general meaning and purposes of a contract rather than its specific functions and terminology.[61] Therefore, the rules of the contract of *al-rahn* can be applied to the margins system since both clearing margin and customer margin are paid for the same purpose as a pledged property is deposited.

The margin money has similar functions to the pledging of property by which the pledged property is kept by the *murtahin* for a certain period until his debt is paid. In a case of a *rāhin*'s default in paying the debt, the pledged property can be sold to pay the debt. Similarly, the margin is deposited into an account belonging to the futures trader under the management of his brokerage firm. Although in this case, the brokerage firm is not actually the real *murtahin*, or the person whom the trader owes an obligation, the majority of scholars say that the pledged property may be held by an upright person who is entrusted by the *rāhin* and *murtahin*.[62]

[61] Al-Nadwī, ᶜAlī Aḥmad. *Al-Qawā'id al-Fiqhiyyah*. Damsyik: Dār al-Qalam, 1994 p. 286.
[62] Al-Sharbīnī, *Mughnī*, v. 2, p. 133, Al-Khafif, *Ahkam*, p. 437.

Therefore, the brokerage firm could be regarded as the third person agreed by the trader and the clearing house.

Although the pledged property might be put on sale, either voluntarily or judicially, in the event that the *rāhin* failed to pay his debt, the margin money, on the other hand might also be used to compensate for a loss incurred from the trader's default. Usually a futures trader posts a letter of credit or securities instead of cash to be his margin deposit. In such a case, the deposits would be liquidated or the securities would be sold in order to compensate any loss and cost resulting from the trader's non-performance of his contractual obligations.

Traditionally, a pledged property has a similar or higher value than the underlying debt. Thus, the price of the pledged property is usually sufficient to pay the debt. On the contrary, the margin deposit is set at only five to ten per cent of the total value of the underlying commodity. Rationally, the margin deposit alone is not enough to recover any loss incurred. In such an event, both clearing house and brokerage firm have their own actions and procedures to compensate the loss. Commonly, a clearing house has its specific fund to overcome this situation, if a clearing member is involved. Ultimately, the clearing house might resort to terminating and selling the membership of the said clearing member. In a case where the default trader is a client of a brokerage firm all his positions in the futures trading would be closed out. Any profit received from liquidating the positions would be used to settle the loss.

As both margin and pledged property are having the same form of execution and sharing some common criteria, it seems that *Qiyās* methodology can be applied between the contract of *rahn* as the principal (*al-aṣl*) and the margin system as the secondary (*al-far^c*). Besides having similar criteria, both transactions are created for the same purpose with a few conditions in common. Though Islamic scholars do not unanimously agree it, some recognise the *Qiyās* based on conditions (*al-shurūṭ*), reasons (*al-asbāb*) and impediments (*al-mawāni^c*). An analogy is also allowed between *al-aṣl* and *al-far^c* if they carry a similar meaning (*al-ma^cnā al-mushtarak*).[63] Therefore, the above similarities between contract of *al-rahn* and margins are sufficient to be the foundation of recognising the margin system – to this extent – under Islamic Commercial Law.

4.2.2 The position of the 'marking-to-market' process in the framework of Islamic Law

As mentioned earlier, all futures traders' open contract positions will be 'marked-to-market' at the end of the daily settlement process. By 'marking-to-market' all open positions, the traders' margin accounts are credited if the price movement were in their favour, but these accounts will be debited if the situation is the reverse. The debits and credits of an account are notified to the respective account owners on a daily basis through the variation call or margin call. By this means of 'marking-to-market' process, it is claimed that the futures traders are protected against the possibility of contract default.

[63] Al- Zuḥaylī, Wahbah. *Uṣūl al-Fiqh al-Islāmī.* Beirut: Dār al-Fiqh al-Mu^cāṣir, v. 1, 1998 pp. 710-

In addition to the above protection, it is also beneficial for the clearing house when exercising its novation[64] role since it guarantees the fulfilment of every obligation of every single futures contract. Thus, should there be any default, the clearing house will compensate the other party. Such compensation would be a minimal amount if the margins of the parties concerned were updated to the current price of the underlying commodity. This price will automatically determine the current value of the futures contract in which the parties were involved. Since every exchange has set a daily speculative price limit for every traded commodity future, any loss would reasonably be minimal due to such limited price changes. However, if the margin account is not updated to the current price, though it represents some five to ten per cent of the whole value, the trader will suffer a huge loss should the price move against him because the speculative price limit is changing from time to time it may cause a big difference between the price at the very first day the commodity was traded and the price at the maturity date. As the clearing house guarantees every contract performance, it must have huge capital resources to compensate the affected trader.

'Marking-to-market' all open positions is, in effect, cancelling the old contract with a new one at the current price. The old contracts are the transaction in which the traders, buyers and sellers, agreed upon a specific month of commodity, its quantity and quality at an agreed price set in the open outcry auction. This original contract is automatically cancelled and renewed – without any fresh agreement between the parties – through the 'mark-to-market' process on each

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711.

[64] It is a legal term used for the clearing house's function in interposing itself as the buyer for every selling contract and as the seller for every buying contract.

trading day. There is no such cancellation and renewal of contract under Islamic law.

The validity and legality of a contract under Islamic Law is determined at the time of the contract. Once the contract is validly concluded, every obligation related thereto must be fulfilled. A futures contract comes under the category of contracts where the parties are responsible for performing a specific work (*al-ilzām bi ᶜamal muᶜayyan*)[65] that is, making and taking delivery of the commodity on a specific date. This contract has been legally entered on the exchange's trading floor and the parties have not made any rescission to withdraw the contract. Therefore, it could not be cancelled and renewed on its own. It is hard to believe that the 'marking-to-market' process can be recognised under Islamic Law.

The change of market price of commodities futures is vital to the 'mark-to-market' process. As the price changes daily, all positions are marked daily, but these positions are actually compltely concluded contracts. The price changes should not affect such contracts since they have been executed at their own prices. Under the provisions of Islamic Law, a contract can only be affected by two factors, legal excuses (*al-ᶜudhr*) such as a tenant who becomes bankrupt, and non-foreseeable events (*al-ḥawādith al-ṭāri'ah*) which are confined to events of crop damage, calamity and disaster. These factors may lead to rescission of a validly concluded contract.[66] However, the fluctuation of market prices of the contractual object cannot be categorised under any of these two factors since price changes are neither an

[65] Al-Sanhūrī, *Maṣādir*, v. 6, pp. 81-83.
[66] Al-Sanhūrī, *Maṣādir*, v. 6, pp. 90-91.

excuse nor an unforeseen destructive event. Thus, the market price changes should have no effect on any legally executed futures contract.

As previously discussed, the margins deposit could be treated as pledged property. If such property is producing any benefits, they belong to its owner, the *rāhin*. The *murtahin* may enjoy such benefits upon the *rāhin's* consent. Likewise, if the margins deposit produces any benefit, the trader is entitled to enjoy it. However, the debiting and crediting of the margins account do not resulted from any production or benefits of the margins, but occur by the 'mark-to-market' process. Besides that, it is quite absurd to gain profit or suffer loss without executing any transaction or dealing. Notably, such gains without consideration may amount to *ribā al-nasī'ah* (usury) since there is no such contract of investment like *al-muḍārabah,* which could possibly result in profit or loss of the capital.

It is alleged that the 'mark-to-market' process is established in order to protect the futures traders against any possibility of contract default. In other words, this process provides protection against an anticipated default that might or might not occur. This anticipation may amount to an element of *gharar*, which usually relates to a contract of probability (*al-ᶜaqd al-iḥtimālī*). Such a contract is usually void, except for instance, for a contract of insurance (*ᶜaqd al-ta'mīn* or *al-takāful*),[67] by some contemporary scholars have recognised.[68] Therefore, the 'mark-to-market'

[67] Al-takāful is a form of Islamic insurance based on the Islamic Law doctrine of al-taᶜāwun or mutual assistance. It provides mutual protection of assets and property and offers joint risk sharing in the event of loss by one of its members. It resembles the conventional mutual insurance only in the aspect that members are the insurers as well as the insured. See, Failaka International, Inc., "Glossary of Islamic Financial Terms,"at, www.failaka.com accessed on 12/05/2000.
[68] Al-Ḍarīr, S. M. Al-Amīn. *Al-Gharar wa Atharuhu fī al-'Uqūd*. Beirut: Dār al-Jīl, 1990 p. 70.

process should be avoided in order to have a legal futures contract free from such dubious elements.

It is alleged further that the clearing house has also been protected from spending huge amounts of money to compensate the affected traders in cases of default. The implementation of 'mark-to-market' process is regarded as a means of securing the interests of the clearing house and also the futures exchange. As regards the issues on interest, it has been classified, under Islamic Law provisions, into three categories according to its degree of necessity. Firstly, the mandatory interest (*al-qaṭʿiyyah*) that has been recognised by divine provision, secondly, the presumptive interest (*al-ẓanniyyah*) that is usually determined by rational perception and thirdly, the delusive interest (*al-wahmiyyah*) that is based on delusive presumption.[69] Certainly, the 'mark-to-market' process does not come under the first and the third categories. Thus, the process may be deemed as a type of the second category of interests since the process is established to ascertain a presumptive default. However, the process is not authentic enough to be recognised under Islamic law. There could be other convincing ways of overcoming contract default.

Based on these arguments, it seems that the practice of the 'mark-to-market' process should be avoided as it adds an element of *gharar* to the basic mechanism of a futures contract. It could invalidate or at least make the legal futures contract a voidable contract. Although the process has its own purpose and functions, its features are not eligible to be admitted in Islamic Law.

[69] Al- Zuḥaylī, *Uṣūl*, v. 2, p. 1057.

4.3. Conclusion and Summary

In the initial formation of a commodity futures contract, a futures trader will have to make an order to buy or sell the commodity futures before the transaction is executed on the trading floor but prior to any trading, the trader must first deposit margins, either with the brokerage firm or with the clearing house. The margins deposit is not a part of the contract's price but a form of guarantee for the performance of the obligations in the futures contract. Although there are two types of margins, clearing margin and customer margin, their formation and functions are the same. Besides the requirement to maintain a margin account, the futures trader is also responsible for margins call, which result from the 'marking-to-market' process, held at the end of each trading day.

The position of margins deposit has been analysed by applying the jurisprudence tools of Islamic Law. Since the creation of additional liability has been recognised, it is not legally wrong to permit the margins system under Islamic Law. The concept of creating additional liability had been derived from the contract of *al-kafālah*, contract of *bay^{c} al-^{c}urbūn* and contract of *al-rahn*. These contracts provide alternatives as well as solutions to the contracting parties should there be any contract default. Although the first two contracts mentioned above differ from the margins system in terms of formation and nature of the contract, an analogy has been successfully made between the contract of *rahn* and margins system. Conceivably, the margins deposit can be treated as a pledged property and therefore most of the rules on the contract of *al-rahn* could apply.

Further examination has been made of the issue of the 'marking-to-market' process. As the process is neither a vital part of the futures contract nor of the margins, it should not affect the validity of the original commodity futures contract. However, since it adds an element of *gharar* and may possibly cause injustice to a futures trader, though it is beneficial to some, this process should be avoided or removed from the whole margins system.

CHAPTER FIVE

THE ROLE AND POSITION OF THE COMMODITY FUTURES EXCHANGE AND CLEARING HOUSE

5.1 Functions and duties of the commodity futures exchange and the clearing house

Apart from the fundamental formation of a commodity futures contract, it is generally required under the relevant law that such a contract must be executed in an auction operated by an exchange on its trading floor. It is further required that such a contract must be registered and cleared by a clearing house which undertakes the role of guarantor for every contractual performance. There can be no commodity futures contract without the existence of the two institutions, the exchange and the clearing house.

Every exchange and clearing house must be operated in accordance with the local relevant laws and with the approval of the respective commission.[1] Local laws and authorities may provide different requirements and procedures for the formation and operation of the exchange and clearing house under their jurisdiction, but usually the institutions serve the same purposes and functions. For the purpose of fulfilling its functions, each exchange and clearing house is empowered to develop

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[1]For instance, in the United States, the relevant laws are the Commodity Exchange Act 1922 (last amended 1992), the Commodity Futures Trading Commission Act 1974 and Futures Trading Act 1978 while regulator is the Commodity Futures Trading Commission. In the United Kingdom, the law is Financial Services Act 1986 and the authorities are the Securities and Financial Authority and, Securities and Investment Board and in Malaysia, the law is the Futures Industry (Amendments) Act 1997 while the authority is the Securities Commission.

and enforce rules and regulations in relation to trading practices and business activities.

5.1.1 The commodity futures exchange

A contract market or an exchange used to be a place or a room where people met to obtain information and to trade.[2] Nowadays, however, an exchange or a board of trade[3] is a voluntary association of individuals interested in trading as principals or as agents for corporations or public.[4] These individuals become the members of this non-profit making organisation. In other words, an exchange is an organisation for its members, which has been designated as a contract market and regulated by the local commission,[5] for example, the Chicago Board of Trade (CBOT) is regulated by the Commodity Futures Trading Commission (CFTC). Such an exchange may regulate and enforce its own business and trading rules which make it different from any other ordinary trade association or informal market.[6]

Although they are non-profit making membership organisations, some exchanges are formed as private companies limited by shares. In these exchanges, the shareholders are the owners, distinct from the trading members. The membership of the latter category is obtained by purchasing or leasing the seats, that is, the rights to trade on the exchange floor.[7] Usually, the seats may be purchased from the

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[2] Parry, H. et al (eds.). *Futures Trading Law and Regulation.* London: Longman Law, Tax & Finance, 1996 p. 73.
[3] Some contract markets are also called a board of trade, instead of an exchange.
[4] Blank, Steven C. *Futures and Options Market: Trading in Financials and Commodities.* New Jersey: Prentice-Hall, 1991 p. 9.
[5] Kroll, Stanley. *The Business One Irwin Guide to the Futures Markets.* Illinois: Business One Irwin, 1993 p. 25.
[6] Parry, *Futures,* p. 75.
[7] Parry, *Futures,* p. 76.

exchange or from a member who wishes to sell his seat. In general, an exchange member must own at least one seat; he may or may not be a broker. A non-member may still have the right to trade on the exchange floor by leasing a seat or, in some exchanges, holding a trading permit. The requirements and procedures pertaining to a member or a non-member are provided by the business rules of each exchange.

Despite the various organisational structures of the exchanges, each serves the sole purpose of providing physical trading facilities. In performing this important economic role, the exchange also disseminates market information as well as establishing all the relevant rules consistent with local commission and government regulations.[8] The primary function of a futures exchange such as CBOT, is to provide a public marketing institution with trading facilities for futures traders in a free competitive auction-type market.[9]

In performing this function, a futures exchange is only responsible for the smooth running of the futures market, free from any fraudulent trading practice. Thus, besides providing and improving the physical trading facilities, every exchange has, several committees to deal with the different tasks relating to the floor operation and activities, records and dissemination of market information and arbitration for any dispute between the traders.[10] Regardless of the number of committees or departments, every exchange has at least one committee to observe and organise the activities of the traders on the trading floor. This committee is

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[8] Blank, *Futures*, p. 9.
[9] Kroll, *The Business*, p. 25.
[10] American Bar Association. *Futures and Derivatives- Basics*. Orlando: American Bar Association, 1996 p. 151.

authorised to report any fraudulent conduct or violation of rules to the respective disciplinary committee for further investigation.

The exchange is also empowered to have its own arbitration proceeding to resolve any dispute between the traders. A trader who feels aggrieved by his counterparty may bring the matter to the committee. Any decision made can always be mitigated and referred to the appeal board, which is usually represented by the exchange board of directors. As well as deciding cases of disputes, the board is also entitled to interpret the provisions of its rules and of the relevant Acts whenever necessary.[11]

An exchange may have as many committees as it needs in collaboration with its various traded futures and categories of traders. In collaboration with the clearing house, the exchange upholds market integrity by preventing price manipulation and enforcing trading and delivery rules and procedures.

5.1.2 The clearing house

Every commodity exchange has an entity associated with it that undertakes all its clearing procedures for all the commodity futures traded on the exchange. This entity, known as the clearing house, may be formed within the exchange organisation or as a separate company.[12] For instance, the Malaysian Derivatives Clearing House Bhd. (MDCH) is owned by two futures exchanges that each hold

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[11] Information sought from an interview with Mr Manoj Devadasan, Manager, Legal and Membership, Commodity and Monetary Exchange (Commex) Malaysia on 12/8/99.
[12] Johnson, P. M. & Hazen, T. L. *Commodities Regulation*. Boston: Little, Brown & Co., 2nd edition, 1989 p. 115.

fifty per cent of its issued share capital.[13] Unlike MDCH, the London Clearing House Ltd (LCH) is a company owned by clearing banks, not by the futures and options markets, for which it clears,[14] while at the Chicago Mercantile Exchange, the clearing operation is organised by a department within the exchange.[15]

The clearing houses have their own membership separate from the exchange membership. An exchange member may also be a clearing member, but a clearing member must be an exchange member. Usually, the clearing house board will approve an applicant to be a clearing member if he meets the stringent clearing house requirements. Among these are the requirement that the applicant must have financial strength so as to be capable of answering financial call from the clearing house.[16] For instance, MDCH has set the operational requirements (which basically require the applicant to have a good management of risk as well as adequate knowledge of the trading) as well as the requirement that the applicant must be able to pay a large sum of money for the membership fee, security deposit and clearing fund contribution.[17]

After due consideration, the clearing house board may approve the application and grant the applicant clearing house membership. Being a clearing member, a trader may clear all trades from his account or the accounts of his clients or third parties. Usually, these third parties are those who hold the related exchange membership only and not that of the clearing house.

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[13] Information sought from an e-interview with Malaysian Derivatives Clearing House on 5/8/1999, see, Appendix 3.
[14] Parry, *Futures*, p. 104.
[15] Fink, Robert E. *Futures Trading*. New York: New York Institute of Finance, 1988 p. 154.
[16] American Bar Association, *Futures*, p. 156.

Whether it is a department within the exchange or a separate corporation, every clearing house plays the same dual role of upholding financial and market integrity and providing clearing and settlement services. To uphold market integrity, the clearing house takes an important part by guaranteeing the performance of every registered contract.[18] This guarantee includes a proper and timely delivery to every buyer and secured payment upon delivery for every seller. It also ensures any payment for a contract that is closed out by an offsetting transaction.[19]

To perform this guarantee, the clearing house acts as third party to all futures contracts. By this third party guarantee, the real buyer and seller of the contract do not create a financial obligation towards each other but rather to the clearing house.[20] The process of becoming a third party guarantor is also called as the principle of substitution,[21] but is commonly known as the 'novation' process.[22] This process simply means the clearing house is assuming the role of counter party for each contract.

Technically, the novation process begins from the moment in which every matched contract is registered by the clearing house. Upon registration, the original contract is nullified and replaced with a new one in which the terms are identical to the original except that the clearing house becomes the new counter party.[23] This contract is named an "open contract". To illustrate, under the original contract, A

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[17] Malaysian Derivatives Clearing House. *Financial Integrity*. Kuala Lumpur: Malaysian Derivatives Clearing House, 1999 p. 5.
[18] New York Institute of Finance. *Futures; A Personal Seminar*. New York: New York Institute of Finance Corp. 1989 p. 77.
[19] New York Institute of Finance, *Futures*, p.77.
[20] Chicago Board of Trade. *Commodity Trading Manual*. Chicago: Board of Trade, 1994 p. 68.
[21] Fink, *Futures*, p. 157.
[22] Parry, *Futures*, p. 108.
[23] Questionnaire at MDCH.

agrees to sell the commodity futures to B. Upon registration through the novation process, there will be two open contracts where A is the seller with the clearing house as the buyer under one contract and B still a buyer but B buys from the clearing house under the other contract (See, **Figure 5.1).**

It is worth mentioning here that this novation process provides a very beneficial way to invest for every futures trader. As under the resulting open contract the trader deals with the clearing house only, he is able to offset his contractual obligation without the need to obtain an agreement or consent from his original counter party.[24] Furthermore, since the open contract is identical with the original, it can easily be matched with a new opposite contract. Once a trader buys the same contract, which he was originally sold or vice versa, he no longer owes any contractual obligation to the clearing house.[25]

On the other hand, if the trader's position remains open, his position will be subject to the margining system set by the clearing house as long as it takes. Effectively, a trader who is a clearing member is responsible for depositing an initial margin for each new contract registered in his name as well as the variation margin that may be demanded by the clearing house from time to time.[26]

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[24] Americn Bar Association, *Futures*, p. 156.
[25] New York Institute of Finance, *Futures*, p. 69.
[26] Parry, *Futures*, p. 109.

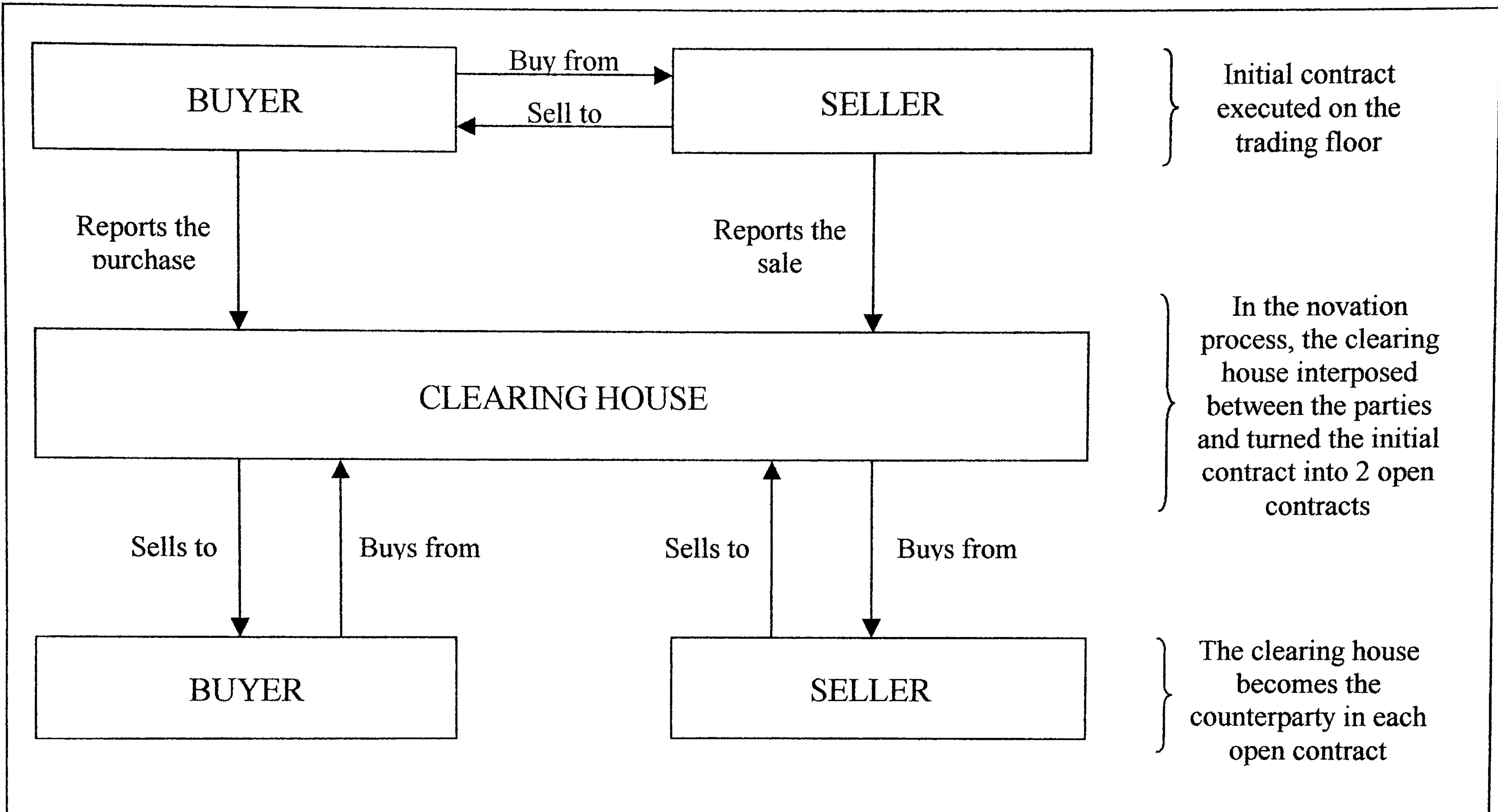

Figure 5.1 The sequence of the registration of a commodity futures contract and the novation process.
Source: Malaysian Derivatives Clearing House Bhd., Kuala Lumpur.

In support to uphold its financial integrity, the clearing house operates a daily settlement on the clearing members' accounts based on their registered open position at the end of each trading day. This daily settlement process is carried out through the margin system.[27] Under this system, the clearing house sets margin levels and calculate the margin requirements[28] according to the clearing members' positions. If he incurs any debit or credit on the accounts, a clearing member will be provided with a margin statement, and any margin call thereafter must be duly paid.[29]

This daily settlement process is commonly operated by every clearing house. The process, which is also known as the 'mark-to-market' process is carried out based on the daily settlement price of each traded commodity. The determination of the settlement price is purely a matter of practice of the clearing house which has absolute discretion in determining the price.[30] However, at LCH, there is no daily settlement price for metal futures contracts. These contracts remain open at their original prices until settlement of the contracts.[31]

An open contract may be settled either by offsetting or by delivery upon contract maturity. The clearing house deals with an offsetting transaction using the same procedure as if it were a newly executed market contract, where as a result, the current position discharges the previous position open contract. On the other hand, any contract that remains open until its expiry date will be subjected to the clearing house delivery process. This process differs technically from one clearing house to

[27] Chicago Board of Trade, *Commodity*, p. 70.
[28] For more explanation on margin, please refer to chapter 4.
[29] American Bar Association, *Futures*, p. 158.
[30] Questionnaire at MDCH.
[31] Parry, *Futures*, p. 110.

another, but the sequence of the procedure of each clearing house is almost the same.

Usually, in the settlement by delivery process a clearing house distributes notices of delivery between the seller who wishes to make delivery and the buyer who needs such delivery. The seller issues a delivery notice via the clearing member to the clearing house. This notice contains the grade, price, place and date of delivery.[32] Once the buyer receives such a notice and accepts or stops it, the clearing house obligation is ended. The delivery process is considered complete and the contract closed when the buyer accepts the warehouse receipts from the seller and, in turn, pays the price in full. The clearing house will retain its margin on account until the actual delivery is made.[33] (See, **Figure 5.2**)

Similarly, at the CBOT, there is a series of steps in the delivery process. It begins with the representation of notice from the seller to the clearing house stating his wish to deliver. Then the clearing house matches it with a buyer who is then notified by the clearing house. After due payment of the relevant fees to the clearing house, both buyer and seller deal directly with each other by respectively presenting a certified cheque for the amount due in return for the warehouse receipt.[34] Likewise, at MDCH, a selling member who intends to make a delivery will notify the clearing house with a storage receipt. By a random selection process the clearing

[32] New York Institute of Finance, *Futures*, pp. 83 & 86.
[33] New York Institute of Finance, *Futures*, p. 90.
[34] Chicago Board of Trade, *Commodity*, p. 73.

house notifies a buying clearing member and requires him to make payment of the delivery.[35]

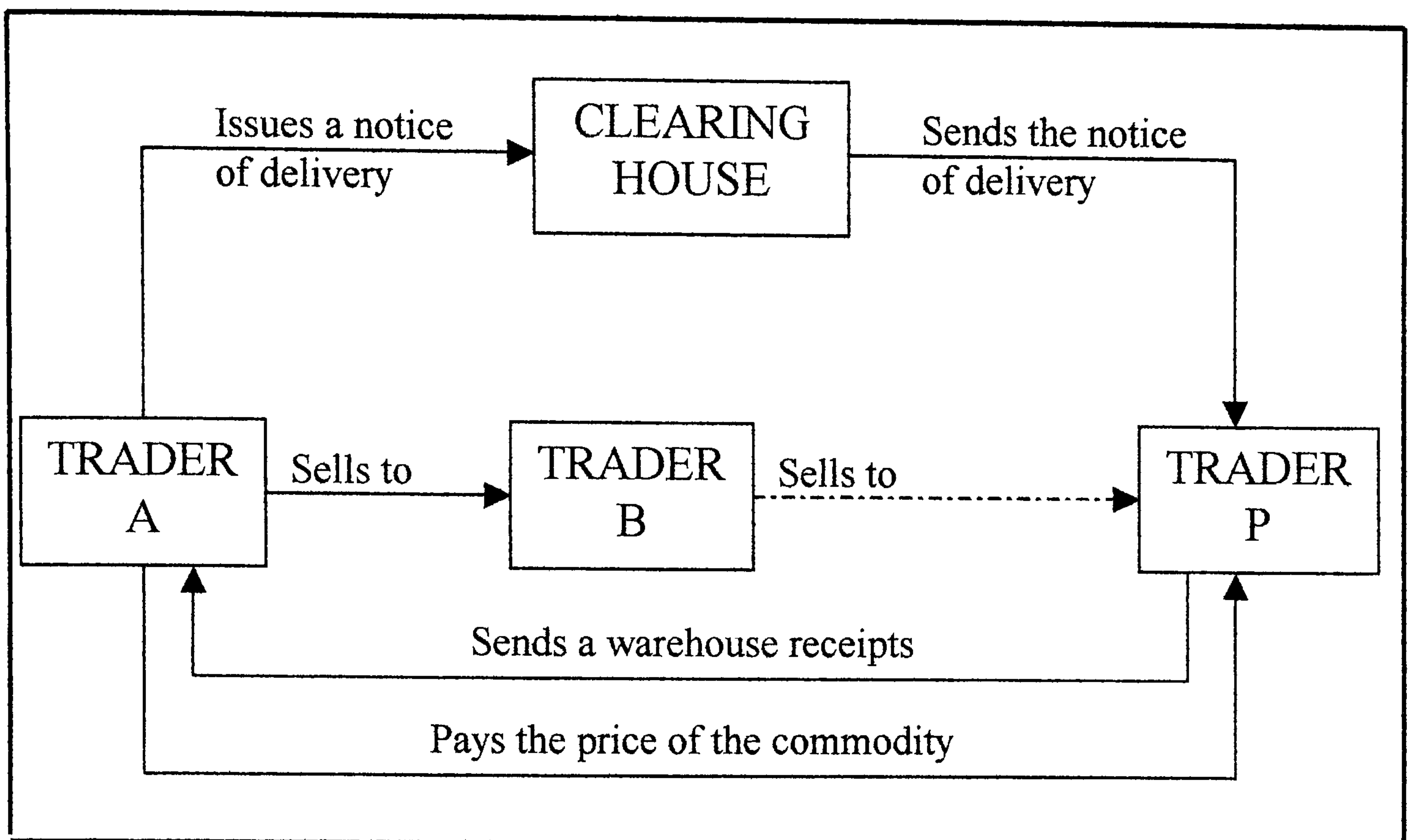

Figure 5.2 The process of settlement of a commodity futures contract by delivery

Commonly, a clearing house does not involve itself directly in the physical delivery settlement. Once the clearing house has matched the seller with a buyer and given them certain settlement directions, it is discharged from its liability as a guarantor for the contracts concerned. Unless there is any default in making delivery or payment of the delivery, the clearing house will take appropriate actions to fulfil its obligation in accordance with the contract specifications.

As regards the actions taken in a case of default either default in performing a contractual obligation or in complying with the business rules, a clearing house

[35] Questionnaire at MDCH.

will recourse to closing out the defaulting member's positions and liquidating his security deposits. In addition, at MDCH for instance, a substantial fine may be imposed on the defaulting member as well as suspension or termination of his membership.[36] Each clearing house may have its own procedures to be taken in case of default. The most appropriate actions to be taken generally depend on each individual case. This may include, finally, utilisation of the clearing house fund.

In addition to the above procedures, some clearing houses may have taken certain actions in advance as a precaution to protect its financial integrity. These actions may include handling financial audit and compliance on the clearing members. At the MDCH for instance, the clearing members have to submit financial reports stating their financial condition. They are also subjected to audits and surveillance as well as position limits set by the clearing house in order to avoid any possibility of default.[37]

5.2. The Islamic Law approach to the commodity futures exchange and the clearing house

The examination of both the exchange and the clearing house under the framework of Islamic Law will be made on the aspects of functionality of these institutions in constituting a legally binding commodity futures contract. As each of these institutions plays a different role in providing facilities and opportunities of

[36] Questionnaire at MDCH.
[37] MDCH, *Financial*, p. 8.

trading for the futures traders, each of them will be dealt separately with the emphasis given to its structure, role and functions.

5.2.1 The position of a commodity futures exchange in Islamic Law

Traditionally, each exchange acts as a contract market providing trading facilities and opportunities for people to buy and sell certain market products or derivatives. While the existence of informal markets has been long recognised by Islamic Law, these were accepted for their importance in providing the opportunity for people to find their daily necessities. However, as regards the exchange, although it shares the same concept as those informal markets, it is a contract market operated by an organisation or private corporation in a specific building and limited to those who own or lease the exchange membership or have trading permits. Further examination will therefore be made of the exchange as an organisation or corporation operating the contract market and as a place for executing futures contracts as well as a contract market.

(i) The exchange as a corporation and the principles of *al-shirkah* (partnership or corporation)

Although some of the exchanges were formed as trade unions or membership associations, most of the exchanges existing at present are private non-profit making companies limited by shares and so they are owned by the shareholders. As these are not profit-making, their sole purpose is to provide the physical trading facilities for traders with the right of control in compliance with their own rules and relevant

legislation. Upon an exchange's registration as a contract market by the local commission, any individual or firm may trade – through an exchange member - on its trading floor.

From the above, it seems that the organisation of an exchange is similar to an ordinary *shirkah al-ᶜinān* (partnership in capital or property) on one part and a *shirkah al-aᶜmāl* (partnership in works or services)[38] on the other. The former simply means a partnership between two persons or more in which they share in providing the capital or works as well as the resulting profits.[39] A partner in this *shirkah* may become a *wakīl* (representative) but not a *kafīl* (guarantor) for the other partners in the course of the partnership business,[40] while *shirkah al-aᶜmāl*, on the other hand, means an incorporation of two or more skilful or experienced persons in which they share the profits or the payment for their works or services. Like partners in *shirkah al-ᶜinān*, partners in this *shirkah* may also act as *wakīl* for the others.[41] Briefly, the contributions of capital or work as well as distribution of profits or losses in these two shirkah depend on the terms of agreement between the partners.[42]

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[38] It is also known as shirkah al-abdān, see, Ibn Qudāmah, ᶜAbdullāh Aḥmad Muḥammad. *Al-Mughnī*. Cairo: Maktabah al-Jumhūriyyah al-ᶜArabiyyah, (No Date) v. 5, p. 5, Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ ᶜalā Matn Minhāj al-Ṭālibīn*. Damascus: Darul Fikr, (No Date) v. 2, p. 212.

[39] Ibn ᶜĀbidīn, Muḥammad Amīn. *Radd al-Muḥtār ᶜalā Durr al-Mukhtār Ḥāshiyah Ibn ᶜĀbidīn*. Pakistan: Maktabah Majīdiyah, 1399H v. 3, p. 373, Ibn Mufliḥ, Abī Isḥāq Burhānuddīn. *Al-Mubdiᶜ fī Sharḥ al-Muqniᶜ*. (No Place): Al-Maktab al-Islāmī, 1980 v. 5, pp. 3-4, Al-Zarkashī, Shamsuddīn Muḥammad. *Sharḥ al-Zarkashī ᶜalā Mukhtaṣar al-Kharqī*. Riyadh: Maktabah al-ᶜAbikān, 1993 v. 4, pp. 124-125, Al-Sharbīnī, *Mughnī*, v. 2, pp. 212-213, Al-Khafīf, ᶜAlī. *Aḥkām al-Muᶜāmalāt al-Shar'iyyah*. (No Place): Dār al-Fiqh al-ᶜArabī, (No Date), p. 459.

[40] Al-Sharbīnī, *Mughnī*, v. 2, p. 213, Ibn Mufliḥ *Al-Mubdiᶜ*, v. 5, p. 4, Al-Zarkashī, *Sharḥ*, v. 4, p. 126, Al-Zuḥaylī, Wahbah. *Al-Fiqh al-Islāmī wa Adillatuh*. Damsyik: Darul Fikr, 1989 v. 4, p. 797, Al- Khafīf, *Aḥkām*, p. 459.

[41] Ibn ᶜĀbidīn, *Radd*, v. 3, p. 380, Ibn Qudāmah, *Al-Mughnī*, v. 5, p. 5, Al- Khafīf, *Aḥkām*, p. 460.

[42] Ibn Qudāmah, *Al-Mughnī*, v. 5, p. 7, Ibn Mufliḥ *Al-Mubdiᶜ*, v. 5, p. 6, Al-Zarkashī, *Sharḥ*, v. 4, p. 130, Al- Zuḥaylī, *Al-Fiqh*, v. 4, pp. 797 & 803.

Generally, the concept of *al-shirkah* in Islamic Law is based on profit sharing. However, though the formation of the exchange is not meant for acquiring profits, there is capital shared between its owners but with no equal distribution. It resembles a *shirkah al- a^c^māl* in terms of providing the trading facilities for the market participants. Indeed, providing such facilities is the main activity of the exchange. Nevertheless, the *shirkah al- a^c^māl,* as originally recognised, is formed without capital but with the purpose of acquiring profits. Therefore, it is preferable to regard an exchange corporation as a form of *shirkah al-^c^inān* rather than *shirkah al- a^c^māl.*

(ii) The exchange as a contracting place and the principles of Islamic Law on *majlis al-^c^aqd* (execution place of a contract)

At present, most commodity exchanges operate the commodity futures trading on the trading floor. Although some futures contract are executed through automated ex-pit transactions, for the purpose of this study emphasis is given to those executed on the trading floor, since most commodity futures are traded this way.

It is a general principle of Islamic Law pertaining to *majlis al-^c^aqd* (place of contract) that both offer and acceptance must be pronounced in the presence of both parties. This necessity for both parties to be in the same place is a prerequisite of a valid contract. Basically, the *majlis al-^c^aqd* means the area where the contracting parties are. It begins from the moment of pronunciation of the offer and may last as

long as there is no refusal or interruption until such an offer is accepted.[43] There are differing opinions among Islamic scholars in the interpretation of this general rule. However, it suffices to note here that some scholars who require an immediate acceptance - while others allow a reasonable gap between the offer and acceptance - do recognise the acceptor's right of *khiyār al-majlis* (option of contracting place).[44]

Similarly, the same rules apply to a contract between two absent parties, except that the *majlis* begins at the time of the offer reaching the other party. In other words, Islamic Law recognises an execution of a contract that is communicated by way of a written document sent by post or any equivalent form of communication.[45]

As mentioned above, a commodity futures contract is executed once a bid is matched with an offer at the same price in the open outcry auction. This auction, which takes place on the exchange's trading floor, is monitored by the exchange staff in order to ensure that there is no illegal or abusive practice. Undoubtedly, the bidding to sell and offering to buy a specific contract has taken place within one area, clearly communicated by verbal and hand signals. Although there is a possibility of mismatching or a bid receiving more than one offer, the staff in charge can always resolve the matter according to the business rules of the exchange. Whatever the resolution, the main concern here is that the auction, which is held on the specially equipped trading floor, would be a perfect *majlis al-'aqd* to transact a

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[43] Al-Sanhūrī, ᶜAbdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī.* Beirut: Dār Ehyā' al-Turāth al-'Arabī, (No Date) v. 2, pp. 6-7.
[44] Al- Sanhūrī, *Maṣādir*, v. 2, p. 7.
[45] Al- Sanhūrī, *Maṣādir*, v. 2, pp. 49-50.

commodity futures contract. Seemingly, there is no reason why such a place for executing a commodity futures contract should not be allowed in Islamic Law.

(iii) The exchange as a contract market and the principles of market in Islamic Law

Every exchange needs to be designated as a contract market by the local commission to handle futures trading. The exchange must first satisfy the criteria specified in the legislation, which is primarily concerned with matters of efficient management, market safeguards and the exchange business rules and regulations. Upon approval, the exchange may operate a contract market according to its own business rules and procedures. However, further approval is needed for each new commodity futures that the exchange wishes to be traded on its floor.[46]

The concept of a contract market is in no way similar to the traditional informal markets, which have been recognised for centuries. There is no self-regulatory body that operates and regulates these markets except that the Prophet (peace be upon him), while He was in Medina, sent someone to inspect the market in Mecca. The subsequent four caliphs carried on this function of inspection or surveillance in order to ensure market integrity and protection for buyers and sellers.[47] Such protection includes preventing fraudulent conduct between the traders.

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[46] Information is based on an interview with Mr Arif Ghani, Executive, Research & Education, COMMEX Malaysia on 06/08/1999.

[47] Al-Sālūs, ᶜAlī Aḥmad. *Al-Iqtisād al-Islāmī wa al-Qaḍāyā al-Fiqhiyyah al-Muᶜāṣirah*. Qatar: Dār al-Thaqāfah, v. 1996 pp. 578-579.

As a matter of fact, the recognition given to the traditional market together with the transactions therein is due to the public necessity of exchanging property for money and vice versa. Thus, as most economists allege that a futures market is necessary for managing risk for farmers, producers and consumers, the existence of exchanges is also a necessity, but, how far do the existing exchanges function in harmony with the norms of Islamic Law?

The precepts of Islamic Law that govern the constitution of a market are that such a market should provide a free, fair and competitive trading atmosphere, the pricing should be based on supply and demand and there is sufficient market information provided for the traders. In addition, there should be no room for price manipulation and any other fraudulent practice.[48] Apparently, these features have been implemented by every exchange through the enforcement of its business rules and surveillance activities. Better still, the present exchanges provide market information that goes beyond the local jurisdiction. Therefore, as regards physical trading facilities, an exchange may well be recognised in the framework of Islamic Law.

However, apart from the convenience of these facilities and trading rules, contemporary Islamic scholars contend that an Islamically approved exchange must trade only in derivatives and financial products that comply with the requirements of Islamic Law. Furthermore, trading practices, which may be allowed under ordinary

[48] Nasīf, Nābil ᶜAbdullāh. "Al-Aswāq al-Māliyyah min Manẓūr al-Niẓām al-Iqtiṣād al-Islāmī", in, *Majallah Majmaᶜ al-Fiqh al-Islāmī*, Jeddah, issue 6, v. 2, 1990 p. 1458.

exchange rules but are still questionable in Islamic Law should be avoided.[49] As far as this study is concerned, a commodity futures contract is an acceptable derivative.

5.2.2 The position of a clearing house in Islamic Law

The examination of the function of the clearing house is not intended to scrutinise the technical mechanism of the clearing operation. As long as the Islamic Law recognises the position of the clearing corporation and its functions as a clearing house, the technical aspects may be deemed as being approved under the purview of Islamic Law. If anything is contradictory to any principle of Islamic Law, it should be indicated accordingly.

Most clearing houses are formed as a corporation, whether or not owned by certain exchanges. This means that they have their own separate entity and board of directors managing the clearing corporation. Although some clearing houses are only departments within the exchange, the clearing operation as well as other functions are the same. Basically, most of the main functions of a clearing house such as registration of the contract, handling the contracts' settlement of contracts and conducting financial surveillance seem to be acceptable.[50]

As for the clearing house's margin function, the system is generally acceptable except the 'marking-to-market' process as discussed in the previous

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[49] Al-Qurrah Dāghī, ᶜAlī Muḥyiddīn. "Al-Aswāq al-Māliyyah fī Mīzān al-Fiqh al-Islāmī", in, *Majallah Majmaᶜ al-Fiqh al-Islāmī*, Jeddah, issue 7, v. 1, 1992 p. 83.

[50] Vogel, Frank E. & Hayes, Samuel L. *Islamic Law and Finance; Religion, Risk and Return*. London: Kluwer Law International, 1998 p. 259.

chapter. There remains the novation process in which the clearing house performs its function as a guarantor for the performance of every single contract. Therefore, the subsequent discussion will be on the position of the clearing house as a corporation and its primary role of guaranteeing contractual performance through the novation process.

(i) The clearing house as a corporation and the rules on *al-shirkah*

The concept of corporation of a clearing house is almost the same as that of the exchange. Except for their different purposes, the clearing house is incorporated in the same way as the exchange. As stated before, a clearing corporation is a private company limited by shares. Likes the exchange, it is a non-profit making company that issues shares to represent the ownership and sells its clearing membership to granting the right to clear through its operation.

Since the clearing corporation has paid-up capital while offering futures trading clearance services for its members, it resembles both *shirkah al- ᶜinān* as well as *shirkah al-aᶜmāl*. As discussed earlier, the clearing corporation, like the exchange company, is best regarded as a form of *shirkah al-ᶜinān.*

(ii) The novation process and the principles on *al-kafālah* (suretyship)

A clearing house undertakes this novation process in order to become the guarantor for every single futures contract. In this process, the clearing house

interposes itself between the original parties of each matched contract it registers. By this interposition, it becomes the counterparty for every open contract. In this way, it guarantees the performance of every contractual obligation of every open contract by its financial strength backed by its members' security deposits and collateral margins.

In relation to this substitution of the counterparty, it is deemed that every futures trader has initially given his consent. Therefore, upon registration of the futures contract, each party has no obligation to the other original party but to the clearing house instead. Principally, this process raises the issue of *al-kafālah* (guarantee or suretyship) where the clearing house assumes the role of a guarantor for the performance of contractual obligations.

The basic principle on *al-kafālah* has already been discussed in the previous chapter. It is stated there that *al-kafālah* is divided into two main categories: *kafālah bi al-nafs* (guarantee for the person) and *kafālah bi al-māl* (guarantee for the property).[51] The latter category consists of three types: *kafālah bi al-dayn* (guarantee for the debt), *kafālah bi al-taslīm* (guarantee for the delivery) and *kafālah bi al-darak* or *ḍamān al-ᶜahdah* (guarantee for the compensation or indemnity).[52] *Kafālah bi al-dayn* is a guarantee to pay a debt if the *makfūl ᶜanh* (the guaranteed person) fails to do so, while the other two may occur in any other type of contractual obligation that the *makfūl ᶜanh* must perform, for instance, in the case of *kafālah bi*

[51] Please refer to chapter 4 for further explanation on contract *al-kafālah*.
[52] Al-Sharbīnī, *Mughnī*, v. 2, p. 201, Al-Zarqā', Muṣṭafā Aḥmad. *Al-Madkhal al-Fiqh al-Ām*. Damascus: Dār al-Fikr, 1968v. 1, p. 542.

al-darak, a guarantee is made for the merchandise to be delivered in accordance with the contractual terms. If there is any default on his part, the guarantor shall be responsible for fulfilling the obligation.[53]

The principle of *al-kafālah* may also be extended to guarantee the performance of obligations that have yet to be obligatory on the *makfūl ᶜanh*. This improvised contract of *al-kafālah* provided by the Ḥanbalī scholars, covers payment of debt or any other equivalent obligation which is continuous and possibly incurred by the *makfūl ᶜanh* sometime in the future.[54] In other words, as long as the guarantor agreed or voluntarily consented, the contract of *al-kafālah* is valid for any present or future obligation.

As regards the role of guarantor played by the clearing house in the novation process, it is clear that the clearing house has voluntarily agreed to guarantee every performance of an open contract. Its concept of guarantee is similar to those of *kafālah bi al-taslīm* and *kafālah bi al-darak*. For an open contract that need to be settled by delivery, the clearing house will ensure that the futures trader concerned receives or makes the delivery of the commodity. If he fails, the clearing house will take the necessary steps according to its default procedures in order to fulfil the delivery obligation. Likewise, the clearing house will compensate an affected trader for any loss incurred resulted from a default in payment for the delivered commodity.

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[53] Al-Sharbīnī, *Mughnī*, v. 2, p. 201.

[54] Al-Sharbīnī, *Mughnī*, v. 2, p. 201. Al-Jazīrī, ᶜAbdul Raḥmān. *Al-Fiqh ᶜalā al-Madhāhib al-Arbaᶜah*. Beirut: Dār al-Kitāb al-'Ilmiyyah, (No Date) v. 3, p.225.

This duty of guaranteeing every contractual performance does not, however, extend to any trader other than the clearing house's clearing members. This is the reason why every cleared contract is registered under a clearing member's name, and not the real trader. Nevertheless, this limitation does not prevent Islamic Law recognition of the duty of the clearing house as a guarantor. As the clearing system indicates that the clearing house will guarantee through the novation process every single contract that it cleared, it should not be wrong to accept such a process within the framework of Islamic Law.

5.3 Conclusion and Summary

The role and functions of both exchange and clearing house are very important in ensuring that there are no fraudulent elements in the execution of a commodity futures contract and also in guaranteeing the performance of the contractual obligations therein. Above all, there would be no traded commodity futures at present without the contract market organised by an exchange and the clearing operation managed by a clearing house. It becomes a natural legal requirement for a commodity futures to be traded on an exchange and cleared by a clearing house.

An exchange company, which has been designated as a contract market by a local commission, under the provision of the relevant law, may provide trading facilities for such a market and organise it in conformity with its business rules. It is entitled to enforce and develop its rules and regulations in order to facilitate the

trader. However, trading on its floor is a privilege for its members and permits holders.

Likewise, clearing a market contract is also an exclusive right given to a clearing member. It is vital to allow such a right to a trader who has the clearing house membership only, since every clearing house needs to be financially integrated in terms of guaranteeing the performance of every open contract it registers. As the clearing right is limited to its members who have fulfilled its financial requirements, the clearing house should minimise the risk of default in any contractual obligation. For this purpose, some clearing houses have their own financial surveillance on its members. Besides guaranteeing the contractual performance of every contract, a clearing house also operates the margining system and handles settlements of contracts.

From the perspective of Islamic Law, an ordinary exchange has meet the criteria of a recognised market where the protection of traders from fraudulent conduct is the main concern. The exchange also represents a good example of a place of contract in which the traders, buyers and sellers can easily and clearly communicate with each other. However, to be regarded as an Islamic contract market, the exchange should not trade any derivatives or financial products or allow any trading practice that is contradictory to the principles of Islamic Law.

On the other hand, the general features and functions of a clearing house seem to be acceptable from the point of view of Islamic Law. Its role as a guarantor for the performance of every contractual obligation is very similar to Islamic Law

principles on *al-kafālah.* Such a guarantee, which is made through the novation process, gives a further protection of the traders' interests. Nevertheless, the clearing house margining system needs to be amended by excluding the 'mark-to-market' process since it adds an element of *gharar* and a typical unlawful gain or unnecessary loss of property into the whole margining system.

PART THREE

THE PRESENT FUNCTION OF A COMMODITY FUTURES CONTRACT

CHAPTER SIX

THE PRACTICE OF OFFSETTING OF A FUTURES CONTRACT POSITION

6.1. An Overview of the Practice of Offsetting

Offsetting of a futures position is synonymous with 'liquidation' and 'closing-out'. Offsetting or liquidating a futures position means selling or purchasing commodity futures of the same delivery month as the initial one, which was purchased or sold in an earlier transaction.[1] However, unlike offsetting, the term 'liquidation' is used for any operation that cancels an existing futures position or a previous transaction.[2] It includes any selling or purchasing that is compulsorily executed by the trader's broker or the clearing corporation as a consequence of default, whereas, offsetting is used to refer to a voluntary liquidation of a futures contract in which an investing trader opts to offset his current position when the price moves in his favour.

As mentioned above, to offset is to close out a futures contract. Here a trader, whether he is a speculator or a hedger, may offset his previous contract by taking an opposite position. In order to do so, he will sell a futures contract that he has bought and vice versa. In this way, he offsets his commitment under the previous contract to make or receive the delivery of the underlying commodity. This

[1] Chicago Board of Trade. *Commodity Trading Manual*. Chicago: Board of Trade, 1994 p. 353.

liquidation could not happen without the substitution function of the clearing house in its clearing operation and the novation process.

In the clearing process, as discussed in the previous chapter, the clearing house assumes the role of the counter party for each contract it clears thus eliminating the relationship between the original buyer and seller.[3] As the clearing house becomes the counter party, any trader, buyer or seller, may freely sell or purchase an equivalent contract without needing to obtain an agreement from the original counter party. Since he is dealing with the clearing house in this open contract, it is sufficient for him to execute an opposite contract with any futures trader to offset his current commitment. (See, **Figure 6.1**)

For illustration purposes, X buys December crude palm oil (CPO) futures from Y. Once the clearing house has cleared this contract, there will be two resulting open contracts. In one of the open contracts, X will be the buyer with the clearing house as the seller and in the other, Y becomes the seller with the clearing house as the buyer. This process allows X and Y to close out their open positions at any time by entering into an equal but opposite contract. X may remain with his obligation to take delivery of the contract but may offset the obligation by selling an equal contract. Theoretically, the new buyer will assume the said obligation.[4] However, effectively, X sold back the commodity that he had previously bought

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[2] Gould, Bruce G. *The Dow Jones-Irwin Guide to Commodity Trading*. Illinois: Dow Jones-Irwin, 1981 p. 340.
[3] New York Institute of Finance. *Futures; A Personal Seminar*. New York: New York Institute of Finance Corp., 1989 p. 77, Chicago Board of Trade, *Commodity*, p. 68.
[4] Gold, Gerald. *Modern Commodity Futures Trading*. New Jersey: Commodity Research Bureau, Inc., 1974 p. 22.

from the clearing house. By this means, any trader may liquidate his contract position.

In order to liquidate a position or to offset an existing contract, a trader must sell or purchase a contract of the same delivery month as the one that he executed earlier. There is no liquidation of a futures contract position if the later transaction is made on a contract of a different delivery month from the earlier. If he does so, the trader is adding a greater commitment to his current position. Furthermore, a trader must also keep to the same amount of the commodity in order to liquidate his position.[5] So, if X has purchased two lots of December CPO futures, he should sell two lots of the same delivery month once or one at a time in order to offset such position.

A futures trader, either a hedger or a speculator, may need to offset his existing position for his hedging or speculation purposes. Even if he is merely an ordinary investor, offsetting is always a way that is available for him to gain a quick profit whenever possible. An investor in a futures market will find that liquidating a position at certain times may be profitable for his investment. The difference between the price of the first transaction and the price of the liquidating transaction may be very profitable.

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[5] Gold, *Modern*, p. 22.

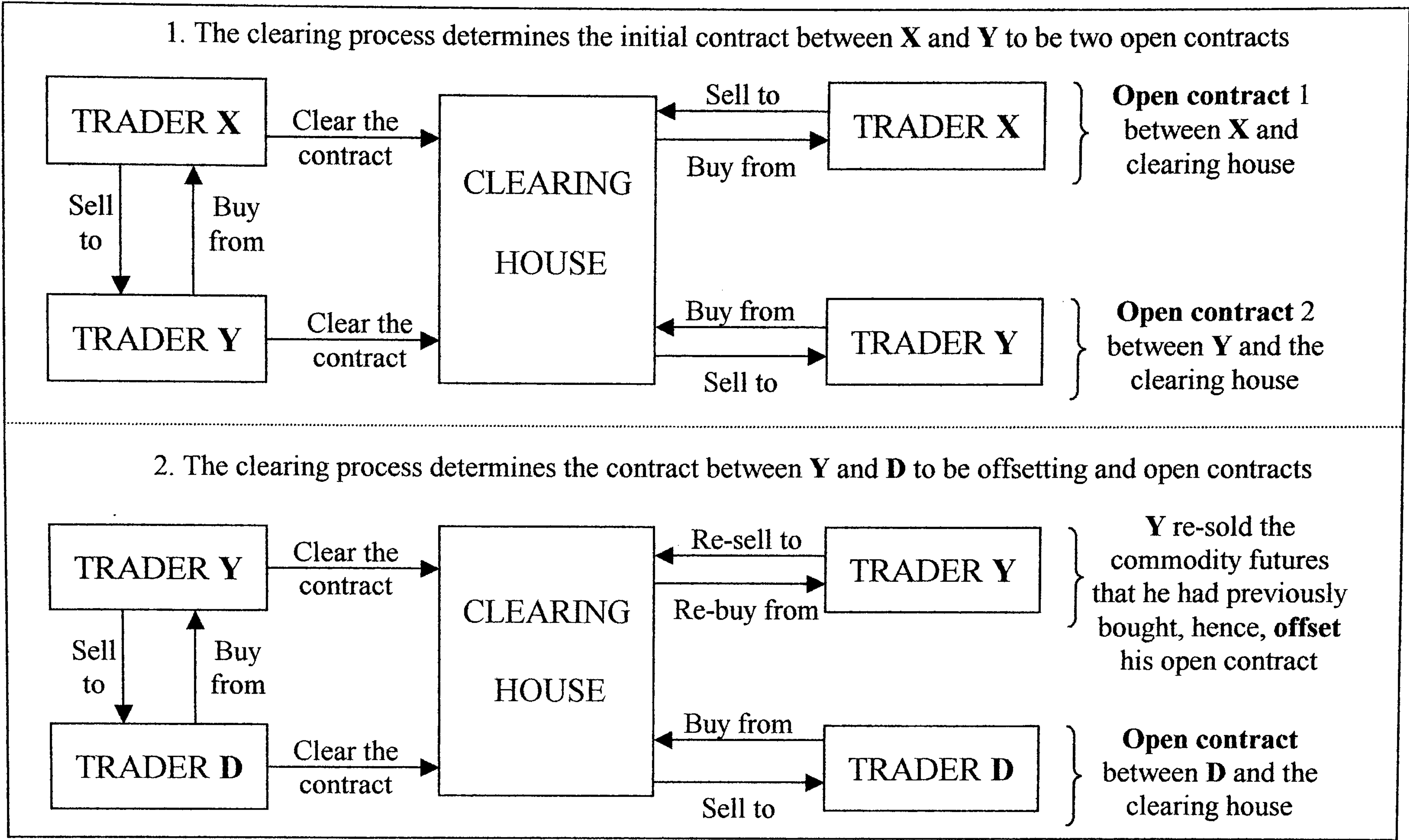

Figure 6.1 The sequence of an initial contract and an offsetting contract

Similarly, a speculator who is an investor as well uses the opportunity of offsetting a position as his basic action in his speculative strategies. Although speculation takes many forms, a speculator, who is also known as a risk-taker, usually dares to take any risk in order to gain profit from the difference between the price of the first contract and the price of the liquidating transaction[6]. The latter transaction could possibly being executed seconds after the former, depending on the speculator's strategies which are always the same, buy low and then sell high or vice versa, sell high and later buy at a lower price.

Likewise, a hedger also benefits from the offsetting practice. However, unlike the speculator, a hedger is risk-averse. He trades in futures in order to avoid the risk of price fluctuations.[7] His involvement in the cash market may require him to lock-in a price of the same commodity in the futures market. Depending on his type of business and the degree of his exposure to the price risks in the cash market, trading in the futures market may be utilised for the protection of his position in the cash market. The hedger will then liquidate his futures position when it is appropriate.[8]

From the above discussion, the practice of offsetting actually occurs all the time, as only one to two per cent of all traded commodity futures will end in delivery. This percentage shows that most futures traders liquidate their open position without the intention of taking or making the delivery of the underlying

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[6] Hieronymous, Thomas A. *Economics of Futures Trading for Commercial & Personal Profit.* New York: Commodity Research Bureau, Inc., 1981 pp. 246-247.
[7] Fink, Robert E. *Futures Trading.* New York: New York Institute of Finance, 1988 p. 228.
[8] Fink, *Futures*, pp. 232-233.

commodity. Nearly all of open futures contracts are closed out by a voluntary offsetting transaction that results from a default. An offsetting transaction, though involuntary, will effectively cause the closeout of an open futures contract.

Legally, an offsetting transaction is deemed as an execution of an ordinary futures contract. The mechanism and procedures relating to an offsetting transaction are the same as those applicable to freshly executed futures contract. The significant difference between the two appears at the clearing process. The clearing house will identify the status of each contract it clears, whether it will become an open contract or a liquidating transaction. The clearing house operates this process based on its clearing records in which all existing contracts of the traders are safely registered. Therefore, in relation to legal issues to which Common Law is most applicable, this practice of offsetting does not cause harm to any right nor does it in any way contradict any relevant rules.

6.2. The Practice of Offsetting in the Perspective of Islamic Law

As mentioned earlier, an offsetting transaction is actually a similar contract but one opposite to the existing contract position. By executing such a contract, the clearing operation will enable the trader concerned to offset his obligation under the previous contract. Therefore, under the purview of Islamic Law, it seems that the issues concerning the offsetting or liquidating transaction are very much related to principles pertaining to *faskh al-^{c}aqd* (rescission or revocation of contract) and *al-iqālah* (mutual discharge of obligation). Both concepts deal with the dissolution of a

legally concluded contract[9] upon the agreement of the parties or due to certain legal reasons.[10] A further relevant reference would be made to the rules on the contract of *al-ḥawālah* (assignment or bill of exchange) in which an obligation of debt is transferred from one person to another by creating or transforming the previous contract of debt into a new one.

6.2.1. The Islamic Law principles on revocation of contract and discharge of contractual obligation

As mentioned above, the principles on revocation of a legally concluded contract and mutual discharge of any contractual commitment in the framework of Islamic Law are mainly discussed in three circumstances, namely, *faskh al-ᶜaqd*, *iqālah al- ᶜaqd* and *ᶜaqd al- ḥawālah*. In each situation, the contracting parties are allowed to revoke an existing contract or to transfer a future performance of a contractual obligation to another person upon the consent of every party involved.

(i) *Faskh al- ᶜaqd* (rescission or revocation of contract)

Generally, revocation of a valid contract is not allowed for mutually binding contract (*al-ᶜaqd al-mulzam li al-jānibain*) or contract of mutual exchange (*al- ᶜaqd*

[9] Dissolution of a contract (*inḥilāl al-ᵉaqd*) may occur due to a voluntary cause or an involuntary reason. The former category is known as *faskh* and includes *al-iqālah*, while the latter is named as *infisākh* (automatic dissolution) and caused by an unforeseen factor, such as the death of a party in a contract of *al-wakālah* (agency). See, Al-Zarqā', Muṣṭafā Aḥmad. *Al-Madkhal al-Fiqh al-ᶜĀm*. Damascus: Dārul Fikr, 1968, v. 1, pp. 524-527, Bakhīt, Maḥmūd ᵉAbdullāh. *Faskh al-ᵉAqd wa Atharuh*. 'Amman: (No Publisher), 1991 p. 22.

[10] Al-Ghayāṭī, Lāshīn Muḥammad. *Iqālah al-ᵉAqd fi al-Fiqh al-Islāmī wa al-Qānūn al-Madanī*. Tanta: University of al-Azhar, 1985 pp. 18-20.

al-muᶜāwaḍah). It is only permissible in a few exceptional cases and to be permitted in its narrowest sense.[11] The rationale is that every contracting party is liable to keep his promises and to fulfil his obligations under the contract. This requirement is necessary in order to maintain the stability of public dealings and to protect the interests concerned.[12] These principles are derived from the following Quranic verses:

> "O you who have attained to faith! Be true to your covenants (solemn undertakings or engagements involving more than one party)."[13]
>
> "...And be true to every promise, for, verily, you will be called to account for every promise which you have made."[14]

These verses outline the requirement that believers must keep their promises and fulfil all obligations of their contracts.

Furthermore, the principles of Islamic Law recognise the obligation of each contracting party individually. There is no relation between the obligation of a seller to submit the object of the contract and the obligation of a buyer to pay the price. In other words, the seller's duty to deliver the goods and his right to the price should not be affected by the buyer's failure to pay the price. Similarly, the buyer retains the right to own the goods, even if the seller failed to produce the goods. Therefore, if the buyer or the seller fails to fulfil his duty, the contract will be deemed as suspended until the defaulting party performs his obligation. If this is not possible,

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[11] Al-Sanhūrī, ᶜAbdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī.* Beirut: Dār Ehyā' al-Turāth al-'Arabī, (No Date) v. 6, p. 215.
[12] Kharofa, Ala' Eddin. *Transactions in Islamic Law.* Kuala Lumpur: A. S. Nordeen, 1997 p. 57.
[13] The translation of the Quran, 5:1, based on, Asad, Muhammad. *The Message of the Quran* (Translation & explanation). Gibraltar: Dār al-Andalus, 1984 p.139.
[14] The translation of the Quran, 17:34, based on, Asad, *The Message*, p. 423.

this defaulting party must pay compensation to the affected party for any loss incurred.[15]

However, Islamic Law does recognise revocation of a valid contract in a case where it is necessary to dissolve the contract, for instance, if there is a pre-contractual defect in the object of the contract of sale. The buyer is entitled to revoke the contract due to such a defect. The revocation of this contract is allowed in Islamic Law since the consent given by the contracting party is vitiated upon the discovery of the defect.[16] This rule is derived from the verse,

> "O you who have attained to faith, do not devour one another's possession wrongfully, but it must be in a way of trade based on a mutual agreement."[17]

The above verse clearly requires that no trade or dealing shall be made without a valid consent given by every party involved. Therefore, if the consent is vitiated by a legal factor, either party is entitled to revoke the contract.

Furthermore, there are other situations that may be exempted from this general principle of 'no revocation of contract', especially in contracts of sale, whereby the terms of the contracts have been stipulated with *khiyār* (option) condition. Such contracts may be revoked whenever the parties exercise their stipulated rights of *khiyār*.[18] In other words, by such a stipulation, the said contract becomes a non-obligatory (*ʿadam al-luzūm*) contract temporarily. Hence, it allows the parties to rescind the contract within the stipulated period for exercising the right

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[15] Al-Sanhūrī, *Maṣādir*, v. 6, pp. 230-231.
[16] Bakhīt, *Faskh*, pp. 30-31.
[17] The translation of the Quran, 4: 29.
[18] Kharofa, *Transactions*, p. 58.

of *khiyār*.[19] In addition, a contract may be rescinded if the object of the contract is partially or totally destroyed. This type of revocation is allowed due to the non-fulfilment (*ᶜadam al-tanfīz*) of the contractual obligation. This exception is applicable only to cases of destruction of the goods and not of the price. It is worth noting here that this permission is based on the position of the goods as being the object of the contract, and not because of the failure of the seller. Since there is no connection between the buyer's obligation and the seller's duty to deliver, such a contract is made revocable solely for the protection of the buyer's interest under the said contract.[20] Islamic Law also recognises the dissolution of a valid contract in which disputes arise between the contracting parties and they have taken oaths for their claims. In such cases, the court may order for the revocation of the contract since the parties are claiming for a different terms or provisions of the contract that they have entered into.[21]

A valid contract may be revoked by a mutual agreement between the parties or by an order of court if the court is satisfied that there are reasonable grounds for rescinding a particular contract.[22] It may also automatically rescind by itself in a case where the object of the contract is totally destroyed before its delivery, but if the object is partially destroyed, the affected party must take action to have the contract rescinded. Similarly, if this party would like to exercise his right of *khiyār*, if stipulated in the contractual terms, he must have it judicially rescinded. That is, he

[19] Al- Sayūṭī, Jalaluddin A. Rahman. *Al-Ashbāh wa al-Naẓāir fī Qawāᶜid wa Furūᶜī Fiqh al-Shāfiᶜiyyah*. Egypt: Maktabah al-ᶜUlūm wa al-Ḥikam, 1959 p. 87, Ibn Nujaym, Zainuddin Ibrahim. *Al-Ashbāh wa al-Naẓāir (commentary by Ibn Abidin, Muhammad Amin Umar and Muhammad Muti' al-Hafiz)*. Damascus: Dār al-Fikr, 1983 p. 80, Bakhīt, *Faskh*, p. 44.
[20] Al-Sanhūrī, *Maṣādir*, v. 6, p. 231.
[21] Bakhīt, *Faskh*, p. 168.

must first obtain a court injunction in order to rescind the contract. Whatever the type of rescission, the effect of a revoked contract is always the same. Upon rescission, both contracting parties must return to their pre-contractual status before the execution of the contract. Likewise, all the consequences of the contract will be retrospectively abrogated. However, if this abrogation is not possible, the affected party may be entitled to compensation.[23]

In so far as the concept of *faskh* is concerned, there is no valid reason for a futures trader to offset a futures contract. As Islamic Law provides no *faskh* for such a bilateral contract except in a few strict cases, the normal practice of an offsetting transaction may be deemed as an irregularity. There is no destruction of the contractual object in the futures contract as well as no stipulation of *khiyār* in its terms so as to render the contract as revocable. The usual reasons associated with the speculation and hedging activities of the futures traders, to gain profit from the different prices and to avoid or manage price risks, do not amount to valid causes of *faskh* as recognised in Islamic Law. Therefore, an offsetting transaction that abrogates a trader's obligations under an existing open contract may not be recognised by Islamic Law under the light of principles of *faskh al-ᶜaqd.*

(ii) *Iqālah al-ᶜAqd* (mutual discharge of obligation)

Iqālah is a transaction that allows the contracting parties to rescind a particular contract, especially a contract of sale that was previously executed

[22] Bakhīt, *Faskh*, p. 181 & 195.
[23] Al-Sanhūrī, *Maṣādir*, v. 6, p. 232, Kharofa, *Transactions*, pp. 58-59.

between them. It is an agreement formed by an offer and acceptance between the parties to revoke an existing contract of sale entered by both of them.[24] This agreement is regarded as permissible by the majority of Islamic scholars,[25] based on the general provision of the *ḥadīth*,

> It is reported by Abu Hurairah that the Prophet (peace be upon him) said, "Anyone who has cancelled his contract of sale regretfully, Allah will cancel (discharge) his false deed in the day of hereafter."[26]

Such revocation of an existing contract is not allowed without the consent of both contracting parties.[27] Rescission of a contract of sale may be made by express terms of offer and acceptance or, impliedly, by the conduct of the parties, such as exchanging the object and the price of the previous contract.[28] Upon the conclusion of *iqālah*, the object and the price of the previous contract must be returned to the original owners, the seller and the buyer respectively. If the cash or goods are no longer available, items to an equivalent value may be substituted.[29]

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[24] Art. 191, The *Mejelle (An Enlish Translation of Majallah al-Aḥkām al-ᶜAdliyyah and A Complete Code on Islamic Civil Law)*, translated by C. R. Tyser, D. G. Demeiriades & Ismail Haqqi Effendi, Lahore: Law Publishing Company (No Date), Ibn ᶜĀbidīn, Muḥammad Amīn. *Radd al-Muḥtār ᶜalā Durr al-Mukhtār Ḥāshiyah Ibn ᶜĀbidīn*. Pakistan: Maktabah Majīdiyah, 1399H v. 4, pp. 160-161, Ibn Mufliḥ, Abī Isḥāq Burhānuddīn. *Al-Mubdiᶜ fī Sharḥ al-Muqniᶜ*. (No Place): Al-Maktab al-Islāmī, 1980 v. 4, p. 123, Al-Sanhūrī, *Maṣādir*, v. 6, p. 249.

[25] Al-Būṭī, Muḥammad Taufīq Ramaḍān. *Al-Buyūᶜ al-Shāiᶜah wa Athar Ḍawābiṭ al-Mabīᶜ ᶜalā Sharᶜiyyatihā*. Damascus: Dār al-Fikr 1998, p. 157.

[26] The translation of the *ḥadīth* is based on, Al-Azdī, Abī Dāwūd Sulaimān. *Sunan Abī Dāwūd*. (Commented by, Muhammad Muhyiddin Abdul Hamid). Beirut: Al-Maktabah al-ʻAṣriyyah, v. 3, (No Date), *ḥadīth* no. 3460 p. 274, Al-Ṣanᶜānī, Muḥammad Ismāᶜīl. *Subul al-Salām Sharḥ Bulūgh al-Marām*. Beirut: Darul Fikr, 1988, v. 3, pp. 59-60.

[27] Art. 190, The *Mejelle*, Ibn ᶜĀbidīn, *Radd*, v. 4, p. 161.

[28] Art. 192, The *Mejelle*. Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, p. 123.

[29] Al-Būṭī, *Al-Buyūᶜ*, p. 157.

Besides the need to have the consent of the parties, it is also required for the parties to have a proper contracting place (*majlis al-ᶜaqd*) for a valid *iqālah*. Generally, all rules and conditions of a valid contract of sale must be observed in the *iqālah* transaction too. Therefore, the object of the contract must be existent at the time of *iqālah* though the price is absent, since the object is the cause of the contract (*maḥall al-ᶜaqd*).[30] In addition, the formation of a valid *iqālah* must be based on an existing valid contract. The latter must remain valid until the time of the execution of the former. For instance, if the goods sold have been totally destroyed or consumed by the buyer, no *iqālah* can be entered into legally, as its purpose of lifting the legal consequences of the sale is defeated.[31] In this case, the goods cannot be returned to the original owner, the seller. However, if the goods are partially destroyed, *iqālah* may be validly executed for the remaining part of the goods in exchange for the value or price of the rest.[32]

As stated earlier, *iqālah* is a type of contract or agreement in which the parties voluntarily revoke an earlier contract entered into by them. In other words, *iqālah* is a way of abrogating the parties' rights and obligations toward each other under the said contract. Therefore, the majority of classical Islamic scholars, such as Imām Abu Ḥanīfah, Imām al-Shāfiᶜī and Imām Zufar, consider that *iqālah* is a revocation of an existing contract. As it revokes the existing contract of sale, each contracting party must return to his original status before the execution of the sale.

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[30] Art. 193-196, The *Mejelle*, Ibn ᶜĀbidīn, *Radd*, v. 4, pp. 161-162, Al-Sanhūrī, *Maṣādir*, v. 6, pp. 249-250.
[31] Ibn ᶜĀbidīn, *Radd*, v. 4, p. 165, Al-Sanhūrī, *Maṣādir*, v. 6, p. 251.
[32] Ibn ᶜĀbidīn, *Radd*, v. 4, pp. 165-166, Al-Khafīf, ᶜAlī. *Aḥkām al-Muᶜāmalāt al-Shar'iyyah*. (No Place): Dār al-Fiqh al-ᶜArabī, (No Date) p. 400.

The object of the sale and the purchase price must be returned to their original owners. If this exchange proves impossible, compensation must be paid to the injured party equivalent to his loss.[33]

While Imām Mālik, on the other hand, considers that *iqālah* is a second contract of sale. Since it is a new contract, every rule of contract of sale should apply thereto and so *iqālah* may have its own contractual terms that may include a different amount of the object of the contract and a different price. Therefore, both buyer and seller may return the object of the sale to the seller at the original price or at a new price as agreed. Likewise, Imām Muḥammad of the Ḥanafī school holds that *iqālah* may be concluded with a new price even though he believes that *iqālah* is actually a revocation of the previous contract.[34] Briefly, those who regard *iqālah* as a revocation of a contract will deem it as having retrospective effects. Vice versa, if it is considered as a newly concluded contract, it can have no retrospective effects.[35]

By virtue of *iqālah* principles, it seems that Islamic Law does allow revocation of a legally concluded contract. Such a contract can be revoked by another contract that is similar but opposite to the first. The second contract will be deemed as valid upon the consent of both contracting parties. Despite different opinions among Islamic scholars, *iqālah* may be concluded with a new price, higher

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[33] Ibn ᶜĀbidīn, *Radd*, v. 4, pp. 160-161, Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, p. 125, Al-Zarkashī, Shamsuddīn Muḥammad. *Sharḥ al-Zarkashī ᶜalā Mukhtaṣar al-Kharqī*. Riyadh: Maktabah al-Abikan, 1993 v. 3, pp. 549-551, Majmaᶜ al-Bayān al-Ḥadīth. *Mausūᶜah al-Aḥkām al-Sharᶜiyyah al-Muyassarah fī al-Kitāb wa al-Sunnah*. Beirut: Dār al-Kitāb al-Lubnānī, 1994, p. 433.
[34] Majmaᶜ al-Bayān al-Ḥadīth, *Mausūᶜah*, p. 433, Al-Sanhūrī, *Maṣādir*, v. 6, pp. 251-252.

or lower than the price of the first sale. However, the object of the contract must be existent and the exchange of the price and the object is necessary at the time of the execution of *iqālah*. Once it is legally concluded, any right and obligation under the previous contract dissolves accordingly.

Based on the discussion above, it is clear that the purpose of *iqālah* is almost the same as the purpose of offsetting position. *Iqālah* allows the parties to revoke a contract entered by them whenever they need to do so. Upon the conclusion of *iqālah*, all rights and obligations under the previous contract are abrogated. It also restores the parties' status before the execution of the contract. Obviously, the same situation happens when a futures trader enters an offsetting transaction. The trader may, at his wish, execute an order to offset his current contract by taking an opposite position. Once his order is matched, the clearing house will automatically close out his previous position through the clearing process. Effectively, the trader's obligation to make or take delivery of the underlying commodity is lifted.

It is necessary to have the consent of both parties for *iqālah* since it concerns the rights and obligations of both. One of them may, initially, need to rescind the contract, but, upon consent of the other, both of them may then execute *iqālah* to revoke the said contract. On the other hand there is no express consent given by the original counter party or the subsequent party, the clearing house. The usual practice is that, when a futures trader needs to offset his current position, he will enter into a transaction that is opposite but equal to his present open contract in which the

[35] Al-ᶜAṭṭār, ᶜAbdul Nāṣir Taufīq. *Naẓariyyah al-Iltizām fī al-Sharīᶜah al-Islāmiyyah wa al-Sharīᶜah*

clearing house becomes his counterparty. In the absence of any provision that requires the trader to obtain the consent of the clearing house, the futures trader may, at his wish, offset the futures obligation that he owes to the clearing house under the open contract.

Although there is no express consent given by the clearing house as required under the framework of Islamic Law to execute a valid *iqālah*, the practice of offsetting may be deemed as permissible as *iqālah*. Since it has been customarily acceptable to every market participant, the exchange and the clearing house that any trader may offset his open position whenever he wishes, it is assumed that all parties have consented to this practice. Again, the principle of customary usage[36] is adopted in determining the assumed consent.

(iii) The contract of *al- ḥawālah* (assignment or bill of exchange)

As indicated earlier, the contract of *al- ḥawālah* is a contract in which *al-muḥīl* (a debtor) is freed from the debt he owes to *al-muḥāl* or *al- muḥtāl* (a creditor) by transferring the obligation to another person known as *al- muḥāl ᶜalaih* (a newly elected debtor). *Al- ḥawālah* literally means to transfer[37] a debt from one person to another. Judicially, it denotes an agreement between two contracting parties

al-ᶜArabiyyah. Cairo: Maṭbaᶜah al-Saᶜādah, v. 1, 1975 p. 244.

[36] This principle is based on the legal maxim, '*Al-maᶜrūf ᶜurfan ka al-mashrūt shartan*' (the common practice has the same implication as a stipulated condition). By virtue of this maxim, any public practice may be recognised in Islamic Law as long as it is not contradictory with any express provision of the Quran and the *ḥadīth* of the prophet (peace be upon him). In addition, there should be no claim made to disapprove such practice. See, al-Zarqā', Aḥmad Muḥammad. *Sharḥ al-Qawāᶜid al-Fiqhiyyah*. Damascus: Dār al-Qalam, 4th edition, 1996 p. 237.

whereby a person is freed from a debt by making another responsible for the debt.[38] Such an agreement was legalised in Islamic Law based on the *ḥadīth*,

> It is reported by Abū Hurairah that the Prophet (peace be upon him) had been said, "Procrastination in payment of debt by a rich person (*maṭl al-ghaniy*) is injustice. If one of you transfer a debt to a wealthy person (*malī'*), it must be accepted."[39]

This *ḥadīth* proved that the Prophet (peace be upon him) allowed a transfer of debt from one person to another with the consent of the parties involved.

A contract of *al- ḥawālah* involves three parties, *al- muḥīl* (the debtor), *al-muḥāl* (the creditor) and *al- muḥāl ᶜalayh* (the newly elected debtor). In practice, such a contract may be executed between two of them. However, it is required that one of the contracting parties must be the creditor or his representative. Briefly, every condition of a valid contract must be fulfilled in establishing a contract of *al-ḥawālah*, such as that the parties must be eligible to enter into a contract and the debt must be valid and known to each party.[40] In addition, this contract may be further (*muqayyad*) by any condition agreed upon by the contracting parties.[41]

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[37] Cowan, J. M. (ed.). *The Hans Wehr Dictionary of Modern Written Arabic*. New York: Spoken Language Services, Inc., 3rd edition, 1976 pp. 215-216.

[38] Ibn ᶜĀbidīn, *Radd*, v. 4, p. 321, Ibn Qudāmah, ᶜAbdullāh Aḥmad Muḥammad. *Al-Mughnī wa Sharḥ al-Kabīr*. Beirut: Dār al-Fikr, 1984 v. 5, p. 54, Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ ᶜalā Matn Minhāj al-Ṭālibīn*. Damascus: Dār al-Fikr, (No Date) v. 2, p. 193, Al-Zarkashī, *Sharḥ*, v. 4, p. 109, Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, p. 270, Al-Khafīf, *Aḥkām*, p. 450.

[39] The *ḥadīth* is quoted in, Al-Shāfiᶜī, Abī ᶜAbdullāh Muḥammad Idrīs. *Al-Umm*. (commented by, Mahmud Matraji). Beirut: Darul Kitab al-'Ilmiyyah, v. 3, 1993 p. 231, Ibn Qudāmah, *Al-Mughnī*, v. 5, p. 54, Al-Zarkashī, *Sharḥ*, v. 4, p. 110, Hasan, Abdullah Alwi. *Sales and Contracts in Early Islamic Commercial Law*. Islamabad: Islamic Research Institute, 1994 p. 182.

[40] Ibn ᶜĀbidīn, *Radd*, v. 4, p. 322, Ibn Qudāmah, *Al-Mughnī*, v. 5, pp. 55-58, Ibn Mufliḥ, *Al-Mubdiᶜ*, v. 4, p. 270, Al-Khafīf, *Aḥkām*, pp. 450-451.

Upon the conclusion of *al- ḥawālah*, the *muḥīl* is free from his debt in terms of the obligation to be performed by the *muḥāl ᶜalayh*.[42] However, if the contract of *al- ḥawālah* is annulled for any legally recognised reason, the *muḥāl* is allowed to return the claim of the payment of debt against the *muḥīl*.[43] A contract of *al- ḥawālah* is annulled in a few circumstances, firstly, in the event of bankruptcy or death of the *muḥāl 'alayh* wherein there is no alternative way to pay the debt; secondly, his sudden refusal to pay the debt where there is no proof establishing his consent to the *al- ḥawālah* contract. This rule has been established in order to protect the *muḥāl's* right vested in the debt.[44]

Although a contract of *al- ḥawālah* initially concerns transfer of debt, in fact it lays down the very basic concept of the permissibility of transferring a contractual obligation from one person to another upon the consent given by all parties involved. As payment of debt is a contractual obligation of a loan agreement, any type of contractual obligation may be legally transferable. As long as the requirements of a valid contract are fulfilled, and the parties concerned have given their consent, a transfer of a contractual obligation can be made. The principles of *Qiyās* may, therefore, be adopted in applying rules of the *al- ḥawālah* contract in the examination of an offsetting transaction.

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[41] Al-Khafīf, *Aḥkām*, p. 451.
[42] Al-Sharbīnī, *Mughnī*, v. 2, p. 195, Al-Zarkashī, *Sharḥ*, v. 4, pp. 114.
[43] Ibn ᶜĀbidīn, *Radd*, v. 4, pp. 325-325, Ibn Qudāmah, *Al-Mughnī*, v. 5, pp. 62-63, Hasan, *Sales*, p. 183.
[44] Ibn ᶜĀbidīn, *Radd*, v. 4, p. 325, Al-Khafīf, *Aḥkām*, p. 453.

Comparing a contract of *al- ḥawālah* and the execution of an offsetting transaction, both have the same purpose and a similar effect. The purpose of a contract of *al- ḥawālah* is to be free from a debt by transferring the obligation of paying the debt to someone who is willing to do so and the offsetting transaction is also executed by a futures trader in order to offset his futures commitment of making or taking the commodity delivery by entering into an opposite position. In theory, his new counterparty will undertake his futures obligation under the previous futures position.

Furthermore, the original debtor in a contract of *al- ḥawālah* is not liable for a claim of debt from the creditor since such a contract has substituted a third person as the new debtor. Likewise, by executing the offsetting transaction, the futures trader is, in effect, no longer obliged to make or take the delivery. If he was buying a certain amount of commodity futures in the previous futures position, he is liable to take the delivery of the commodity. By selling the same amount of the commodity futures, he is transferring his obligation of taking the delivery of the same commodity futures to his counterparty, the new buyer. What frees him from any new obligation specified under the latter transaction of selling the commodity is spelled out in the theory that he is now taking the opposite position that makes him responsible to make the futures delivery. It is as if he were dealing with himself, making the delivery that is needed in order to meet his previous obligation of taking the delivery. This presumed co-incidence would, in effect, release the trader from owing any obligation to either counterparties.

Based on the discussion above, it is possible to recognise an offsetting transaction as the same as a contract of *al- ḥawālah*, as they share a similar *ᶜillah*, the transfer of a contractual obligation, which has yet to be performed. Although the formation of *al- ḥawālah* contract is different from the execution of an offsetting transaction, it is sufficient to hold that both of these transactions has the same cause of contract (*maḥall al-ᶜaqd*) i.e. the release from a future contractual obligation. Such a cause of contract should therefore, put both of them in a similar position in the framework of Islamic Law.

6.3. Conclusion and Summary

The practice of offsetting a futures contract position has long been recognised as one of the usual futures markets practices. It can be proved from the futures markets' record that usually stated that not more than three per cent of all commodity futures traded on all exchanges end in delivery, while the rest are settled through the practice of offsetting. Since the mechanism of most of the futures markets at present[45] allows the futures traders to offset their open position before the maturity date, there is a chance of making a profit. Consequently, almost all futures traders nowadays are actually investors, hedgers and speculators. These groups of futures traders have no interest in owning the underlying commodity. By this

[45] Most of the futures markets at present have their own or an associated clearing house. In the clearing house's novation process (interposing between the contracting parties), a futures trader is allowed to liquidate or offset his position easily, which means the resulting profit from the price difference must be paid promptly to the trader, unlike the system in the London Metal Exchange, though it allows offsetting practice, there is no clearing house that could play the novation or substitution role. In effect, any profit made will only be paid on the maturity date. See, M. C. Brackenbury & Co. Dealing on the London Metal Exchange and Commodity Markets. London: M. C. Brackenbury & Co., 1975 p. 21. For further information, see, Jarvie, Robert Gibson. *The London Metal Exchange, a commodity market*. Cambridge: Woodhead-Faulkner Ltd., 1976 pp. 141-143.

practice, they trade in commodity futures and liquidate their futures position without the need to fulfil their futures contract obligations, taking or making the delivery of the commodity.

An offsetting transaction is similar to any other execution of a futures contract. It may be either buying or selling the commodity futures, depending on the trader's existing position. If in that position he were buying the commodity, the trader would simply sell the commodity of the same amount and of the same delivery month in order to offset the existing position. Through the clearing process, the latter transaction would be considered as a liquidating contract, that is, it will not result in an open contract. Upon the clearing of the offsetting transaction, the trader is, in effect, free from any contractual obligation under the previous position.

Examining this practice of offsetting a futures position together with its obligations within the framework of Islamic Law, some issues arise on the question whether the practice is tantamount to *faskh al-^{c}aqd* (a dissolution of a contract) or, it is a mere *iqālah al-^{c}aqd* (a discharge of a contractual obligation). In determining whether an offsetting transaction is a type of dissolution of a valid contract, it is hard to find an effective cause in the offsetting transaction so that it could be considered a legal dissolution of contract in Islamic Law. There is no destruction of the object of the contract and the contractual terms have not been stipulated with any right of *khiyār* (option).

With further examination, the offsetting transaction may be regarded as a mutual discharge of contractual obligation by an agreement to revoke an existing contract. Comparing the offsetting transaction with *iqālah al-ᶜaqd*, both have a similar purpose and effect of revocation of a contract and discharge of its obligation, except that there is no express consent given by the parties involved, especially the clearing house, in the execution of an offsetting transaction. If such a transaction is deemed a customary market practice that has been recognised by every market participant, an implied consent may be inferred.

An offsetting transaction may also be legalised within the framework of Islamic Law if it is regarded as a transfer of a contractual obligation owed by the trader to the clearing house. As in a contract of *al- ḥawālah*, a debt may be transferred from a debtor to another person who is willing to pay the debt. By the offsetting transaction, the trader may be considered as transferring his futures contract obligation to his counterparty, and subsequently being discharged from the obligation. Since the clearing house will interpose between the trader and his counterparty in the offsetting transaction, the clearing house will effectively liquidate the trader's previous position and discharge him from any obligation of that position.

CHAPTER SEVEN

THE ACTIVITY OF HEDGING AND SPECULATION IN COMMODITY FUTURES TRADING

7.1. An overview of the activities

In the mid nineteenth century before the modern futures market developed, traditional traders in grain markets locked in a price for the commodity in an agreement known as 'to-arrive' or 'cash-forward' contract. Under such a contract, the cash grain is purchased but the delivery is forwarded to some time in future. Thus, the seller owes the delivery of the grain and the buyer is obliged to accept this delivery and to pay the price. At this stage, however, the risk of price fluctuation is unavoidable; sometimes it may cause monumental loss to the seller if it fluctuates against him. In other words, if the price of the commodity is declines sharply at delivery time, he receives a very low price for the delivered commodity. Likewise, if the price movement is in his favour, his counterpart will suffer the loss. At this point, real traders need to pass on or to hedge such unavoidable risk to anyone who is willing to bear it by speculating on the price, i.e. whether it will rise or fall.[1]

As a consequence of the need to manage the price risk, risk takers or speculators arose hoping for profit from the price fluctuation, and the futures market was developed to accommodate these activities.[2] The futures market provides a convenient place and opportunities for hedgers to seek for those who are willing to

assume their risks, while speculators, on the other hand, are attracted to the opportunities that could possibly enable them to make a big return from the price fluctuation if the price moved according to their speculation. So the futures market allows these traders to offset their obligations under each futures contract by taking an opposite position, i. e. by executing an opposite contract. Comparing this market with the previous 'cash-forward' market, there was no such chance of offsetting there but only the obligatory contractual fulfilment of taking or making the actual delivery of the underlying commodity.[3]

As mentioned in the previous chapter, the offsetting practice is the basic tool for hedgers as well as speculators in achieving their hedging and speculation purposes. Instead of establishing the futures contract commitments, the hedgers close out their futures position before its maturity date and sell or buy the cash commodity in the cash market, while speculators, who have no intention of making or taking the actual delivery, will certainly offset their futures position at any time after the execution of the initial contract but before the maturity date of the said contract.

7.1.1. The Hedging Activity

Hedging is generally known as a method of risk reduction. It is actually the practice of offsetting or at least, reducing the risk of price fluctuation attached to any

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[1] Belveal, L. D. *Commodity Speculation - with profits in mind.* Illinois: Commodity Press, Belveal & Co, Inc., 1967 pp. 18 & 20.
[2] Belveal, *Commodity*, p. 18.
[3] Courtney, D. & Bettelheim, E. C. *An Investor's Guide to the Commodity Futures Markets.* London: Butterworths, 1986 p. 50.

cash market position. Such a risk is offset by taking an equal but opposite position in the futures market. A hedger, either an individual or a company that owns or plans to own a cash commodity, is a futures trader who has interests in the cash market as well as the risk reduction motive.[4] In attempting to avoid the price risk of the commodity, the hedger passes the risk to the speculator by engaging in a futures market position that is opposite but equal to his cash market position. Conceivably, he is protected against the risk of price fluctuation by offsetting this futures position to secure a profit even if the cash price moves unfavourably.[5]

For illustration purposes, suppose a crude palm oil (CPO) producer agrees to sell the commodity to an oil refiner in four months time. The producer now, is considered as having a long position in the cash market, like a trader who is buying the commodity, since he owns the CPO. As the producer fears or anticipates that the price will decline during the four months, he hedges this risk by selling (or taking a short position) of an equal amount of CPO futures in the futures market. Eventually, at the end of period of four months before the maturity of his futures position, he offsets his futures position by buying the same amount of the CPO futures and sells the CPO in the cash market at current price. If the cash price falls, he will suffer loss in his cash market position but will secure a profit from his futures position since the price usually has also fallen in the futures market in relation to its cash price. This profit materializes due to his selling of CPO futures at a higher price than the purchase price of the said commodity. Therefore, he may use his gain in futures to

[4] New York Institute of Finance. *Futures; A Personal Seminar*. New York: NYIF Corp., 1989 p. 145.
[5] Chicago Board of Trade. *Commodity Trading Manual*. Chicago: Board of Trade, 1994 p. 351, Gould, Bruce G. *The Dow Jones-Irwin Guide to Commodity Trading*. Illinois: Dow Jones-Irwin, 1981 p. 339.

cover the lower cash price and protect his profit from his sale of cash CPO to the refiner.

The example given above represents one of the two types of hedging; selling hedge or 'short' hedge. As indicated earlier, selling hedge involves ownership and a subsequent sale of the cash commodity. By selling an equal or approximate amount of the commodity in the futures market the hedger manages to secure the current value of the commodity. If the price declines as anticipated, the profit resulting from the futures position offsets the loss incurred in the cash market position. On the contrary, a buying hedge is practiced by a hedger who is planning to purchase a cash commodity (having a short position) in the cash market. If he anticipates that the price of the cash commodity is increasing, buying the same amount of the commodity in the futures market will enable him to lock in the current price, hence ensuring him a substantial profit. Similarly, this profit could neutralise the loss resulting from his cash market position should the price actually increase.[6]

Although hedging practices may protect the hedger against the risk of price changes, it can give a reverse result, especially when the market price moves contrary to the hedger's anticipation. Therefore, the hedger must know precisely the relationship between the cash and futures prices. The difference between the cash price and the futures price of the same commodity is known as 'the basis'. The prices of both markets usually run parallel since both of them react to the same economic factors that affect the value of the commodity. Nevertheless, the basis may widen or

[6] Kaufman, Perry J. *The Concise Handbook of Futures Markets*. New York: John Wiley & Sons, 1986 pp. 9.9-9.10, Fink, Robert E. *Futures Trading*. New York: New York Institute of Finance, 1988 pp. 232-233.

narrow if the prices of both markets run independently.[7] Thus, by knowing the basis, the hedger may hedge the risk properly as to when and in what delivery month to hedge. A perfect hedge is made when the basis is unchanged.

Normally, cash prices are higher than futures prices, since rationally, cash prices include storage costs and other related fees. Thus, in order to calculate the basis, the futures price should be substracted from the cash price.[8] The result of a hedge, whether incurring loss or providing gain, may be determined by comparing the basis between the time the hedge is put on (buying or selling the commodity futures) and the time it is taken off (executing an offsetting position). If the basis is unchanged, it means that the hedger's loss in the cash market is fully hedged. Fortunately, he may entitle to an additional profit if the futures price has declined more than the cash price. This event is represented in the narrowing of the basis. Vice versa, the basis widening will effectively burden the hedger with additional loss.[9] (See, **Figure 7.1**)

[7] New York Institute of Finance, *Futures*, p. 147.
[8] Chicago Board of Trade, *Commodity*, p. 93.
[9] New York Institute of Finance, *Futures*, pp. 158-159.

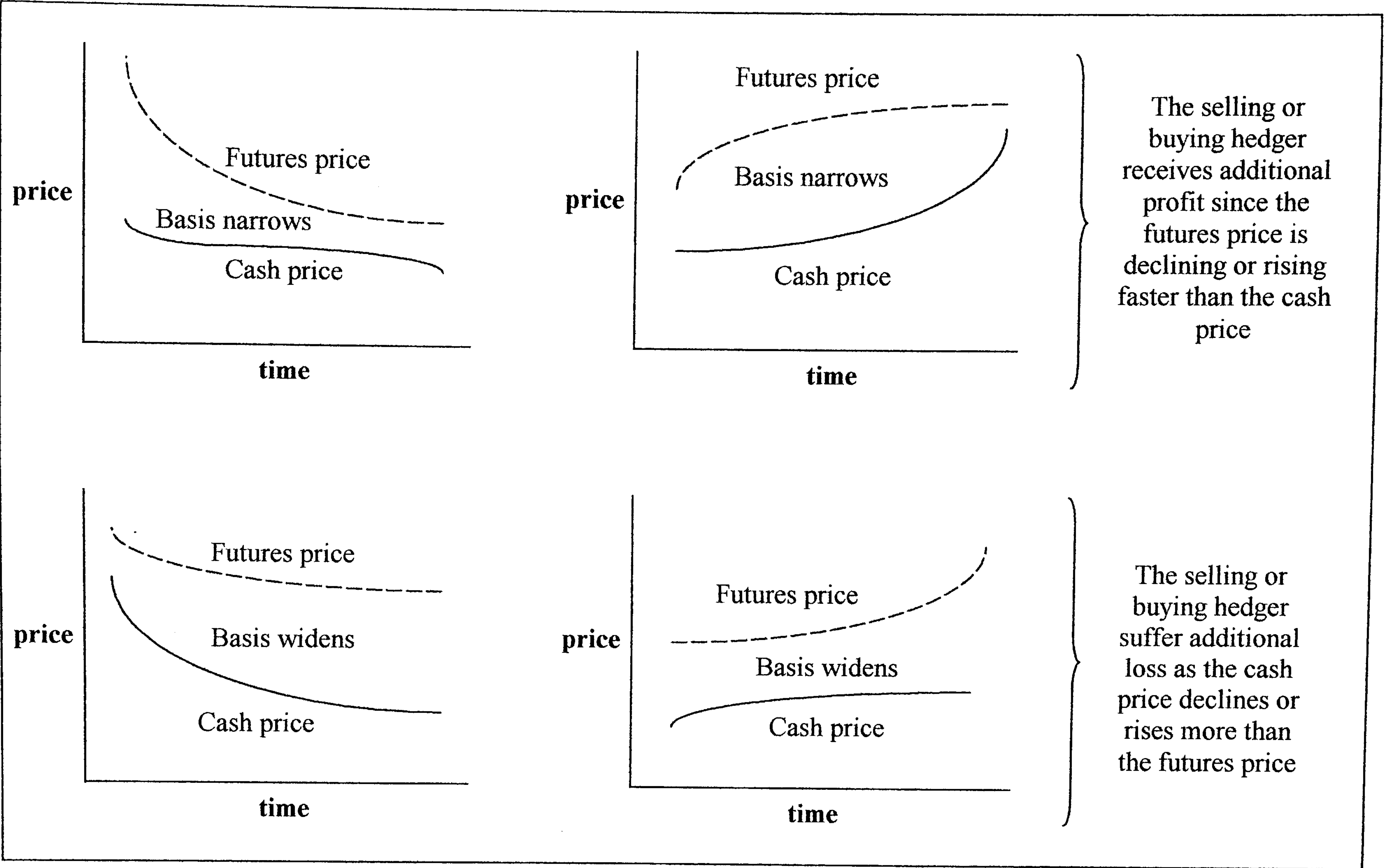

Figure 7.1 The basis relationships in a normal market
Source: New York institute of Finance. *Futures; A Personal Seminar*. New York: NYIF Corp., 1989 p.159.

It is important, then, to forecast the change in the basis accurately in order to materialise the full protection of hedging against price risk. There is no precise method of forecast the basis. A hedger must pay attention to a variety of factors affecting the change in the basis. These factors are mainly rooted in the supply and demand equilibrium of the commodity. The stronger the demand is, the higher the price will be. In contrast, the larger the supply but with demand being relatively moderate, the price will automatically decline. In addition, other extraneous factors can be a stimulus (an activating factor) to basis change, such as government policies, supply and demand of comparable substitutes, foreign production and certain related costs, like storage, transportation and insurance costs.[10] As stated earlier, the basis cannot be predicted easily, but it is less volatile than the cash and futures prices.

The factors mentioned above may sometimes lead to a widening of the basis, so that the futures and cash prices do not converge[11] at the expiry date as they are supposed to do. Usually, cash prices change faster or slower than futures prices. In such an event, the hedging may be unsuccessful, and the hedger suffers additional loss instead of having protection against the loss incurred in his cash market position.[12] Furthermore, the hedger may not be fully protected in his hedging since futures contracts are standardised as to grade, amount and delivery months. The standard amount of the futures contract may not offer him the exact amount to hedge his cash market position. For instance, a CPO producer needs to hedge a hundred and twenty tonnes of CPO for his cash sale whereas, in the futures market, a contract is based on twenty-five tonnes of CPO. In this case, he could either being

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[10] Chicago Board of Trade, *Commodity*, p. 95.

[11] Convergence of futures and cash prices means, both prices will reach at the same value at the expiry date.

underhedged by selling four contracts (a hundred tonnes of CPO) or overhedged, by selling five contracts (a hundred and twenty-five tonnes). In any case, it is usually advisable for the hedger to be underhedged since the profit gained in the futures transaction can usually cover the underhedged portion while the hedger could simply avoid an extraneous margin requirement if he is overhedged.[13]

In addition to the above weaknesses of hedging, the activity certainly adds more costs that need to be borne by the hedger, such as carrying charges, execution and clearing costs. Added to these disadvantages, a futures market does not usually provide a standard price trend for the hedger to identify the basis changes.[14] Every futures market has its own seasonal tendency that may affect the futures price trend. A hedger must have a thorough knowledge of the market's seasonality in order to put his hedge on the most favourable basis.[15]

Besides these disadvantages, it has been suggested by academics that futures markets must rely principally on these hedging activities in order to perform its basic economic function which is to discover the market price of commodities.[16] In other words, this practice of hedging is the original reason for the existence of futures markets.[17] On the other hand, hedging activities will not be successful in the absence of speculative activities. It is claimed that speculation facilitates hedging practices in by adding liquidity to the market. It is further contended that speculators play the

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[12] Gold, Gerald. *Modern Commodity Futures Trading*. New Jersey: Commodity Research Bureau, Inc., 1975 p. 172.
[13] New York Institute of Finance, *Futures*, p. 160, Fink, *Futures*, p. 241.
[14] New York Institute of Finance, *Futures*, pp. 160-161, Fink, *Futures*, p. 243.
[15] Kaufman, *The Concise*, p. 9.19.
[16] Meyer, Thomas Otto. *Effects of Speculation and Hedging in Several Commodity Futures Markets*. Michigan: U. M. I., 1990 p. 19.
[17] Gold, *Modern*, p. 163.

same role as hedgers. While speculators speculate on the price and expose themselves to its risks, the hedgers too, speculate on the basis and are exposed to basis risks.[18]

7.1.2 The Speculation Business

As stated earlier, the speculators' main activity is to speculate on the futures price thus accommodating themselves to the hedgers' needs. They enable the hedgers to spread their price risks by assuming such risks with the anticipation of making profit.[19] Without speculators, buying (long) hedgers could only trade with selling (short) hedgers. This trade, however, is difficult to achieve since finding the exact opposite position is a hard process among the very limited number of hedging traders. The presence of speculators between them provides, in effect, more opportunities for hedgers to operate their hedging activities.[20] Thus, speculators contribute substantially to the efficiency of the futures market.

In a commodity market, speculators are referred to those who try to profit from buying and selling commodity futures by anticipating future price movements.[21] In such attempt, the speculators have no intention at all, of making or taking the delivery of the commodity, though they contribute towards the performance of the market in stabilising the commodity prices.[22]

[18] Meyer, *Effects*, pp. 21-24.
[19] New York Institute of Finance, *Futures*, p. 172.
[20] Chicago Board of Trade, *Commodity*, p. 111.
[21] Chicago Board of Trade, *Commodity*, p. 358.
[22] Gould, Bruce G. *The Dow Jones-Irwin Guide to Commodity Trading*. Illinois: Dow Jones-Irwin, 1981 p. 343.

Based on their trading and speculation methods, speculators can be divided into many categories. By using price forecasting methods, a speculator may be a fundamental analyst, who looks at the primary factors of supply and demand, whereas a speculator who uses market factors and charts to plot the price movement is called technical analyst or technician. Speculators may also be classified according to the size of their trading, whether they hold a large position as the professionals do or a small position as do public speculators. These position holders are also known as position traders, that is, speculators who hold positions over a period of days or longer. Unlike position traders, day traders or scalpers[23] hold positions during the course of one trading session only. They rarely hold positions overnight.[24]

Regardless of the category to which they belong, all speculators use the same basic techniques, they buy contracts when they believe the prices are low and sell them when the prices are high. In both cases, speculators anticipate that the prices will subsequently rise in the former and fall in the latter cases. With these speculations, the speculators can gain profits by making an offsetting sale or purchase when the prices rise or fall. An effective market expectation is highly dependent on the speculators' skill in analysing market factors and other external factors that could affect the prices. By this analysis, speculators may be able to determine whether and when the market prices are too high or too low as well as being able to formulate their expectations of price movements or market direction.[25]

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[23] Scalpers are speculators who trade rapidly for their own account and are willing to accept small profits.
[24] Chicago Board of Trade, *Commodity*, p. 113.
[25] Chicago Board of Trade, *Commodity*, p. 112.

The above-mentioned said basic method of speculation is not confined to buying or selling contracts of the same amount of commodity and the same month. In the advanced techniques of speculation, known as 'spread' and 'straddles' trading, again the speculators apply the same principle - buy when the price is about to rise and sell when the price seems about to fall. However, in spread trading, it involves two opposite position of the same commodity but different delivery months are involved. In trading known as inter-delivery spread,[26] speculators have both long and short positions simultaneously. Yet the motive of such trading is the same, to profit from the price difference between the two contracts. Unlike spread trading, straddles trading, which is actually a type of spread, involves two simultaneous long and short positions of two different commodities (inter-commodity spread), or of the same commodity but traded in two different markets (inter-market spread).[27]

Both spread and straddles trading are based on the expectation of changes in the relationship between the two contracts. For instance, there is a close relationship between corn futures and oat futures since both feed grains are good substitutes for each other. Rationally, if corn is cheap relative to oats, the demand for corn would be higher. Thus, the relative prices of the two could help the speculator in determining the demand factors.[28] As in any ordinary speculative method (usually referred as an outright position), the two simultaneous long and short positions in such advanced techniques are liquidated by taking an opposite position for each of them. If the speculator's expectations turn out to be true, he will gain profits by such a liquidation.

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[26] New York Institute of Finance, *Futures*, p. 182.

In reality, price expectations in speculation and spread trading involve complicated formulas and calculation. Yet the primary purpose is still to forecast price changes of a specific commodity or related commodities. To be a successful speculator, a futures trader needs both knowledge and practice in price forecasting. The required knowledge includes all relevant information relating to a specific commodity, such as its distribution, growing season, historical production and consumption of the commodity and its substitutes, government support and policy. Furthermore, information on its trading in the futures market is very important. That includes historical price movements, hedging activities and trading volumes of the said commodity futures. From historical and published information, a speculator may be able to know what sort of events may probably make an impact on the price of the commodity. Besides this past and present information, using charts to plot price movement is equally important. These charts can provide information for the speculator on past price behaviour that may help him to think in terms of price trends and to determine the best position to take in order to profit or to limit loss.[29]

The above-mentioned strategy represents a combination of fundamental analysis (the study of supply and demand) and technical analysis (the use of price and volume charts). Various academic studies suggest that it is necessary for every speculator to analyse market factors and price changes in order to be successful in price forecasting and futures trading.[30] In addition, the speculator should also adopt a well-developed trading plan[31] and avoid making judgments based on rumours.[32]

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[27] Gold, *Modern*, p. 266.
[28] Gold, *Modern*, pp. 273-274.
[29] Belveal, *Commodity*, pp. 120-124.
[30] Chicago Board of Trade, *Commodity*, p. 115.
[31] An effective trading plan varies from one speculator to another. It includes limiting and maintaining risk capital on any trade.

However, sometimes favourable news, when published may result in the opposite effect. For example, positive news on export activity would cause a price rise of the related commodity as the news represents a higher demand. On the contrary, many traders who have heard about this activity through rumours or informal sources have already bought the contracts, anticipating of the price rise, while the other traders who act upon such news will eagerly buy such contracts with the same expectation. Since most of the traders buy or take the long position, the price is dragged down due to lack of sellers in the market.[33]

From this example, it seems that analysing the market and adopting a well-developed trading plan could not per se ensure a profitable position for a speculator. Besides the influence of his temperament and objectivity, the speculator's judgment on the prices is also subjected to the randomness of price variations. Although most technical analysts believe that past price behaviour can be used to forecast the futures price movement, the technique cannot prove that the price movement is non-random.[34]

Besides the unpredictable price behaviour that may cause an indefinite risk, a speculator is also subject to the limits of his risk capital. He should carefully examine his speculative strategy in order to avoid over-trading, i.e. trading beyond his risk capital limit. Over-trading is usually based on the speculator's opinion and highly dependent on his good luck in gaining large profits. In such trading, the

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[32] Chicago Board of Trade, *Commodity*, p. 115.
[33] Belveal, *Commodity*, pp. 274-276.
[34] Hieronymous, Thomas A. *Economics of Futures Trading for Commercial and Personal Profit*. New York: Commodity Research Bureau, Inc., 1981 pp. 251-252.

potential loss is also as great as the expected profit.[35] To maintain an ongoing profitable position, a speculator must be able to place his stop loss order at an appropriate price. Adversely, if he is consistently in a losing position, he will be subjected to variation or margin calls proving that his speculative strategy is in error.[36]

Due to the various pitfalls in the speculation business, many studies have shown that more speculators turn out to be losers than winners. To name a few, the *Blair Stewart Study* found that there is a tendency for the size of losses to exceed the size of profits, while in a later study, *A Cursory Look*, of 462 speculative accounts, 298 incurred losses. Similarly, *One Time Traders*, a study of a large number of accounts has shown that the winners made a total of $37,237 while the losers lost $461,659. Out of 170 accounts, 44 were winners and 126 were losers.[37] These studies clearly show that most of the speculators end up in their trading as losers rather than winners. It is believed that the risk capital they lost was partly as payment for commission and fees, and partly profits for the successful professional speculators and hedgers.

Although it is evident there are more losers than winners, futures traders are always attracted to speculative activities. The potential gain of big profits with a small margin requirement makes such business sound feasible. In addition, there is a strong belief that market prices can be anticipated through analysis, fundamental or technical analysis. Further, their presence is justified in the whole operation of a futures market, since they assume the price risks for the hedgers and introduce more

[35] Belveal, *Commodity*, pp. 264-265.

capital and liquidity into the market. They also provide additional information that is vital and necessary to the fulfilment of the price discovery role of the market. Though most speculators are motivated by the hope of potential profit, ultimately they are contributing to the price stability of commodities in the market.

7.2. The Positions of Hedging and Speculative Activities in Islamic Law

In theory, hedging and speculation practices do not affect the validity of a commodity futures contract since both hedger and speculator utilise the same mechanism of execution of a futures contract but for the purposes of their hedging and speculation activities. As all futures contracts are standardised and upon each execution the clearing house will interpose between the parties, trading in futures becomes fungible, where it allows a trader to offset a previous contract freely. The price difference between the contracts offers a substantial profit or an equally substantial loss. Therefore, in order to avoid losses, a hedger or speculator will normally take into consideration any relevant information and news, including rumours, so as to forecast the price changes correctly.

Hedging and speculation activities are generally acceptable under the rules and regulations of commodity exchanges and, permissible under most relevant Common Law but under Islamic Law, these activities raise some major issues in relation to the legality of such activities and their effects on the validity of commodity futures contracts. In particular, hedging and speculation in commodity futures trading obviously add more *gharar* (risk and uncertainty) elements to the

[36] Belveal, *Commodity*, pp. 266-268.

trading of commodity futures contracts. Both practices involve anticipation of price changes that normally move randomly. Although this expectation of price movement is based on published information and data, the price may change adversely. In spite of expecting a big return, a hedger or speculator may face a substantial loss.

Furthermore, in the course of anticipating the price changes, it is more likely for fraud to occur since some of the information is not verified by any authority concerned. If such fraudulent information is spread over the market, it could possibly cause an imbalance between the number of buyers and sellers. Thus, it will lead to an excessive supply and demand in the market that implies a very low or a very high price of the commodity. In this context, these two activities of hedging and speculation must be carefully examined in terms of the risks and uncertainties attached to them and the likelihood of other prohibitory elements such as fraud and excessive pricing or swindles occuring in the market due to these activities.

7.2.1. The principles of Islamic Law on risk, uncertainty, fraud and excessive price

Under the purview of Islamic Law, trading in futures with the anticipation of favourable price changes is a transaction that may be associated with *gharar* as well as other prohibitory elements, such as *al-ghish* (deceit), *al-tadlīs* (fraud) and *al-ghubn al-fāḥish* (excessive swindle). As a decision to sell or to purchase (especially for speculators) is highly dependent on market factors as well as non-verifiable information, the above prohibitory elements are unavoidable. Some speculators may

[37] Hieronymous, *Economics*, pp.256-261.

create false information or rumours so as to ensure the price changes according to their expectation.

In order to determine whether these activities and any actions therein amount to *gharar* or any of the prohibitory elements, it is necessary to discuss onwards the principles of Islamic Law concerning the prohibitory elements that may vitiate the validity of a particular contract.

(i) *Gharar* (risk and uncertainty): the general vitiating element

The term *gharar* takes the forms of *ghish*, *tadlīs* and *ghubn* that synonymously refer to wrongful or unlawful gain of property (*akl al-māl bi al-bāṭil*). *Gharar* is generally defined as risk, uncertainty, deceit or anything that has invisible results. By this definition, the term *gharar* includes anything that is unknown or uncertain in terms of its existence and delivery.[38] Any type of transaction associated with an element of *gharar* is generally rendered as void or voidable. This rule is derived from the *ḥadīth*,

> It is reported by Abū Hurairah that the Prophet (peace be upon him) forbade the sale of *ḥaṣāh* (sale of things or land which is roughly determined by a throw of a stone or pebble) and the sale of *gharar* (sale that involves a non-existent, uncertain or unknown object).[39]

[38] Al-Ḍarīr, al-Ṣiddīq Muḥammad al-Amīn. *Al-Gharar wa Atharuhu fī al-Fiqh al-Islāmī*. Beirut: Dār al-Jīl, 1990 pp. 27-28, Al-Zuḥaylī, Wahbah. *Al-Fiqh al-Islāmī wa Adillatuh*. Damsyik: Dār al-Fikr, 1989 v. 4, pp. 436-437.

[39] The *ḥadīth* is quoted and explained in, Al-Shawkānī, Muḥammad ᶜAlī Muḥammad. *Nayl al-Awṭār Sharḥ Muntaqā al-Akhbār*. (No Place): Maktabah al-Aymān, (No Date) v. 5, pp. 147-148. For more *ḥadīth*, see, Al-Ḍarīr, *Al-Gharar*, pp. 58-61, Masyhūr, Amīrah ᶜAbdul Laṭīf. *Al-Istithmār fī al-Iqtiṣād al-Islāmī*. Cairo: Maktabah Madbūlī, 1991 pp. 246-247.

The prohibition on *gharar* transactions is enforced because of the possibility of deceit, fraud or injustice occuring between the contracting parties. It may lead to disputes and unlawful gain of another's property.[40] Nevertheless, Islamic scholars have unanimously agreed that the transaction with minor or slight *gharar* may be exempted from this rule. This type of *gharar* includes any unavoidable uncertainty or one that forms part of the contractual object, such as the sale of a house without specifying the fitting of its ceiling or floor. In addition, it is also permissible to have a slight *gharar* in any transaction that usually regards the object as the same as in any similar contract due to its minimal task or if it is hard to be determined.[41] For instance, sale of food in a buffet service in which the price is fixed per head, and not dependent on the amount of food taken. As long as the existence of such *gharar* is not intended (*ghayr maqṣūd*), it will not invalidate the outstanding contract.[42]

On the other hand, the forbidden *gharar* is meant for a major or excessive *gharar*, which is not a necessity in any particular contract. The existence of such a *gharar* will definitely render the contract void. Although the scholars agree on these two categories of *gharar*, there is no clear-cut guideline to determine the degree of *gharar* that amounts to the permissible *gharar* or the prohibited one. Basically, it depends on *ijtihād* of the scholars to determine the permissibility of a particular *gharar* associated with a transaction. For instance, in a contract of insurance, there are many uncertainties attached to the subject matter of the contract. One of them is the uncertain duration of the contract since the insurer will only get the compensation upon the occurrence of a specific event. This obviously amounts to a

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[40] Al-Gharyānī, al-Ṣādiq ᶜAbdul Raḥmān. *Al-Muᶜāmalāt Aḥkām wa Adillah*. Andalus: Dār al-Ḥikmah, v. 1, 1992 p. 208.
[41] Al-Zuḥaylī, *Al-Fiqh*, v. 4, p. 438, Masyhūr, *Al-Istithmār*, p. 247.

prohibitory *gharar*. However, the majority of modern Islamic scholars consider such a contract as a type of contract of guarantee (*al-takāful*) in which the said *gharar* is inherent and is not intended in the contract.[43]

Adapting the principle of *gharar* to the hedging activity, the element of *gharar* that attaches to a commodity futures contract has been minimised since the hedger owns the commodity or is willing to take the delivery of the commodity, although it is in the cash market. They trade in futures trading in order to reduce the risks of their cash trading as well as to avoid any unnecessary loss. Whether they make a loss or a profit from this activity, it does not affect their potential in the fulfilment of the contractual obligations of making or taking the delivery of the commodity upon the maturity of the contract. However, in reality, hedgers would rather liquidate their futures position than take or make the futures delivery. As indicated earlier, their prime interest is vested in the cash market position where they fulfil these obligations in the cash market.

On the other hand, it is universally understood that when a speculator enters into a futures contract, he has no intention at all of taking or making the future delivery of the underlying commodity. Nevertheless, he uses the same format as other traders in executing the contract that is conceivably valid and enforceable. However, in his speculative activity per se, *gharar* or uncertainty elements are unavoidable. In forecasting the prices, the speculator must consider a lot of factors that may affect the rise and fall of the price. In many cases, as proved by the studies mentioned earlier, speculators suffer more losses than gains due to mistakes in

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[42] Al-Gharyānī, *Al-Muᶜāmalāt*, pp. 208-209.

anticipating price movements. This business is clearly associated with a high degree of risk. There is no certainty in price changes despite the use of fundamental or technical analysis. Furthermore, speculation is to be considered as a zero-sum game[44] in which there is no real merchandise involved. Speculators may either acquire profit or suffer pure loss. Obviously, this risk is amount to an element of *gharar* that is prohibited.

(ii) *Al-tadlīs* (fraudulent terms and conduct)

In addition to the above risks, a speculator may also be exposed to false information or news, because information and news forms the basic factors in his speculation strategy. False information could lead the speculator to a wrongful expectation of price movement. The circulation of such false information may amount to *al-ghish,* that means an act of exposing the reverse facts of the contractual subject matter. In particular, this term includes any attempt at concealing the defects of the subject matter and any fraudulent actions that are deliberately made to attract or induce the other party to enter into a contract. Such fraudulent means are referred to by Islamic scholars as *al-tadlīs.*[45]

Generally, any contract which has been executed by the parties based on an element of *al-tadlīs* is rendered as void *ab initio*. Although the injured party has initially volunteered to enter into the contract, his consent was based on a false

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[43] Al-Gharyānī, *Al-Muᶜāmalāt*, pp. 209 & 212.

[44] A zero-sum game is referred to a situation in which a gain by one party requires any other party involved in it to sustain a corresponding loss. See, *Encarta World English Dictionary*, London: Bloomsbury Publishing Plc, 1999 p. 2168.

knowledge about the object. This leads to unlawful gain of profit by the other party, a thing that is expressly prohibited in Islamic Law.[46] This rule is derived from the verse,

> "O you who have attained to faith, do not devour one another's possession wrongfully, but it must be in a way of trade based on mutual agreement."[47]

Fraudulent means, as defined in Islamic Law, may be in the form of actions or verbal statements. Thus, Islamic scholars have divided *al-tadlīs* into three categories: *al-tadlīs al-fiᶜlī* (fraud by conducts), *al-tadlīs al-qaulī* (fraud by verbal statement) and *al-tadlīs bi katmān al-haqīqah* (fraud by concealment of the truth). The first category includes any positive or negative action that fraudulently attracts the other party to the contract. Among the famous classical examples is the sale by *al-taṣriyah* (the practice of tying the udder of the merchandise for example a she-goat or she-camel). In this contract of sale, the udder of a she-goat or she-camel is tied up by the seller for a certain period in order to deceive the buyer into thinking that the goat or camel produces a lot of milk.[48] The second category, *al-tadlīs al-qaulī*, includes any false statement and cheating in order to induce the other party to deal with him. For instance, a seller who is selling a merchandise at a higher price falsely claims that he is offering the best price as compared to other sellers. The last category, *al-tadlīs bi katmān al-ḥaqīqah* refers to any concealment or hiding of the

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[45] Al-Qurrah Dāghī, ᶜAlī Muḥyiddīn. *Mabda' al-Riḍā fī al-ᶜUqūd.* Beirut: Dār al-Bashāir al-Islāmiyyah, 1985 v. 1, p. 601.
[46] Masyhūr, *Al-Istithmār*, p. 250.
[47] The translation of the Quran, 4:29.
[48] Al-Sharbīnī, Muḥammad al-Khaṭīb. *Mughnī al-Muḥtāj, Sharḥ ᶜalā Matn Minhāj al-Ṭālibīn.* Damascus: Dār al-Fikr, (No Date) v. 2, p. 63, Al-Zarkashī, Shamsuddīn Muḥammad. *Sharḥ al-Zarkashī ᶜalā Mukhtaṣar al-Kharqī.* Riyadh: Maktabah al-ᶜAbikān, 1993 v. 3, pp. 558-559.

true condition of the subject matter of a contract, for example, hiding the defect of merchandise by exposing only the good part of it.[49]

In order to prove the commission of *al-tadlīs* and to claim the right of option due to such an element (*khiyār al-tadlīs*), three requirements must be fulfilled. First, there must be a proof that the fraud has occurred and that it was intentionally committed by one of the parties. Secondly, it is required that such fraud is the main cause leading to the execution of the contract. It must be proved that the injured party entered into the contract because of his belief that the fraud was the truth. Finally, it is necessary that the fraud was committed by the deceiving parties, or that they knew about the commission of the fraud in a case where it was perpetrated by a third party.[50]It is further required in such a case that the third party must have conspired with the deceiving party in committing the fraud.[51]

From the requirement above, a contract that was legally concluded may be rescinded if there is proof that a fraud was committed by one of the parties or by a third party. As long as there is a conspiracy between the third party and the deceiving party, the contract is voidable. The best example for such a fraud is the sale of *al-najash.*[52] In this sale, the seller conspires with a person who later pretends to buy his merchandise at a higher price so as to induce the other buyer to purchase the merchandise at a price higher than it should be. Although Imām Aḥmad held that

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[49] Al-Zarkashī, Sharḥ, v. 3, p. 583, Al-Qurrah Dāghī, *Mabda'*, v. 1, pp. 601-610, Al-Zuḥaylī, *Al-Fiqh*, v. 4, pp. 218-220.

[50] Al-ᶜAṭṭār, ᶜAbdul Nāsir Taufīq. *Naẓariyyah al-Iltizām fī al-Sharīᶜah al-Islāmiyyah wa al-Sharīᶜah al-ᶜArabiyyah*. Cairo: Maṭbaᶜah al-Saᶜādah, v. 1, 1975 pp. 161-168.

[51] Al-Sanhūrī, ᶜAbdul Razzāq. *Maṣādir al-Ḥaqq fī al-Fiqh al Islāmī*. Beirut: Dār Ehyā' al-Turāth al-ᶜArabī, (No Date) v. 2, p. 172.

there is no requirement to prove the existence of conspiracy as required by the majority of scholars, scholars are unanimously agreed that such a practice is prohibited.[53] If the sale was executed by the parties based on this practice, the sale is rendered void. However, if the seller has no conspiracy with the third person, such a contract is considered as voidable.[54] This prohibition is based on the *ḥadīth*,

> 'It is reported by Ibn 'Umar that the Prophet (peace be upon him) had forbade *al-najash* (a practice where the price is increased by a person who is not at all interested in buying the merchandise but wishes to induce another to buy the property).'[55]

Besides the opinion that says the sale of *al-najash* is void or voidable, some scholars, such as Imām Ibn Ḥazm, consider that the practice of *al-najash* does not invalidate the contract since such a sale is legally concluded and all requirements of a valid contract are satisfied.[56] Furthermore, it is held by other scholars, such as the Ḥanbalī scholars, that such fraud of excessive price must be associated with an element of *al-ghubn al-fāḥish* (excessive swindle) so as to render the contract voidable and to entitle the buyer to right of option.[57]

There is very little likelihood for an element of *al-tadlīs* to be present in the hedging activity. Since this activity is based on the analysis of basis change and study of the market factors, there should be no room for *al-tadlīs* or any other type

[52] Sale of *al-Najash* is actually a fraudulent practice in which a third person is falsely bidding a higher price for the merchandise in order to induce a prospective buyer to buy such property.
[53] Al-Zarkashī, Sharḥ, v. 3, p. 643, Al-Sanhūrī, *Maṣādir*, v. 2, p. 172.
[54] Al-Zarkashī, Sharḥ, v. 3, p. 644, Masyhūr, *Al-Istithmār*, pp. 252-253.
[55] Quoted and explained in, Ibn Ḥajar (Al-ᶜAsqalānī), Aḥmad ᶜAlī. *Fatḥ al-Bārī*. Dār al-Kutub al-'Ilmiyyah, 2nd edition, v. 4, *ḥadīth* no. 2142, 1997 p. 447.
[56] Al-Qurrah Dāghī, *Mabda'*, v. 1, p. 637.

of fraud to occur. The decision as to when to put on a hedge or to take it off is normally made by the hedger on his own. If it is established that such a decision is based on fraudulent information, then the rules on *al-tadlīs* may be applied.

Similarly, the rules on *al-tadlīs* are applied to any contract that has been executed in a speculation business if there is a fraudulent element in the execution of the contract. Unlike the professional speculators who manage to use fundamental or technical analysis, most of the public speculators are highly dependent on their futures brokers to anticipate the price changes and to decide when to execute a futures contract. Again, if there is proof that shows a fraud has occurred, the deprived trader should be entitled to a right of option or compensation.

(iii) *Al-ghubn* (prohibitory swindle)

This is another situation of *gharar* that might occur in the activities of hedging and speculation. The rules on *al-ghubn* are derived from the prohibition of *al-ghish*. The term *al-ghubn* is referred to unfair return of value in an exchange for a property. There are two categories of *al-ghubn*, *al-ghubn al-yasīr* (slight swindle) and *al-ghubn al-fāḥish* (excessive swindle). The former category is permissible according to majority of Islamic scholars. The degree, size or amount of such *al-ghubn* is decided by the common practice or custom, or by a regulatory body.[58] For example, the market price of a kilogram whole meal flour is £1.00. It is permissible for any retailer to sell the same amount at a little more, like £1.20 or a little less, such as £0.80 since these small differences are commonly acceptable to the general

[57] Al-Sanhūrī, *Maṣādir*, v. 2, p. 172, Al-Zuḥaylī, *Al-Fiqh*, v. 4, p. 223.

public. On the contrary, the second category of *al-ghubn* is referred to the pricing of merchandise at prices excessively higher or lower than the normal or designated price.

In determining whether the element of *al-ghubn al-fāḥish* affects the validity of a contract, some of the scholars, such as the Ḥanbalī scholars consider that the existence of such *al-ghubn* per se in a specific contract does not render the contract void. Likewise, the Shāfiᶜī scholars consider that such an element does not affect the contract even though it is associated with *al-ghish* (deceit), because such a contract is concluded due to the ignorance of the buyer concerning the real price of the merchandise. Except in the sale of *talaqqī al-rukbān* (meeting the riders out of town)[59], the Shāfiᶜī scholars find that the abused party has the right to revoke the contract based on the *ḥadīth* in which it is reported that the Prophet (peace be upon him) forbade the activity of *talaqqī al-rukban.*[60]

On the other hand, the Hanbalī scholars consider that the presence of the element of *al-ghubn al-fāḥish* in any contract, with or without fraud, renders that contract voidable. In such a contract, the injured party is entitled to rescind the contract.[61] For instance, in the above sale of *talaqqī al-rukban*, the innocent seller, who has no knowledge of the real value of his merchandise, has received an offer to

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[58] Al-ᶜAṭṭār, *Naẓariyyah*, p. 172, Al-Zuḥaylī, *Al-Fiqh*, v. 4, p. 221.

[59] It is a traditional practice to deceive rural merchants by telling them that the price of their merchandise is declining in the market before they learn the real market price, hence, the merchandise is sold at a lower price. This practice is forbidden for it consists of gharar as well as fraudulent elements. See, Al-Shīrāzī, Abī Isḥāq Ibrāhīm. *Al-Muhadhdhib fī Fiqh al-Imām al-Shāfiᶜī*. Beirut: Dār Ehyā' al-Turāth al-Arabī, 1994 v. 1, p. 386.

[60] Al-Zuḥaylī, *Al-Fiqh*, v. 4, pp. 222-224.

[61] Al-Zuḥaylī, *Al-Fiqh*, v. 4, p. 223.

sell the merchandise at a price far lower than the real market value. Once the sale is concluded in such situation, the seller may revoke the contract.

Thus, in examining the hedging and speculation activities, it seems that every hedger and speculator, who is supposed to know the market value of the underlying commodity, should be well aware of any attempt to cause an artificial rising or falling of prices. Fortunately, every futures market has its own regulations in limiting the highest or the lowest price for each business day. Usually, a market will permit a certain percentage of fluctuation in the market value of the commodity from day to day. In this way, the price found in the market should not be excessively higher or lower than the usual price.

7.3. Conclusion and Summary

Initially, it seems that the hedger and speculator are the same as any other real futures trader who needs to buy or sell a certain commodity to be delivered after a certain period, or, at least, being a trader who uses the market facilities for his investment purposes. However, the objectives that underline his hedging or speculation activity have drawn a difference between the hedger or the speculator and the rest of the traders. This distinction is not obvious in their trading, since every market participant, including the hedger and the speculator, duly follow all the procedure and formation of a futures contract. A real futures trader would rather keep his futures position open until the contract matures, and then take or make the delivery. A hedger or speculator, however, does not wait until maturity but offsets his position at any time before the maturity date according to his trading plan.

The facts mentioned above clearly show that the activities of hedging and speculation should be regarded as different types of transaction from the commodity futures trading. Although these activities operate in all commodity futures markets, each of them is a business on their own. The facilities provided by the market for the trading in commodity futures becomes a business tool in risk management for the hedgers and a speculative device for the speculators. Due to the suitability of commodity futures contracts for this type of trading, it is believed that most futures traders are either hedgers or speculators.

In examining the hedging activity, it is hard to find any irregularity in a hedger's transaction that involves his futures position. Whether it is a buying hedge or a selling hedge, the execution is the same as other futures contracts executed by other traders. Thus, it is safe to say that the futures transaction involve in a hedging activity is validly concluded. In support of this view, a *fatwā* (Islamic legal tradition) has been given concerning this activity saying that the hedging activity is lawful in the sense that it is based on an agreement to enter into a contract in the future, in which the subject of the contract is lawful.[62]

In a further examination of the hedging activity from its contractual aspect, this activity involves only an offsetting transaction of the futures position and a subsequent sale or purchase of cash commodity in the cash market. The only problem in this activity is the perfect time to put the hedge and to take it off. At this point, a hedger makes an in-depth analysis of the basis and a thorough study of the factors that may have an impact on the basis. This analysis and study are supposed

to help the hedger to anticipate the basis changes and determine the correct time to put on a hedge, i.e to buy or sell the commodity futures. If the decision to put on this hedge is made relying on the verified analysis or study, the subsequent contract should be considered as valid, based on the hedger's consent. However, if there is any undue influence or fraud in the decision, the rules on *al-tadlīs* shall be applied thereto.

In a speculative business too, the transactions involved in the activity are merely the execution of buying and selling of commodity futures, which are followed by the offsetting transaction. Although in certain speculative methods, such as the straddles trading where two simultaneous contracts are involved, the two contracts are treated separately under Islamic Law. This does not affect the validity of the trade. Similarly, the speculator's pre-contractual motives or intention of entering into any futures contract has no effect on the validity of the contract.

It should be noted that the distinctive feature of the speculation business is the ability to anticipate future price changes. This anticipation is developed from fundamental and/or technical analysis together with past and present information on the commodity. These factors will be the grounds for the speculator in his decision to execute any futures contract. If there is established proof of an element of fraud, either committed by the counterpart or a third party, the rules on *al-tadlīs* apply. It is worth mentioning that most public speculators are dependent on their broker to make such decisions. In this type of relationship, potentially undue influence can occur.

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[62] *Fatwā* no. 27, 6th al-Baraka Seminar available at, www.islamic-finance.net/research/al-baraka

Unlike the position holder speculators, many of the day traders or scalpers, who hold a position during one trading session only, have no interest in the analysis and market factors. Their main concern is to make a profit, either big or small, from price fluctuation. It is evident that the business of speculation is rooted in the anticipation of price change without the actual interest of selling or buying the underlying commodity.

Legally, an anticipation of price movement is not prohibitory in Islamic Law, based on the maxim, "the original state of things is permissible". However, a business that is dependent on anticipation that would randomly become true is highly associated with uncertainty and a high risk of loss. Expectation on prices can never be certain. As proved by the studies mentioned before, speculators are more likely to incur losses than profits, with whatever prediction they have made. Therefore, it is clear that this speculation business is a sort of *ᶜaqd al-gharar* (aleatory transaction) that has attained the prohibitory degree in Islamic Law.

In summary, the activities of hedging and speculation in commodity futures trading do not affect the legality and validity of such trading. The mechanism of the contract remains as it is, though the majority of the traders consists of hedgers and speculators. They use the system in the commodity futures trading as part of their business or price risk management and accumulation of profits. In the hedging activity, the risks of loss that are associated with the hedger's transaction in the cash market are reduced by executing a futures position (putting a hedge) in order to lock in a profitable price. Since the offsetting of futures position (taking off a hedge) has

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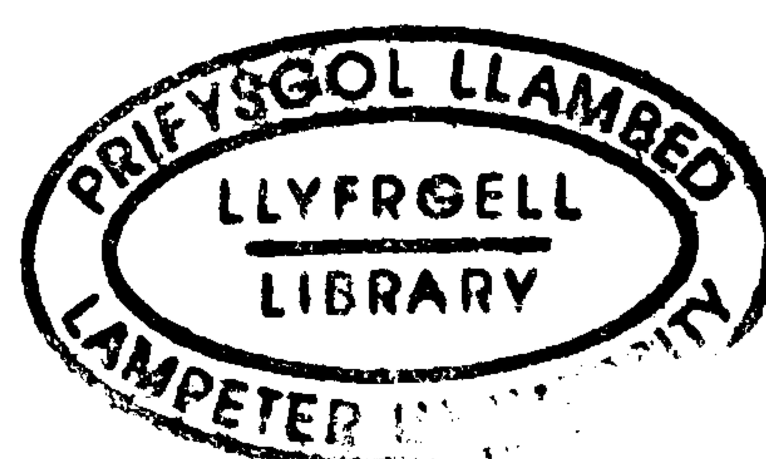
accessed on 12/05/2000.

been made possible in all futures markets, the hedger of capable in reducing his risks.

Unlike hedging, speculation is a business in which the futures positions have been utilised to realise profits from the price difference of each position. The anticipation of a favourable price change leads the speculators to assume the risk of losing their capital in their margin accounts. This assumption of risks, though it may realise a profit, is too uncertain, whereas the results or consequences of the activity are unpredictable. These elements clearly amount to the forbidden excessive *gharar* that may cause the prohibition of such activity.



CONCLUSION AND SUGGESTION*

This study, which has analysed the basic structure of a commodity futures contract and some of its other contractual aspects, has finally concluded that such a contract, in its basic fundamental structure, is legal in Islamic Law since there is no element of excessive *gharar*, *ribā* or any type of unlawful gain of property. However, this legality is confined to futures contracts involving a lawful underlying commodity, such as metals, grains and petroleum.

Although a few provisions of the *Sunnah* disallowed sales of non-existent objects in spite of an exception given to *bay^c al-salam*, this exception suggests that it is possible to legalise a similar sale of a non-existent object. Like the legality of *bay^c al-istiṣnā^c*, which is recognized for its importance based on *istiḥsān* methodology, a commodity futures contract might well become a legal contract for its important position in determining the commodity's market price. Furthermore, it is found that a commodity futures contract is constituted in a more definite manner than *bay^c al-istiṣnā^c* in which the delivery time and place are fixed initially and the price for the commodity is required to be paid upon the delivery.

Yet to define the relationship between the market participants involved in the formation of a commodity futures contract, it seems that each of them is assumed to have full contractual capacity and thus be eligible to execute the contract himself or on behalf of others. Whatever part they take in the basic formation of a commodity

* This conclusion lists down the results and findings of the analyses on the legal and contractual aspects of commodity futures contracts. It also comprises some suggestions and alternatives so that such contracts can be executed in accordance with Islamic Law.

futures contract, the actual parties of this contract are the futures traders, sellers or buyers, who might employ the services of a futures broker or a futures adviser to assist them in executing the contract. In this kind of trading it is clear that the relationship between the traders and the broker or the adviser, is similar to that of principal and agent. An agent must act only according to the principal's instruction and shall carry no liability for any loss or damage incurred, unless it is due to his deliberate negligence or fraudulent conduct, but even if there is proof of such an offence, it only affects the validity of that particular transaction.

The analyses have been extended to the actual mechanism of a commodity futures contract. This contract is initiated by an order to buy or sell, placed by the futures trader. Through his broker, the order is executed in the open outcry auction that takes place on the exchange's trading floor. The execution is completed when the order is fulfilled by another order upon which all the contract specifications are duly specified. This method of execution has no inconsistency with any principles of Islamic Law on the valid formation of a contract of sale. The open outcry auction process, which may be recognised in Islamic Law for its fairness and equal treatment, becomes one of the common practices approved by the authorities concerned. Based on these grounds, the present method of executing a commodity futures contract should be permissible in Islamic Law.

Nowadays, the sequence of an order in a commodity futures contract does not end upon its completion in the open outcry auction but a matched order must be cleared by the clearing house, an independent institution or a division of the exchange. These institutions, the exchange and the clearing house, which set the

minimum margin for each futures contract, seem to be regarded as ordinary limited companies. But the fixed margin required of any futures trader is deemed to be a vital element in a formation of a commodity futures contract. As it is paid to ensure the contractual performance of the futures trader, the margin resembles the *ᶜurbūn* deposit that is required from a buyer in order to ensure the fulfilment of his contractual obligation. It also resembles a pledged property that is deposited with a creditor to secure the payment of debt. Both the *ᶜurbūn* and pledged property may be forfeited or liquidated in a case of default on behalf of the depositor.

Thus, by such similar objectives and modus operandi, the present margin system is entitled to be recognised in Islamic Law. However, the 'mark-to-market' process that forms a part of the margin system operated by the clearing house should be excluded from the system since it causes unnecessary loss to the futures traders. This process is only introduced into the margin system due to the presumption of default that may be committed by the futures traders. This proves that a valid commodity futures contract has no connection with the process and it should therefore be removed from the margin system.

Beyond the apparent mechanism of executing a commodity futures contract, the interchangeable nature of such a contract allows the futures traders to transfer this ordinary contract of sale and purchase into a mode of investment. It is applied by hedgers and speculators alike in their financially designed strategies to reduce risks and maximise profits. These activities are not possible without the interchangeable nature of commodity futures contracts by which each contract sold or purchased, may be liquidated or offset with another equal amount and delivery

month but opposite contract. Upon examining this liquidation process or offsetting a futures contract position, such liquidation appears to be a type of *iqālah al-ᶜaqd* in which the contracting parties mutually rescind a contract. It may also be considered to be a type of *ᶜaqd al-ḥawālah* for the effect of offsetting position is to transfer a future contractual obligation.

In so far, whether it is a cancellation of a contract or a transfer of an obligation, there is no ambiguity in the execution of a liquidating contract, but doubts arise when this practice is associated with an anticipation of price changes in a speculation activity. Unlike hedging, in which anticipation of basic changes is based on thorough analysis and market study, a speculation may be a pure speculative business that hopes that the price movement will change favourably as anticipated with no intention of owning the commodity or interest in its market factors, like the day traders or scalpers. It is a business that depends on the anticipation of price changes that move randomly with an assumption of risk of losing the capital. From the perspective of Islamic Law, such an assumption of risk is purely speculative and uncertain and would amount to the forbidden excessive *gharar*, as in gambling. However, although speculation may be deemed as a type of excessive *gharar* dealing, it does not affect the validity of the whole transaction of a commodity futures contract.

Based on the analyses and findings in this research, it is believed that trading in commodity futures is legal and permissible in the Islamic Law of Contract. The whole mechanism of executing a commodity futures contract that begins with depositing a margin and is settled by a liquidation contract or delivery, has relatively

no inconsistency with any fundamental principle or doctrine in Islamic Law. Although it generally forbids the sale of a non-existent object for such contract is associated with a *gharar* element, it does permit a few transactions that involve a non-existent object. A commodity futures contract appears to be an innovated *bay^c al-istiṣnā^c* with a standardised contract specification and additional guarantee performed by the clearing house in its novation process.

This concept of additional guarantee is actually a distinctive principle introduced in the contract of *al-rahn*, *bay^c al-^{c}urbūn* and contract of *al-kafālah*. In these three transactions, Islamic Law provides the concept of additional liability by which the payment of a debt or the performance of a contractual obligation is guaranteed by imposing an additional security. On the other hand, in the execution of a commodity futures contract, the margin is required to ensure the contractual performance of the futures contract.

Since the required margin represents only between five to ten per cent of the total value of the contract, the role played by the clearing house in the novation process is much appreciated. By this process, in which the clearing house interposes between the buyers and sellers to be the counterparty for each open contract, the clearing house manages to ensure that each futures trader either performs his obligation by making or taking delivery or liquidates his open position. Therefore, this improvised concept of *al-kafālah* needs no alteration to fit in the Islamic framework.

However, the extra precaution taken by the clearing house for any possible default in operating the 'mark-to-market' process is impugnable. As indicated earlier, this process works as a daily settlement of each margin account. One's margin account is debited or credited based on the daily closing price of the underlying commodity. If the price declines, the account is debited accordingly and vice versa. It is obvious that there is no transaction involved but the futures trader may be made liable to pay additional or variation margin if the price goes against him or he may obtain an additional capital gain if the price moves in his favour. Relatively, neither the former nor the latter is allowed in Islamic Law. One should not be burdened with payment in exchange of nothing. Based on the maxim, 'No damage and no mutual infliction of damage', such a process should not be allowed. Again, in the latter situation, the additional capital gain accredited to the margin account would amount to *ribā*. A capital gain in return of nothing is only equivalent to *ribā*. Thus, it is firmly suggested that the process of mark-to-market should be withheld from the margin system.

It might be alleged that operating the mark-to-market process is among the core duties that every clearing house should perform in order to maintain its financial integrity. Yet, it still requires from each of its clearing members a fixed contribution for the fund that is utilised, whenever necessary, to pay any compensation in a case of default. However, should there be any economic reason for every clearing house to maintain this process, there is another alternative, which, though it requires major changes and alterations, works for the London Metal Exchange (LME).

The LME, which is termed as a principal-to-principal market, is actually similar to any ordinary commodity futures market in terms of its modes of execution of the contract. Hence, each of its contracts is interchangeable by which it allows the traders to offset before the delivery date. The only difference between the LME and other markets is that the former has no clearing house. At the LME, its office clears each contract in the same manner as the clearing process of a clearing house but without the novation role and 'mark-to-market' process. The LME's clearing does not intervene in the determination of settlement price but only instructs the traders who have not liquidated their position to make or take the delivery at the maturity date. By such a clearing process, all profits or losses are only incurred upon execution of contract. The profits resulted from any dealing are only paid at the maturity date. On the other hand, any loss incurred is paid in advance using the margin deposit. Thus, there is no profit or loss due from price changes.

Using the LME as an example, it is possible for any commodity futures market to exclude the 'mark-to-market' process without the need to abolish the clearing house institution. By the removal of this process, the mechanism of executing the commodity futures contract is freed from the element of *ribā* and so this transaction can maintain its permissibility in Islamic Law. As for the speculation activity, which is found to be an excessively *gharar*-based business, this must be discarded by a Muslim futures trader since there is no way of stopping market participants from speculating on futures price changes.

APPENDIX 1

A RISK DISCLOSURE STATEMENT

THIS BRIEF STATEMENT DOES NOT DISCLOSE ALL THE RISKS AND OTHER SIGNIFICANT ASPECTS OF TRADING IN FUTURES AND OPTIONS. IN LIGHT OF THE RISKS, YOU SHOULD UNDERTAKE SUCH TRANSACTIONS ONLY IF YOU UNDERSTAND THE NATURE OF THE CONTRACTS (AND CONTRACTUAL RELATIONSHIP) INTO WHICH YOU ARE ENTERING AND THE EXTENT OF YOU EXPOSURE TO RISK TRADING IN FUTURES AND OPTIONS IS NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC. YOU SHOULD CAREFULLY CONSIDER WHETHER TRADING IS APPORIATE FOR YOU IN LIGHT OF YOUR EXPERIENCE, OBJECTIVES, FINANCIAL RSOURCES AND OTHER RELEVANT CIRCUMSTANCES.

COMMON RISKS IN TRADING IN FUTURES:

(1) Effect of 'leverage' or 'gearing'

Transactions in futures carry a high degree of risk. The amount of initial margin is small relative to the value of the futures contract so that transactions are "leveraged" or "geared". A relatively small market movement will have a proportionately larger impact on the funds you have deposited or will have to deposit. This may work against you as well as for you. You may sustain a total loss of initial margin funds and any additional funds deposited with the firm to maintain your position. If the market moves against your position or margin levels are increased, you may be called upon to pay substantial additional funds on short notice to maintain your position. If you fail to comply with a request for additional funds within the time prescribed, your position may be liquidated at a loss and you will be liable for any resulting deficit.

(2) Risk-reducing orders or strategies

The placing of certain orders (e.g. "Stop-Loss" orders, where permitted under local law, or "Stop-Limit" orders), which are intended to limit losses to certain amounts, may not be effective because market conditions may make it impossible to execute such orders. Strategies using combinations of positions, such as "spread" and "straddle" position may be as risky as taking simple "long" or "short" positions.

(3) Terms and Conditions of Contracts

You should ask the firm with which you deal about the terms and conditions of the specific futures or options which you are trading and associated obligations (e.g. the circumstances under which you may become obligated to make or take deliver of the underlying interest of a futures contract and, in respect of options, expiration dates and restrictions on the time for exercise). Under certain circumstances the specifications of outstanding contracts (including the exercise price of an option)

may be modified by the exchange or clearing house to reflect changes in the underlying interest.

(4) Suspension or restriction of trading and pricing relationship

Market conditions (e.g. illiquidity) and/or the operation of the rules of certain markets (e.g. the suspension of trading in any contract or contract month because of price limits or "circuit breakers") may increase the risk of loss by making it difficult or impossible to effect transactions or liquid/offset positions. If you have sold options, this may increase the risk of loss.

Further, normal pricing relationships between the underlying interest and the future, and the underlying interest and the option may not exist. This can occur when, for example, the futures contract underlying the option is subject to price limits while the option is not. The absence of an underlying reference price may make it difficult to judge "Fair" value.

(5) Deposited cash and property

You should familiarize yourself with the protections accorded money or other property you deposit domestic and foreign transactions. Particularly in the event of firm insolvency or bankruptcy. The extent to which you may recover your money or property may be governed by specific legislation or local rules. In some jurisdiction, property which had been specifically identifiable your own will be prorated in the same manner as cash for purposes of distribution in the event of a shortfall.

(6) Commission and other charges

Before you begin to trade, you should obtain a clear explanation of all commission, fees and other charges for which you will be liable. These charges will affect your net profit (if any) or increase your loss.

(7) Transaction in other jurisdictions

Transactions on market in other jurisdictions, including markets formally linked to a domestic market, may expose you to additional risk. Such markets may be subject to regulation, which may offer different or diminished investor protection. Before you trade you should enquire about any rules relevant to your particular transactions. Your local regulatory authority will be unable to compel the enforcement of the rules of regulatory authorities or markets in other jurisdictions where your transaction have been effected. You should ask the firm with which you deal for details about the types or redress available in both your home jurisdiction and other relevant jurisdictions before you start to trade.

(8) Currency Risks

The profit or loss in transactions in foreign currency-denominated contracts (whether they are traded in your own or another jurisdiction) will be affected by

fluctuations in currency rates where there is a need to convert from the currency denomination of the contract to another currency.

(9) Trading Facilities

Most open-outcry and electronic trading facilities are supported by computer-based component systems for the order routing, execution, matching, registration or clearing of trades. As with all facilities and systems, they are vulnerable to temporary disruption or failure. Your ability to recover certain losses may be subject to limits on liability imposed by the system provider, the market, the clearing house and/or member firms. Such limits may vary, you should ask the firm with which you deal for details in this respect.

(10) Electronic trading

Trading on an electronic trading system may differ not only from trading in an open-outcry market but also from trading on other electronic trading systems. If you undertake transactions on an electronic trading system, you will be exposed to risks associated with the system including the failure of hardware and software. The result of any system failure may be that your order is either not executed according to your instructions or is not executed at all.

(11) Off-Exchange Transactions

In some jurisdictions, and only then in restricted circumstances, firms are permitted to effect off-exchange transactions. The firm with which you deal may be acting as your counter party to the transaction. It may be difficult or impossible to liquidate an existing position, to assess the value, to determine a fair price or to assess the exposure to risk. For these reasons, these transactions may involve increased risks. Off exchange transactions may be less regulated or subject to a separate regulatory regime. Before you undertake such transactions, you should familiarize yourself with applicable rules and attendant risks.

This sample of risk disclosure statement is based on the RULE 1.55(c) of the CFTC Rules and Robbins Trading Company account application form accessible at, www.robbinstrading.com

APPENDIX 2

A SAMPLE OF A CUSTOMER AGREEMENT

In consideration of THE BROKER FIRM (THE FIRM) accepting the account(s) in commodities, commodity futures contracts, options on commodities, or options on commodity futures contracts (collectively, "futures contracts") for the undersigned ("Customer"), it is agreed:

1. AUTHORIZATION. Customer authorizes THE FIRM to purchase and sell futures contracts for Customer's account in accordance with Customer's oral or written instructions. Each Customer having in interest in a joint account shall have the authority to issue instructions and generally to deal with THE FIRM.

2. GOVERNMENT AND EXCHANGE RULES. All transactions shall be subjects to rules, regulations, and interpretations of the exchanges, and to all applicable federal or state laws and regulations.

3. CLEARING. THE FIRM may execute all purchases and sales of futures contacts for Customer's account through THE FIRM, or through an omnibus clearing arrangement. All rights and obligations extended to THE FIRM pursuant to this agreement shall also be extended to the exchange clearing member firm.

4. MARGINS. Customer shall provide to and maintain with THE FIRM cash or acceptable margin in an amount that THE FIRM, in its sole discretion, may from time to time determine. Customer agrees to monitor his account to determine if it is properly margined. Customer will immediately forward sufficient funds to cure my margin deficiency without waiting for notice from THE FIRM. Information regarding exchange and THE FIRM margin requirement is available on request from THE FIRM. Margin requirements established by THE FIRM may exceed the margin required of THE FIRM by an exchange. No previous margin establish by THE FIRM shall establish any precedent.

5. SECURITY AGREEMENT AND TRANSFER AUTHORIZATION. All property of Customer, which THE FIRM may at any time be carrying, is held by THE FIRM as security and subject to a general lien and right of set off all liabilities of Customer to THE FIRM. THE FIRM, in its sole discretion, may apply or transfer any of Customer's property between any of Customer's accounts at THE FIRM as may be necessary for margin or to satisfy or reduce any deficit or debit balance in any of Customer's accounts. Subject to Commodity Exchange Act segregation requirements, Customer hereby grants to THE FIRM the right to pledge, hypothecate, or invest, either separately or with the property of other customers, any securities or other property held by THE FIRM for the accounts of Customer, to any exchange or clearing house through which trades of Customers are executed. THE

FIRM shall be under no obligation to pay Customer any interest income or benefit derived from Customer's property.

6. LIQUIDATION OF ACCOUNTS. THE FIRM is hereby authorized, in its sole discretion, to take any or all of the following actions to protect itself: (1) satisfy any obligation Customer may have to THE FIRM out of any of Customer's property held by THE FIRM; (2) offset any or all futures contracts positions; (3) initiate new long or short futures contracts positions; (4) cancel any or all open orders; and (5) take any other action THE FIRM deems appropriate. Any of the above actions may be taken without demand for margin or additional margin, or without prior notice of Customer. Customer at all times shall be liable for the payment of any debit balance upon demand by THE FIRM. Customer promptly shall pay the debit and all unpaid liabilities, together with interest and all costs of collection, including attorney's fees.

7. DELIVERY MONTH LIQUIDATION INSTRUCTIONS. Customer is responsible for providing to THE FIRM appropriate liquidating instructions, funds, or documents at a reasonable time in advance of expiration of open futures contracts. If customer fails to do so, THE FIRM may, without notice, liquidate, or make or receive delivery on behalf of Customer. Customer will indemnify THE FIRM for all costs incurred (including but not limited to all fines, loss if interest, or attorney'' fees) by THE FIRM in liquidating, or making or receiving delivery, or re-tendering delivery notice.

8. CHARGES. Customer agrees to pay such brokerage and commission charges and fees as THE FIRM may establish and change from time to time. Such fees include, fees imposed by the exchange and a markup to reflect other processing and servicing costs. In the event that Customer's account is transferred to another futures broker, a reasonable transfer charge shall apply, which shall be charged against Customer's account or which Customer shall pay prior to such account being transferred. If Customer has not maintained any futures contracts for 30 days, THE FIRM may charge an inactive monthly maintenance fee.

9. STATEMENT AND CONFIRMATIONS. All communications, monies, securities, and other property shall be transmitted to Customer at the address and telephone number shown on the account application. All communications transmitted to Customer shall be deemed to have been received by Customer personally at the time so sent, whether actually received or not. Reports of the execution of orders and daily statements of account shall be conclusive and final and shall be deemed to be accepted and ratified by Customer, whether made orally or in writing, unless Customer objects by written communication actually received by THE FIRM prior to the opening of the next regular trading session o the market in which the transaction to which Customer objects was, or was to be, executed. Such written communication shall be sent by certified mail, return receipt requested. In addition, Customer agrees to contact THE FIRM by telephone to verify Customer's account status as soon as is reasonably practicable but in no event later than one business day after placing any order if Customer

has not been advised by telephone of the status of such order by THE FIRM within 24 hours after any order is placed. Customer's failure to contact THE FIRM shall relieve THE FIRM of any responsibility or liability with respect to such order. All order shall only be good for the day such orders are place, unless specified by Customer to be open orders. THE FIRM will not cancel all open orders placed by Customer unless Customer specifically regards cancellation. THE FIRM shall not be held responsible for delays in the transmission or execution of orders due to a breakdown or failure of transmission or communication facilities, or for any other cause beyond THE FIRM's control.

10. MARKET INFORMATION. Customer acknowledges that any market information provided by THE FIRM does not constitute an offer to sell or buy any security or commodity futures contract. THE FIRM makes no representation, warranty or guaranty as to, and shall not be responsible for, the accuracy or completeness of any information furnished to Customer. THE FIRM makes no representation, warranty or guaranty as to, and shall not be responsible for, the accuracy or completeness of any information furnished to Customer. THE FIRM makes no representation, warranty or guaranty with respect to tax consequences of Customer's transactions.

11. CUSTOMER REPRESENTATIONS. Customer represents that he is of legal age and sound mind and that, except as disclosed in writing to THE FIRM, no one except Customer has an interest in any account or accounts carried for Customer by THE FIRM. Customer further represents that he is not an employee of any exchange, any corporation in which any exchange owns a majority of the capital stock, any member of any exchange, any firm registered on any exchange, any futures broker, any introducing broker, or any bank, trust, or insurance company. In the event that Customer becomes so employed, he will promptly notify THE FIRM in writing of such employment.

12. NO WAIVER OR AMENDMENT. No provision of this Agreement may be waived or amended unless the waiver or amendment is in writing and signed by an authorized officer of the firm.

13. BINDING EFFECT. This agreement shall inure to the benefit of THE FIRM and its successors and assigns, and shall be binding upon Customer and hits estate, executors, administrators, legal representative, successors and assigns.

14. TERMINATION. Customer may terminate this agreement only when customer has no positions held by or no liabilities owed to THE FIRM. THE FIRM may terminate it at any time. Termination shall affect any transaction entered into and shall not relieve Customer of any obligation under this Agreement.

15. RECORDING. Customer agrees that THE FIRM in its sole discretion may record any telephone conversation between THE FIRM and Customer or his agent. Customer agrees that THE FIRM may erase such recordings. The

rights in this paragraph extend to any introducing broker or account controller.

16. THIRD PARTY BENEFICIARIES. All right extended to THE FIRM pursuant to this Agreement shall also be extended to any introducing broker, futures broker, commodity trading advisor, or securities broker/dealer that introduced this account to THE FIRM, which is expressly made a third party beneficiary of this Agreement.

17. PROSPECTIVE CONSENT TO ASSIGNMENT OR TRANSFER OF ACCOUNT(S). Customer hereby prospectively consent to an assignment or transfer of his account(s) at any time hereafter from THE FIRM to another futures broker; provided, Customer receives a written notice of the assignment or transfer and has a reasonable to object in accordance with all applicable regulations.

18. PUNITIVE DAMAGE. The parties agree not to sue each other for punitive damages in court or in arbitration before any forum even if the rules of the forum allow arbitrators to award punitive damage.

19. ACCEPTANCE. This Agreement shall not be deemed to be accepted by THE FIRM or become a binding contract between Customer and THE FIRM until approved by THE FIRM's Accounts Department.

20. FORUM SELECTION, CONSENT TO JURISDICTION AND VENUE. Customer acknowledges that investments in futures contracts are speculative, involve a high degree of risk, and are suitable only for persons who can afford to lose all funds invested. Customer understands that because of the low margin normally required in futures trading, price changes in futures contracts may result in significant losses, which may substantially exceed Customer's margin deposits. Customer recognizes that guarantees of profit or limitation of loss are impossible in futures trading. Customer acknowledge that he has received no such guarantees from THE FIRM or others, and he is not entering into this Agreement in reliance on any such guarantees. Customer agrees not to hold THE FIRM responsible for losses incurred through following trading recommendations or suggestions by THE FIRM or others.

21. FORUM SELECTION, CONSENT TO JURISDICTION AND VENUE. Customer agrees that all disputes initiated by Customer related to this Agreement, or any related agreement, shall be litigated or arbitrated only in a court of law or equity, administrative tribunal, or arbitration association. Customer consents and submits to the jurisdiction of any state or federal court. Customer appoints and designates THE FIRM (or any other party whom THE FIRM may from time to time hereinafter designate) as Customer's true and lawful attorney-in-fact and duly authorized agent for service of legal process, and agrees that service of such process upon THE FIRM or such other party shall constitute valid personal service of such process upon Customer; provided, that THE FIRM or such other party shall, within five days after receipt of any such process, forward the same by air courier or by certified or registered mail, together with all papers affixed thereto to Customer at Customer's mailing addresses. Customer hereby waives any right to transfer or change the venue

of any litigation or arbitration. Notwithstanding the foregoing, THE FIRM may initiate any action to collect any amounts due THE FIRM in any state or jurisdiction where there is personal jurisdiction over Customer or where Customer may have property located.

22. LIMITATION OF ACTIONS. Customer agrees that customer may bring no action arising out of transactions under this agreement more than one year after the cause of action arose. This time limitation may be substantially shorter than that granted by federal or state law. Other futures brokers may not include this limitation in their customer agreement. Though THE FIRM will not accept your account if you do not voluntarily agree to this limitation, you may open your account with another futures broker.

23. INDEMNIFICATION. Customer agrees to indemnify THE FIRM and hold THE FIRM harmless from and against any and all liabilities, losses, damages, costs and expenses, including accountant's and attorneys' fees, incurred by THE FIRM because any of Customer's representations and warranties shall not be true and correct, or because the agreements made by Customer shall not be fully and timely performed. Customer also agrees to indemnify THE FIRM and hold THE FIRM harmless from and against any and all damages, costs, and expenses, including attorney's fees, incurred by THE FIRM in enforcing of any of the provisions of this agreement or any related agreement. If Customer initiates a legal action, regardless of form, against THE FIRM, and the customer does not prevail, Customer will indemnify THE FIRM for all costs and expenses incurred by THE FIRM to defend itself, including attorney's fees.

This sample of a standardized customer agreement is based on customer agreement form of Robbins Trading Company accessible at, www.robbinstrading.com

APPENDIX 3

E-INTERVIEW WITH THE MALAYSIAN DERIVATIVES CLEARING HOUSE BHD (MDCH)

This e-interview is a kind of questionnaire e-mailed to the MDCH at the address, sofia@mdch.com.my and the answers were replied in printed documents by Ms Sofia Johan, executive, Strategic Development & Legal Affair, for the MDCH on August 5, 1999. MDCH is a clearing house for two futures exchange in Malaysia, the Kuala Lumpur Options and Financial Futures Exchange Bhd (KLOFFE) and the sole Malaysian commodity futures exchange, the Commodity and Monetary Exchange of Malaysia (COMMEX Malaysia). As a company limited by shares, MDCH is equally owned by these two exchanges. By such ownership structure, the board manages to ensure the smooth running and continuing commitment and responsibility of MDCH in the fulfillment of its role as a clearing house.

Therefore, based on such outstanding performance, it is appropriate to address the questions to MDCH in order to gain further practical information about clearing house; its structure, the clearing operation and its role in guarantee the performance of every contractual obligation under the futures contacts that it cleared. Upon these aims before hand, the questions were drafted with the emphasis given to the operational aspects of a clearing house. The supplied answers had successfully fulfilled the objectives of this e-interview. It had finally proved that every clearing house does have the same role and functions in clearing operation and ensuring the performance of each contractual obligation under the futures contracts.

The revised questions and answers for this e-interview with the MDCH are as follow:

1. **Briefly, please explain the organisational structure of MDCH.**

MDCH is a company limited by shares and is owned by KLOFFE and COMMEX Malaysia who each hold 50% of the total issued shares. MDCH has an authorised share capital of RM25 million and its issued share capital currently stands at RM8 million, comprising 8 million ordinary shares RM1 each. Its board of directors comprises:

1. four directors elected by KLOFFE and COMMEX Malaysia
2. five directors elected by clearing members
3. two directors appointed by the Minister of Finance

The Chief Executive Officer is in charge of daily operations.

2. **What are the requirements to become a clearing member of MDCH?**

The operational requirements are:

- membership of an exchange for which MDCH clears
- where necessary, compliance with Futures Industry Act 1993 licensing requirements

- derivatives knowledge and experience
- business integrity and financial probity
- administrative and system to maintain proper records and the manage risk
- corporate power to carry out clearing member activities

The financial requirements are:

- one-time membership fee of RM50,000
- minimum adjusted net capital of RM50,000 or 10% of margins, whichever is higher
- clearing fund condition RM1 million in cash
- security deposit contribution of RM1 million in cash or irrevocable standby letter of credit (LC)

the membership requirements are continuing obligations during the tenure of membership. Please note that in addition to the fixed clearing fund contribution of RM1 million. MDCH can seek a variable contribution from the clearing member based on the proportion of its margin requirements to that of the entire market. The clearing member must also contribute another 100% of its fixed and variable clearing fund contribution upon MDCH's request. MDCH can also impose higher minimum financial requirements on a clearing member if the circumstances require it.

3. How does MDCH perform the role of third-party guarantor of every trade?

All traded executed on the exchange, or market contracts, are required to be submitted for registration with MDCH. As MDCH's assurance of performance commences on registration and only extends to its clearing members, non-clearing exchange members who were parties to the market contract have to clear their contracts through a clearing member.

MDCH becomes a counterparty to these contracts upon registration. The process is known as novation, which generally means that an existing is extinguished and a new contract is created in its place. In the case of MDCH, the market contract between the clearing members are extinguished upon registration and two open contracts are created in its place. The open contracts will have terms identical to the exchange contract except that MDCH assumes the opposite side of the transaction under each open contract. If A is the buyer and B is the seller under the market contract, the resulting open contract will have A as the buyer with MDCH selling to it under one open contract, and B as the seller with MDCH buying form it under the other contract.

4. In an event of 'out-trade' (unmatched order), the appropriate clearing member must reconcile such trade. What are the steps to be taken for reconciliation?

MDCH only accepts confirmed, matched trades for registration.

5. **Please explain in detail the operation of daily pay/collect system in connection with settlement positions and margin calls. Please, if possible attach any relevant diagram.**

All open contracts are valued daily against a settlement price determined by MDCH at the end of a trading day and the resulting gains or losses are posted to each clearing member's account. The losses must be paid in cash to the clearing house before the start of trading on the next business day. The gains, if still available after deducting other payment obligations of the clearing member, can be withdrawn by the clearing member on the next business day.

Cash

The fund transfers between MDCH and its clearing members are conducted through MDCH-appointed settlement banks. Each clearing member can only maintain oen settlement bank account, and MDCH maintains an account at each of the settlement banks. The clearing member, MDCH and the settlement bank enter into a tri-partite agreement which sets out the procedures for effecting the transfer of funds between MDCH and the clearing member via the settlement bank. An important feature of the agreement is the enforcement of strict timing schedules for the settlement of cash shortages each morning before trading starts, settlement of intra-day margin calls and transfer of excess funds to clearing members.

Another feature of the agreement is that the clearing member authorises the settlement bank to sweep the clearing member's funds into the MDCH account in the event the clearing member has a cash shortage and fails to instruct the bank to pay before the cut-off times for payment. The bank also has an obligation to notify MDCH in the event there are insufficient funds in the clearing member's account to meet the cash shortage. To facilitate this arrangement, MDCH faxes details of cash shortages to the relevant settlement bank. The relevant clearing members are also notified of their cash shortages.

The clearing member will notify MDCH if it wishes to lodge additional cash or withdraw it excess cash by filling out standard operating forms and faxing or sending the same to MDCH. The clearing member or MDCH will instruct the bank to transfer the funds via the bank's electronic desktop banking system or by fax.

Collateral

Clearing members can lodge collateral to cover their security deposit and initial margin requirements. Currently MDCH only accepts LCs in RM which are issued by approved banks and are in the MDCH prescribed format. Members can also withdraw the LC when it has expired or if they wish to replace it with cash of a fresh LC.

6. **What is the method used by MDCH in determining the settlement price?**

As a matter of practice, MDCH will determine the daily settlement price as the middle price of the last traded price, bids and offers which have occurred within a

certain period of time before market closes. However, MDCH has the absolute discretion to determine the settlement prices at all times.

The final settlement price of the FKLI contract is determined by taking the weighted average of the last 30 minutes of the KLCI, excluding the highest and lowest.

7. Please explain in detail every default procedures maintained by MDCH.

The risk management tools of MDCH, insofar as they relate to the rights and the obligations of the clearing member vis-à-vis the clearing house, are implemented through its business rules. Therefore, a clearing member default means both a failure to perform the obligations under an open contract as well as obligations under the MDCH business rules. Disciplinary and default actions perform the dual role of:

- discouraging clearing member defaults in performing contractual and membership obligations
- ensuring that a clearing default does not adversely affect the entire clearing membership and the market

MDCH can:

- impose a fine of up to RM1 million on a clearing member
- require additional funds to be deposited in the case of a default other than a default in payment obligations
- suspend or terminate a clearing membership
- liquidate or transfer open contracts of a defaulting clearing member
- utilise any cash or collateral of the defaulting clearing member to cover its obligations
- utlise the security deposit and clearing fund

In the event of an emergency where there is a threat to the financial integrity of MDCH or its clearing members, MDCH can take special actions such as refusing to register market contract or placing conditions on their registration, obtaining emergency settlement prices from the exchange, liquidating contracts and obtaining additional cash or collateral from clearing members.

8. Generally, how does MDCH conduct the financial surveillance of the clearing members and their positions?

MDCH monitors the financial position of its clearing members through:

- Financial reporting
- Audits
- Information-sharing
- Intra-day monitoring

Financial reporting

The clearing members submit financial statements to MDCH monthly. These include an ANC statement (prepared according to the business rules), an income/loss statement and a statement of client's segregated funds. The clearing members are also required to submit their annual audited accounts to MDCH.

Audits

MDCH conducts routine and surprise audits of the clearing member's financial statements and reviews compliance with the business rules and internal controls. The audit team also reviews the clearing member's risk management policies and procedures.

Information-sharing

The exchanges conduct audits on their members to ensure compliance with the exchanges' business rules and the results of the audits are shared with MDCH where it concerns a clearing member. In addition the exchanges are obliged under the clearing agreement with MDCH to inform it of the general conduct and trading activities of members particularly if the member faces any financial difficulty.

Intra-day monitoring

The clearing members' position during the trading day are constantly monitored. This enables MDCH to assess the impact of price movements and economic events on the adequacy of the clearing members' margins and capital base.

9. How does MDCH perform the physical settlements on the maturity dates of contracts, especially the CPO futures?

Physical settlement is only carried out on the Crude Palm Oil futures ("CPO") contract. The CPO contracts are settled by the clearing members making or taking delivery of the underlying in exchange of receiving or paying, as the case may be, the delivery amount. A selling clearing member who intends to make delivery shall tender to MDCH a signed and completed Notice of Tender together with the Negotiable Storage Receipt on any business day beginning from the first up to the twentieth day of the delivery month. On the day of tender, a random selection process is performed to allocate the obligation to take delivery to the buying clearing members having long positions. The buying clearing members who have been allocated the tender are notified by MDCH through a Tender Advice. The buying clearing member must then make payment of the delivery amount 2 business days following the day of tender.

GLOSSARY

A. Terms and Phrases of Commodity Futures Trading*

Arbitration: the procedure of settling disputes between members, or members and clients.

Basis: the difference between the current cash price and the futures price of the same commodity.

Basis risk: the risk of the relative change in the relationship between a hedged commodity and the hedge. It is possible for the basis to narrow or widen depending upon relative demand for the underlying cash commodity and commodity futures. A basis risk shall exist if the position being hedged is not precisely reflected or protected by the hedge.

Bear: someone who anticipates market prices will decline.

Bid: an expression indicating an intention to buy a commodity at a given price.

Board of trade: see, **contract market**.

Broker: an individual or a company that executes futures transaction on behalf of an association or institution and general public.

Brokerage: a fee or commission charged by a broker for executing a transaction.

Bull: someone who anticipates the market prices will rise.

Buying hedge: buying futures contract in order to protect against possible price increase of cash commodity that will be purchased in future.

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* The definition and explanation of these terms and phrases are derived from the following sources; Gould, Bruce G. The Dow Jones-Irwin Guide to Commodity Trading. Illinois: Dow Jones-Irwin, 1981, Chicago Board of Trade. Commodity Trading Manual. Chicago: Board of Trade, 1994, US Feed Grains Council, "Trade Partners in Feed Grains Risk Management," accessible at, www.grains.org accessed on 01/08/1998, Inglis-Taylor, Andrew. *The Dictionary of Derivatives*. England: Macmillan Press Ltd. 1995.

Cash commodity: an actual physical commodity.

Cash market: a place where the traders buy and sell the actual commodities.

Clearing: the process by which a clearing house maintains records all trades and settles the margins.

Clearing house: an inner division or separate corporation established by a futures exchange to carry the clearing process and margining system, and to guarantee daily performance on all transaction. It acts as an intermediary in all purchases and sales of exchanged –traded futures and options.

Clearing margin: financial safeguards to ensure that clearing members' performance or on behalf of their clients.

Clearing member: a member of a clearing house corporation.

Close: the end of the trading session during which those traders who wish to liquidate do so.

Close out: execution of a contract which will cancel a previous obligation, see **offset**.

Closing price: the last price paid for a commodity on any trading day.

Commission: see **brokerage**.

Commodity: an article or product traded on a commodity exchange.

Commodity futures: the contracts whose underlying asset is a physical commodity, whether agricultural, metal or oil-based product.

Contract market: an organized commodity futures market designated and authorized by the local authority.

Contract specification: the terms of the futures contract that mainly specify the type, grade, quantity and initial price of the underlying commodity.

Convergence: a term referring to cash and futures prices tending to come together as the futures contract near to its expiration.

Customer or client margin: financial guarantees required of any futures trader that is deposited with his broker to ensure the fulfillment of the contractual obligations.

Day trader: a trader who enters into a contract and liquidates such position during a single day.

Delivery: the transfer of the cash or physical commodity from the seller of a futures to the buyer.

Delivery month: a specific month in which the delivery of certain commodity may take place according to the terms of the contract.

Equilibrium price: the market price at which the supply quantity of a commodity equals to its demand quantity.

Financial instrument: two basic types; a debt instrument which is a loan with an agreement to pay back funds with interest and, an equity security which is a share or stock in a company.

Floor broker: an individual who executes for the purchase or sale of any commodity futures on any contract market on behalf of his clients or sometimes for himself.

Floor trader: an individual who executes the sale an purchase of a commodity futures contract for his own account.

Fundamental analysis: a method of anticipating futures price movement using supply and demand information and other cash market factors.

Fungibility: the property of interchangeability, identical to and interchangeable with another of the same specification.

Futures contract: a legally binding agreement made on trading floor of a futures exchange in order to buy or sell a commodity sometime in the future. It is standardized according to the quantity, quality and delivery time for the underlying commodity.

Futures exchange, market: a marketplace, with established rules and trading regulation, where the futures traders meet to trade in futures contract. See, **contract market**.

Hedging: the practice of offsetting the price risk inherent in any cash market position by taking an equal but opposite position in the futures market.

Last trading day: the final for trading certain futures contract. Any outstanding contract at the end of the day must be settled by delivery of the underlying commodity.

Liquidation: the sale or purchase of the same amount and delivery month but opposite to an earlier transaction in order to offset the latter position, or, making the delivery of the underlying commodity in accordance with the terms of the contract.

Local: an independent futures trader who trade for his own account on the exchange trading floor.

Long: one who has bought commodity futures contract or owns the cash commodity.

Lot: the minimum contract size in which a futures trader may deal.

Maintenance margin: a set minimum margin that a customer must maintain in his margin account.

Margin: the amount of money put up by a clearing member with the clearing house or, by a customer with his broker firm to assure contractual performance.

Margin call: a request by the clearing house or the broker firm of an additional money when account below the maintenance margin level.

Mark-to-market: the practice of crediting or debiting a trader's account based on the daily closing price of the futures contract.

Market order: an order for immediate execution of a futures contract at the best available price.

Maturity: the period of time during which a selling trader may tender a delivery notice until the expiration date of the contract.

Notice: a slip of paper by a seller advising the exchange and the buyer of his intention to make an actual delivery of the underlying commodity.

Offer: an expression indicating willingness to sell a commodity futures contract at a given price.

Offset: a liquidation of a commodity futures contract by taking a position opposite to the initial position.

Open contract: contract which have been bought or sold and are still outstanding and not having been liquidated.

Open outcry: the method of public auction for making verbal bids and offers on the trading floor of a futures exchange.

Original, initial margin: a set amount of money that the futures trader must deposit into his margin account at the time he place an order to buy or sell the commodity futures contract.

Pit: the area on the trading floor where the commodity futures contracts are bought and sold.

Position: an interest in the futures market in the form of open commitment.

Position limit: the maximum limit by which a trader can hold in the futures market.

Position trader: a trader who either buys or sells commodity futures contract and holds such position for an extended period of time.

Price discovery: the generation of information about the future movement of cash market prices through the futures market.

Price limit: the permitted maximum advance or decline of the price of a contract in one trading session.

Scalper: a floor trader who trades futures rapidly in a single trading day in hopes of making a series of small profits.

Settlement price: the closing price or an average of various closing prices of any trading day.

Short: opposite to long, a trader who has sold commodity futures or plans to own a cash commodity.

Speculator: a trader who tries to profit from buying and selling futures contracts by anticipating the future price movements.

Spread: a trading method of simultaneous buying and selling of two related markets with the expectation that a profit will be made from the price difference between the two when the position is offset.

Straddle: a type of spread, involves two simultaneous long and short positions of two different commodities or of the same commodity but traded in two different markets.

Technical analysis: a method of anticipation of future price movement using historical prices, trading volume, open interest and other trading data.

Trading limit: limit on the trading range for a session or limit on the number of contracts which any trader may hold.

Trading session: the trading period for commodity futures contract on any trading day.

Trend: the general price direction of the prices of a particular commodity or futures contract.

Variation margin: additional margin required of clearing members or customers of a broker firm in certain situations, such in the case of high risk accounts or during the period of great market volatility.

Volatility: a measurement of the change in price over a given period of time.

Volume of trading: the number of contract which are sold or bought during any trading period.

B. Terms and Phrases of Islamic Commercial Law**

Ahliyyah: legal capacity.

Ajīr: a person who provides the service or a hired person.

Ajīr khaṣ: a hired person who serves one party only.

Ajīr mushtarak: a hired person who is free to serve any party.

ᶜAqd: contract or agreement.

ᶜArayā: a traditional contract of sale of fresh dates by estimation.

** Besides this research's own interpretation, the definition and explanation of these terms and phrases are derived from the following sources; Cowan, J. Milton (ed.). *The Hans Wehr Dictionary of Modern Written Arabic*. New York: Spoken Language Services, Inc. 3rd edition, 1976, (AL-) Faruqi, Harith Sulaiman. *Faruqi's Law Dictionary*. Beirut: Librarie Du Liban, 1991, Bosworth, C. E. et al (eds.). *The Encyclopaedia of Islam*. Leiden: E. J. Brill, 1995, Institute of Islamic Banking & Finance. *Encyclopaedia of Islamic Banking & Finance*. London: Inst. Of Islamic Banking & Finance, 1995, VOGEL, Frank E. & HAYES, Samuel L. *Islamic Law and Finance; Religion, Risk and Return*.

Bay^c^: a contract of sale.

Ḍamān: liability or guarantee.

Ḍarar: damage or loss.

Dayn: debt, credit or generic property.

Fāsid: defective or voidable.

Faskh: rescission or revocation.

Fatwā: authoritative legal opinion issued by an Islamic scholar.

Fuḍūlī: an unauthorized agent.

Ghalaṭ: mistake or misrepresentation.

Gharar: risk and uncertainty.

Ghish: deceit or trickery.

Ghubn: fraud or swindle.

Ḥadīth: a binding provision from the statements of the prophet (peace be upon him).

Ḥaṣāh: a type of sale of thing or land which is roughly determined or measured by a throw of a stone or a pebble.

Ḥawālah: a contract of assignment of debt or obligation.

Ḥilah or ḥiyal: justification of rule using a legal device, evasion or stratagems.

Ḥukm: a legal value or a rule assigned to certain object or act.

Ījāb: an offer.

Ijārah or isti'jār: a contract of leasing goods or hiring services.

London: Kluwer Law International, 1998, Failaka International, Inc. *Glossary of Islamic Financial Terms*, at, www.failaka.com/Glossary accessed on 12/05/2000.

Ijmā^{c}: general consensus or unanimous agreement of all qualified Islamic scholars of certain age.

Ikrāh: duress or coercion.

^{c}Illah: an effective cause, usually an attribute or a characteristic of an object or case that forms as a basis of Qiyās.

^{c}Inah: a contract that involves two sales, a cash sales and a deferred payment sale.

Iqālah: a contract of sale that rescinds a previous one.

Istiḥsān: a method of derivation of rules by preference in which it allows exceptions to a strict general principle or Qiyās in consideration of public interest.

Istijrār: a type of contract of sale that continuous for a specified period.

Istiṣḥāb: a method of derivation of rules by assurance of the original status.

Istiṣlāḥ: a method of derivation of rules by establishing the public interest.

Istiṣnā^{c}: a contract of manufacture.

Kafālah: a contract of guarantee or suretyship.

Kafīl: a surety or guarantor.

Khiyār: a right of option or a power to annul or cancel a contract.

Madhhab al-saḥābī: a method of legislation based on the words and deeds of the companions of he prophet (peace be upon him).

Ma^{c}dūm: non-existent object of contract.

Madīn: an indebted person.

Majlis al-^{c}aqd: the place of execution of a contract.

Māl: property.

Ma^cqūd ^calayh: the contractual object.

Marhūn: the pledged property.

Marhūn bih: a debt in a contract of pledge.

Marīḍ maraḍ al-maut: a sufferer of terminal illness.

Maṣlaḥah: public interest.

Maysir: gambling or games of chance.

Mu'ajjal: a type of contract of sale in which the price of the object is deferred to certain date.

Muḍārabah: a silent or dormant partnership or profit sharing in which a capital is provided by a partner and invested by the other.

Muḍārib: a person or an agent who is responsible to carry the investment of a partnership.

Muflis: a bankrupt person.

Muḥāl or muḥtāl: a creditor in a contract of assignment of debt.

Muḥāl ^calayh: a newly appointed debtor in a contract of assignment of debt.

Muḥīl: the initial debtor in a contract of assignment of debt.

Murtahin: a pledgee.

Musta'jir: a tenant or a person who is hiring the service.

Muwāṣafah: a contract sale by description without a proper inspection or possession.

Muzābanah: a traditional sale of non-estimated fruit on the tree in exchange of a specified measure of fruit.

Muzāyadah: a sale by auction.

Najash: a practice of a conspiracy in bidding a high price with the intention to cause other bidder to bid a higher price and consequently buy the merchandise at the said price.

Qabūl: an acceptance.

Qiyās: a method of derivation of rules by analogy.

Rabb al-māl: a capital provider or an investor.

Rāhin: the debtor in a contract of pledge.

Rahn: a contract of pledge.

Ra's al-māl: the capital provider.

Ribā: usury or interest.

Riḍā: consent or approval.

Ṣabiyy: a minor.

Sadd al-dharāi^c: a method of derivation of rules by blocking the evil means.

Safīh: a profligate or a spendthrift.

Salam: a contract of forward sale.

Shar^c man qablanā: a method of legislation based on the divine rules of the previous prophets (peace be upon them).

Shirkah or sharikah: a contract of partnership or incorporation.

Ṣīghah: the forms of an offer and an acceptance.

Simsār: a broker or auctioneer.

Sunnah: the binding words, deeds and tacit approval of the Prophet (peace be upon him).

Tadlīs: fraudulent statement or conduct.

Talaqqī al-rukbān: literally means, meeting the riding traders out of town but it is referred to as a prohibited practice of purchasing merchandise from an innocent trader who has no knowledge about the market price.

Thaman: the price of the contractual object.

ᶜUrbūn: a non-refundable deposit money paid to the seller to ensure a contractual performance.

ᶜUrf: public customs or common practices.

Wakālah: a contract of agency.

Wakīl: an agent or representative.

Waliyy: a guardian for a minor or an impeded or interdicted person.

Wilāyah: jurisdiction.

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