Overcoming *Shariah* Objections to Derivatives in Islamic Finance through Comparative Analysis

By

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A thesis submitted in total fulfillment of the requirements of the degree of Doctor of Philosophy.

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June, 2009

Addendum

p.6 second last line: Delete "Firstly, this research will identify a similar parallel development trend in conventional finance and Islamic finance" and read "Firstly, this research will identify similarities in the objections towards derivatives in conventional finance in the past with objections to derivatives in Islamic finance in the present".

p.7: Add at the end of para 1 "Fourthly, this thesis documents the state of readiness of Islamic finance practitioners to use derivatives as risk management tools, as long as *Shariah* can address *gharar* (excessive speculation and risk-taking)."

p. 265: Add seven lines from the bottom of the page:

"It should be noted that, despite the fact that, the interviews were conducted during[1] the global financial crisis, derivatives were still viewed by the majority of participants as needed in Islamic finance. Derivative instruments which have been severely blamed for the financial crisis (Birch 2009) includes instruments such as the credit default swaps[2](Torre 2009). While the use of these instruments have been severely criticised (Birch 2009; Torre 2009), it is not the instrument itself that should be blamed for the financial crisis but the way the instruments were used (Mirakhor 2009). That is, for speculative and gambling puposes. Thus it is opined that if the *maqasid* or objectives of *Shariah* and the principles of *Shariah* i.e avoiding *gharar, maisir, qimar* and *jahala,* are adhered too, forwards, futures and options will not be used for speculative and gambling purposes. This is why it is opined that the interviewees believed that forwards, futures and options are needed in Islamic finance."

p. 277: Add after the 9th reference:

Birch, T 2009, 'The Role of Derivatives in Creating the Financial Crisis', paper presented to AlBarakah 30th Synposium on Islamic Economics, Hilton Jeddah, August 26-27.

[1] The interviews were conducted from the 28th of February 2008 until the first week of September 2008. According to Felton and Reinhart (2008, p.2) the current financial crisis began from late summer 2007.

[2] Credit default swaps (CDS) a' is a type of insurance against counterparty's going bankrupt. ...A CDS can also be used as a bet on a company's bankruptcy or survival. ...The price of the insurance would rise as the likelihood of the company's bankruptcy increased, and vice versa' (Torre 2009, p. 46).

p.278: Add after the 19th reference:

Felton, Andrew and Carmen Reinhart eds. 2008. The First Global Financial Crisis of the 21st Century. London: VoxEU.org Publication.

p.281: Add after the 14th reference:

Mirakhor, A 2009, 'Strengthening the Islamic Financial System: Lessons from the Crisis', paper presented to Public Lecture by Dr, Abbas Mirakhor, Securities Commission Malaysia, September 29.

p.283: Add after the 5th reference:

Torre, Idl 2009, 'The Role of Derivatives in the Credit Crisis ', paper presented to AlBarakah 30th Synposium on Islamic Economics, Hilton Jeddah, August 26-27.

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Abstract

The objective of this research is to determine ways to overcome *Shariah* objections to derivatives in Islamic finance, through comparative analysis with conventional law. In Islamic finance, derivatives are still at the stage of infancy, where there is a lot of resistance from scholars against its usage. This research uncovered that these *Shariah* objections are very similar to earlier legal objections in conventional finance that attempted to ban or render illegal derivatives because they were considered to be, *inter alia,* instruments of gambling. Various laws, rules and regulations were enacted in conventional finance which eventually led to the legalisation of derivatives. This research attempts to focus on the laws that were enacted in the UK and US, to overcome or reduce the objections therein, and explore whether these laws can overcome similar objections in Islamic finance.

This research followed the qualitative inquiry paradigm where two methods were used to collect data – the historical and the case study methodologies. Under the first stage the historical method was used to review laws in the UK and US from the 17th century to the 20th century. From the laws that were reviewed, only relevant provisions that may overcome the objections in *Shariah* against derivatives were selected, analysed and discussed. The second stage followed the case study methodology. Thirty semi-structured interviews were conducted with participants who had expertise in Islamic finance and conventional finance and/or law. The participants were asked on the need for derivatives in Islamic finance, the applicability of conventional laws in Islamic finance, and other recommendations on risk management solutions in Islamic finance. The transcribed interviews were analysed and interpreted using the qualitative software tool NVivo version 8.

The findings of this research unveiled that the underlying objection in conventional finance against derivative usage was the prohibition of gambling, whereas in *Shariah* it is *gharar*. Gambling and *gharar* are not different types of objections, they are actually related. Analysis of the relationship between gambling and *gharar* led to the unearthing of the fact that *maisir* or gambling falls within the definition of *gharar*; in other words, gambling is a subset of *gharar*. Thus Islamic finance may learn from the legal history of derivative development in

conventional law in relation to objections which relate to excessive speculation and gambling. Further, from the responses of the participants it was gathered that Islamic finance can turn towards conventional finance to use the laws therein as long as it complies with *Shariah* principles.

Results also unveiled that derivative instruments such as futures and options, that have hedging properties, are needed in the Islamic financial industry today. Participants believed that futures and options are more useful than harmful to the economy. However, the participants opined that futures and options as they exist in their present form are not acceptable in Islamic finance. At the same time when the participants were queried whether, if all the objections towards derivatives could be overcome they would be accepted in Islamic finance, the participants answered that this was possible. The laws that have been enacted in conventional finance deal with issues of speculation, gambling and other abuses in the futures and options exchange such as dishonest behaviour, cornering and set-offs. These laws that were enacted in conventional finance may be used in Islamic finance to address similar issues.

Originality Statement

‘I hereby declare that this submission is my own work, and that this thesis contains no material which has been accepted for the award of any other degree or diploma in any university or other institution, and I hereby affirm that to the best of my knowledge this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.’

Signed……………………………………………………………………………………….

Dated……………………………………………………………………………………….

Notice 1

Notice 2

Acknowledgments

In the Name of Allah Most Gracious, Most Merciful. I am thankful to Almighty God that I have come to the end of my PhD journey and have completed this immense task. May Allah swt be pleased with my effort, ameen.

My sincere gratitude is given to my husband, Dr. Mohamed Ali, for his unwavering belief in me, his love and his understanding. You have always been there for me in my most trying times, thank you. I also want to thank my children Muhammad Shahir and Aliya Shahirah, for accepting that their mommy is still studying and making me feel joy in doing so.

Heartfelt appreciation is given to my parents Haji Kunhibava and Hajjah Nafeesa for providing me with the crucial physical and emotional support that I especially needed. My deepest gratitude is given to my sister, Norliah, who patiently read this manuscript at its final stages, and to my relatives and friends for their well wishes and kind words of love and support.

I would like to thank my supervisor Professor Bala Shanmugam for being able to get me 'unstuck' when I thought there was no way out, and for always being calm when calamity seemed so imminent to me.

My heartfelt thanks to Monash staff and lecturers and especially those at the postgraduate department and centre for all their kind words of encouragement and excellent facilities provided, without which I could never have completed my PhD.

Finally I am exceedingly grateful to all those who graciously accepted my interview requests and also those who were willing to listen to my woes and still offer excellent advice.

List of Publications

Journal Article

1. Kunhibava, S 2009, 'Understanding the Sources of Law that Governs Islamic Banking', *The Law Review*, vol. 1, p. 12.

Edited Book Chapter

1. Kunhibava, S 2008, 'Flexibility Versus Fairness, Conventional Derivatives and Islamic Derivatives', in D Bakar & ERA Engku Ali (eds), *Essential Readings in Islamic Finance*, Cert Publications, Kuala Lumpur.

News Bulletins

1. Kunhibava, S & Shanmugam, B 2006, 'Islamic Derivatives: Boon or Bane', *INCEIF*, vol. 1, no. 3.

2. Kunhibava, S 2006, 'The Fair Side of Islamic Derivatives', *Islamic Finance News*, vol. 3, no. 43.

3. Kunhibava, S 2007, 'Speculation and Derivatives', *Islamic Finance News*, vol. 4, no. 22.

Conferences/Colloquiums

1. Kunhibava, S. 2006, Overcoming Risks of Currency Exchange Fluctuations: Derivative Contracts in Islamic Finance, *Islamic Banking and Finance Educational Colloquium*, INCEIF, Kuala Lumpur Convention Centre.

2. Kunhibava, S 2008, '*Shariah* Objections to Derivatives in Islamic Finance, Determining the Path towards Overcoming Objections', in *Monash University's 10 Anniversary Celebration*, Monash University, Kuala Lumpur.

3. Kunhibava, S 2008, '*Shariah* Objections to Derivatives in Islamic Finance, Determining the Path Towards Overcoming Objections – A Comparative Analysis', in Doctoral Colloquium *3rd Islamic Banking and Finance Conference*, KUIM, Legend Hotel Kuala Lumpur.

4. Kunhibava, S 2008, '*Shariah* Objections to Derivatives in Islamic Finance, Determining the Path Towards Overcoming Objections – A Comparative Analysis', in Doctoral Colloquium *6th International Islamic Banking and Finance Conference Monash University*, Monash University and IBBM, JW Marriot Kuala Lumpur.

5. Kunhibava, S 2008, '*Shariah* Objections to Derivatives in Islamic Finance, Determining the Path Towards Overcoming Objections – A Comparative Analysis, in *Doctoral Colloquium Monash University*, Monash University**,** Genting Highlands.

Abbreviations

AAOIFI -	Accounting and Auditing Organisation for Islamic Financial Institutions
CBOT -	Chicago Board of Trade
FSMA -	Financial Services and Markets Act 2000 (UK)
IDB -	Islamic Development Bank
IIFM -	International Islamic Financial Market
IRTI -	Islamic Research and Training Institute
ISDA -	International Swaps and Derivatives Association
OIC -	Organisation of the Islamic Conference
OTC -	Over the counter
pbuh -	Peace be upon him
SAC -	*Shariah* Advisory Council
SCERH -	Standing Committee on Ethics in Research involving Humans
SSF -	Single Stock Futures
swt -	Subahana Wa Taala (means 'glorious and exalted is He' (Allah))

Chapter 1 Introduction

1.1 Background to the Research

The word 'derivative' is a relatively new term in the commercial world. Its first usage in the courts took place only in 1982 in the US, and 1995 in the UK (Swan 2000). It is therefore not surprising that historical articles, cases and books do not mention the word 'derivative' but rather words such as 'forwards', 'futures' and 'options'. 'Derivative' has been defined as '… a financial instrument whose value depends on the value of other, more basic variables', (Hull 2005 p.1). 'Derivative' is therefore a generic term that classifies instruments that display the same features. The necessity to form a common terminology describing these instruments came about because of the explosion of financial engineering and innovation of these instruments. Some examples include Interest Rate Swaps, Forward Rate Agreements, Caps, Floors, Swap options (Market Traders Institute 2002), butterflies, straddles, condors and strangles (Tickell 2000).

The forward[3] contract has been recorded as the first derivative instrument to be used and is also the simplest in form (Bacha 2001). A forward contract is where two parties undertake to complete a transaction at a future date but at a price which is determined today.

A futures[4] contract is basically a forward contract which is standardised with respect to contract size, maturity, product quality, place of delivery etc. Future contracts are traded on exchanges, where all buyers and sellers transact through the exchange (Bacha 2001).

An option[5] entitles the holder the right but not the obligation to buy (or sell) the underlying asset at a predetermined exercise price at or any time before maturity. To acquire this right under an option a payment of a premium is required (Hull 2005).

The market size of trading in derivatives in conventional finance[6] is enormous and increasing. For example, the average daily volume of derivatives for the first quarter of 2007 reached a

[3] For a more detailed definition see glossary at Appendix 10.
[4] For a more detailed definition see glossary at Appendix 10.
[5] For a more detailed definition see glossary at Appendix 10.

record 3.87 million contracts at the Chicago Board of Trade, one of the world's leading derivatives exchanges. This is an increase of 24% compared with the first quarter of 2006 (Grabiner 2007). On the other hand NYSE Euronext's[7] derivatives trading operations on Liffe in 2008 experienced 'its busiest May ever', leading to a 30% increase in total contracts traded year-to-date compared to the same period in 2007. 'In May, Liffe traded more than 91 million futures and options contracts, representing an average daily volume of 4.3 million, up 20.8% from the same month in 2007' (*NYSE Euronext Business Summary for May 2008*). Further, NYSE Liffe traded an average of 3.7 million futures and options, during the fourth quarter of 2008, a 5% increase from the year ago quarter (NYSE Euronext 2009).

The increasing popularity of derivatives in conventional finance can be attributed to their flexibility or ease of use. They are easier to buy and sell than the underlying commodity or financial asset, such as agricultural commodities, metals, energy, currencies, stock indexes etc. Derivatives are a useful alternative to holding the underlying commodity or financial asset; also a relatively small amount of capital is sufficient to trade in derivatives as compared to the actual amount of money needed to buy the commodity or financial asset. There are also other benefits that have been noted such as better risk allocation, and reduced information asymmetry (Stoll & Whaley 1985), (Merton 1995) and (Koski & Pontiff 1996).

While derivative usage in conventional finance has shown tremendous positive strides, in Islamic finance currently there are no derivative markets. Islamic finance is the conduct of banking and finance in accordance with the principles of *Shariah. Shariah* is Islamic law and the basic requirements of *Shariah* are that banking and finance must not contain the elements of, *inter alia, riba* (interest), *gharar* (excessive uncertainty), *maisir* (something attained through no effort), *qimar* (gambling) and *jahala* (ignorance) (Usmani, 2002). The development of Islamic finance itself has been unparalleled as 'no other financial industry, market or jurisdiction in the last decade has witnessed the staggering financial engineering and innovation as the Islamic finance industry' (Grewel 2007, p. 29). With such growth in the Islamic capital markets one would expect similar growth in the Islamic derivative markets.

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[6] In this research conventional finance means finance as it is practiced today around the world in business that does not include Islamic finance.

[7] NYSE Euronext is part of a family of exchanges, located in six countries, and includes the New York Stock Exchange, the world's largest cash equities market; Euronext, the Eurozone's largest cash equities market; Liffe, Europe's leading derivatives exchange by value of trading; and NYSE Arca Options, one of the fastest growing U.S. options trading platforms (NYSE Euronext n.d.).
NYSE Euron cash equities, options and derivatives, ETFs, bonds, market data, and commercial technology solutions.

However, although scholars such as Kamali (1996, 1997, 1999, 2002, 2007) have argued that futures and options are permissible in Islamic finance, the overwhelming majority of scholars in Islamic finance believe that forwards, futures and options, as they are currently traded in conventional finance, are impermissible in Islamic finance (Delorenzo; Mahmassani 1983; Chapra 1985b; European Council for Fatwa and Research; Khan A. 1988; Usmani 1996; Obaidullah 1998; El-Gamal 1999; Khan F. 2000; OIC Fiqh Academy 2000; Naughton and Naughton 2000; Kahf 2002; El Gari 2006; Wilson 2007). One academic succinctly summarises the dilemma of derivative usage in Islamic finance: 'Options and futures contracts cannot be traded under *Shariah*, as they are too remote from the underlying assets … The concern in Islam is with *gharar* (contractual uncertainty)' (Wilson 2007, p.14).

Thus it is the objective of this research to investigate means to overcome and manage the objections raised against the usage of derivatives in Islamic finance. This thesis does not argue the permissibility or otherwise of derivatives according to *Shariah*, but rather, How can we overcome the objections that have been raised by scholars of Islamic finance? How this will be done is to turn towards the more mature conventional finance and learn from its rich legal history. The legal history of conventional finance features similar legal objections to forwards, futures and options. These objections as to the legality of derivatives were similar to the ones raised today by scholars in Islamic finance. In conventional finance, laws were passed to overcome these objections. Could these laws be adopted and modified and applied to Islamic finance today to overcome similar objections? This is the pertinent question that will be researched in this thesis.

1.2 Research Questions, Research Objectives and Contributions

The **problem statement** or **research question** to be addressed in this research is:

How can the objections towards derivatives in Islamic finance be overcome by adapting laws from the legal history of derivatives usage in conventional finance?

This core research question seeks to encapsulate this whole research into one question. This research question asks the question of 'How?' the objections towards derivatives in Islamic finance can be overcome. Even though the question starts off with a very broad approach it is narrowed down by focussing on the legal history usage of derivatives in conventional finance. Thus this research attempts to research how the objections towards derivatives in Islamic finance can be overcome by focussing on the legal history usage of derivatives in conventional finance.

To answer the problem statement this research investigates six subsidiary research questions. The **subsidiary research questions** that will be investigated, which point towards the necessary data to be gathered in order to satisfactorily solve the above problem statement, are as follows:

1. **How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance?**

The first subsidiary research question is answered in Chapter 3. The *Shariah* objections towards derivatives will be compared and contrasted with the conventional law objections towards derivatives. How the legal objections in *Shariah* are similar and different to the conventional law objections towards derivatives is described through a detailed study of the objections. Answering this subsidiary research question will enable the researcher to investigate in what ways the conventional law objections are similar to *Shariah* objections, and also in what manner the laws of conventional finance can overcome the objections of derivatives in Islamic finance.

2. **Why are there similarities in objections towards speculation in *Shariah* and conventional law?**

The second subsidiary research question is answered in Chapter 4. It will be answered by looking at the possible reasons why there are similarities in the objections between conventional laws and *Shariah*. By researching and understanding the root reasons why there are similarities in the objections in these two separate fields, it may be easier for Islamic finance to actually appreciate and accept the conventional laws researched in this thesis.

3. **What laws passed in conventional finance can be used to overcome the objections to derivatives in Islamic finance?**

The third subsidiary research question is answered in Chapter 6, by archival research where US and UK laws from the 17th century onwards are reviewed. The relevant laws which deal with the objections towards futures and options that could possibly be used to overcome the objections in *Shariah* are compiled and analysed. Answering this subsidiary research question will identify relevant legislation that may be used to overcome the objections towards derivatives in Islamic finance.

4. **Are derivatives needed in Islamic finance?**

The fourth subsidiary research question is answered in Chapter 7 through case study and in-depth semi-structured interviews. Answering this subsidiary research question will enable this research to investigate, through qualitative means, the necessity of derivatives in Islamic finance.

5. **Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?**

The fifth subsidiary research question is answered in Chapter 7 through in-depth semi-structured interviews. This subsidiary research question is different from subsidiary research question three above in the following way – subsidiary research question three is answered by proposing past laws in conventional finance that might be able to overcome the objections in *Shariah*. This research question however, follows from subsidiary research question three by researching whether the laws which have been proposed will be accepted by those in Islamic finance. Thus answering this question will enable this research to determine the possible acceptance of those within the Islamic financial industry and academia of conventional laws to overcome the objections towards derivatives in *Shariah*.

6. **Are further laws or other recommendations, unique to Islamic finance, required to be introduced to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?**

The sixth and last subsidiary research question is also answered in Chapter 7 through in-depth semi-structured interviews. This subsidiary research question explores other laws or recommendations that might be used in Islamic finance to enable derivatives to become acceptable according to the requirements of *Shariah*.

The **research objectives** of this PhD are:

- To identify the objections towards derivatives in conventional finance and Islamic finance.
- To compare and contrast these objections towards derivatives in conventional finance with the objections in Islamic finance and identify if the objections are similar.
- To identify the laws that were passed to overcome the objections in conventional finance.
- To explore whether these laws from conventional finance can be adapted to Islamic finance, to overcome similar objections.
- To propose possible recommendations that would enable the introduction of derivatives in Islamic finance.

Addressing the research objectives will provide three **contributions** to the Islamic finance industry:

- Firstly, this research will identify a similar parallel development trend in derivatives in conventional finance and Islamic finance.

- Secondly, this research will identify the laws that were passed to overcome the objections in conventional finance, and determine whether these laws from conventional finance can be adapted to Islamic finance.
- Thirdly, recommendations will be proposed that can be incorporated into the Islamic financial framework to minimise the objections that have been aimed towards derivatives.

1.3 Rationale of Research and Contribution to Scholarship

This research is significant because it is among the first, if not *the* first, research to compare and draw from the legal history of derivative usage in conventional finance to Islamic finance. Research in the legal admissibility of derivatives in Islamic finance has wholly focussed on the interpretation of various *Shariah* sources, and *hadith* (sayings and the conduct of the holy Prophet Muhammad, pbuh) in particular, for example Kamali (1996, 1997, 1999, 2002, and 2007). The various researches carried out try to identify either the impermissibility or permissibility of derivatives from the point of view of Islamic law by delving deep into the meanings of *Shariah* and *fiqh* (Islamic jurisprudence) sources. However there is minimal work or research in Islamic finance and conventional finance identifying a sort of parallel development and similar objection to the legal admissibility of derivatives. There seems to be an absence of any major research which attempts to explore and compare the legal development of derivatives in conventional finance and Islamic finance. This gap is what this research seeks to fill.

The pilot introduction of derivatives in Islamic finance has already begun. For example, the recent approval in Malaysia by the *Shariah* Advisory Council of the Securities Commission of the Single Stock Futures, as *Shariah* compliant in June 2006, and in November 2006 the signing of the derivative master agreement to document Islamic derivative transactions between Bank Islam Malaysia Bhd and Bank Muamalat Malaysia Bhd. However this pilot introduction has only occurred in Malaysia, and there are no derivative exchanges in Islamic finance even in Malaysia or other parts of the world.

At the same time there also seems to be a need to ensure that those participating in Islamic finance have a means to manage their risk (Al-Suwailem 2006). There are proposals in Islamic finance that try to introduce Islamic contracts such as *salam*[8], *istisna*[9], *urbun*[10] and *ja'alah*[11] as alternatives to forwards, futures and options in Islamic finance (Bacha 1999; Al-Amine 2000; Kunhibava 2006).

There are however very minimal attempts made to overcome the objections against forwards, futures and options. This is what this research attempts to do and thus contribute to the knowledge of derivatives and risk management in Islamic finance.

The significance of this study on a state or governmental level, where policies and laws are passed, reviewed and amended, is that this research will enable policy makers to view and take note of the laws that were passed in conventional finance to overcome the objections towards derivatives. Policy makers could incorporate laws that are reviewed in this research and also use the recommendations suggested in this thesis to postulate guidelines to be passed in the future involving derivatives in Islamic finance.

Further, this research is in line with Malaysia's Ninth Plan for the years 2006–2010. According to the Ninth Malaysian Plan, the Malaysian Government plans to 'elevate the domestic Islamic financial system and further integrate it with the international financial infrastructure, … strategic initiatives will continue to be undertaken to strengthen Malaysia's position as a global Islamic financial hub' (The Economic Planning Unit, Prime Minister's Department 2006, p. 184). Thus this research will enhance the Islamic financial industry in Malaysia by venturing into the area of derivatives in Islamic finance.

At an industry level this research will benefit the Islamic finance industry in particular, as it explores the opinions of *Shariah* Advisors, professionals and academicians in Islamic finance on issues involving derivatives such as, 'Are derivatives needed in Islamic finance?' The

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8 The *bai-salam* (*bai* means contract) allows delivery of an asset at a predetermined future date where the price is paid in full today. *Bai-salam* can be compared to a forward contract except for the fact that in a *salam* contract only one party is deferring his obligation under the contract (Rosly 2005), For a more detailed definition see glossary at Appendix 10.

9 *Istisna* - is another deferred sale contract, where the price is paid in instalments as the work progresses in manufacturing or building an object (Usmani 2002). For a more detailed definition see glossary at Appendix 10..

10 *Bai al-urbun* is a sale in which the buyer deposits earnest money with the seller as part payment of the price in advance and agrees that if he does not continue with the contract he will forfeit the deposit money which the seller can keep. If the buyer, after some time, decides to go ahead with the transaction, the payment is adjusted for the initial deposit (Al-Amine 2000). For a more detailed definition see glossary at Appendix 10.

11 The *ja'alah* contract can be defined as an open promise by one party to pay whoever performs a particular task a named reward (the *jul*) (Kunhibava 2006). For a more detailed definition see glossary at Appendix 10..

answers to the interviews conducted would enable those in the Islamic finance industry to gauge the opinion of those within the industry, take note of the recommendations suggested by those interviewed and accordingly innovate and incorporate the recommendations made.

At an individual level this research will enable individuals to understand the usage of derivatives, the objections against them, and how they may be overcome in Islamic finance. By researching this area, a greater understanding of the use, the purpose, and the need for derivatives in Islamic finance will be achieved.

1.4 Parameters and Justification

Discussion of derivatives in this thesis will be limited to the conventional derivative contracts of forwards, futures, and options only. These derivatives are chosen as these are the more popular derivatives traded on Exchanges (Bank of International Settlements 2008, p.109A). Further the legal history of derivatives shows us that it was only in the late 20th century that other more exotic types of derivatives such as swaps[12], swaptions LEAPs, CMOs etc, were created (Swan 2000). Legal objections in conventional finance to derivatives, which occurred mainly in the late 19th century and early 20th century, did not involve these more exotic derivatives. In Islamic finance legal opinion and objections focuses mainly on futures and options and to a lesser extent towards forward contracts. If the basic derivative contracts themselves are opposed to, there is very little chance of more advanced derivatives featuring in Islamic finance. Therefore the more exotic derivatives are not discussed in this thesis.

Also, derivatives can be characterised into two types depending on the manner in which they are traded, that is, over-the-counter (OTC) derivatives and exchange traded derivatives. The former type of derivatives are privately negotiated between the two parties of the contract with no intermediaries, whereas in the latter case, an intermediary in the form of a derivative exchange exists. A derivatives exchange acts as an intermediary to all related transactions, and takes initial margin from both sides of the trade to act as a guarantee. Futures are only traded on an exchange, whereas forwards are OTC type of contracts and options can be traded both OTC and on an exchange (Bacha 2001). In this thesis, discussion of the objections

[12] For a definition see glossary at Appendix 10.

towards derivatives in Islamic finance or conventional finance has not made this distinction. In other words, this thesis, in presenting the objections towards derivatives in Islamic finance and conventional finance, has not discussed whether they apply to OTC derivatives or exchange traded derivatives. Rather a general approach has been taken where this distinction between OTC and exchange traded derivatives has not been highlighted; instead the individual contracts, that is, forwards, futures and options have been discussed. The reason for this is because, in the objections towards derivatives in *Shariah* no distinction has been made as to whether the objections applied to OTC or exchange traded derivatives. Instead the objections have focussed on particular types of derivatives such as ‘forwards’, ‘futures’ and ‘options’. Since futures are traded on an exchange, whereas forwards are privately negotiated and options can be traded OTC or on an exchange, the discussion in this thesis has revolved around those particular instruments rather then focussing on the ‘OTC’ versus ‘exchange traded’ distinction. Thus this thesis does not make particular reference to the distinction between OTC traded derivatives and exchange trade derivatives, but rather explores the individual instruments, that is, forwards, futures and options.

Another limitation of this thesis is that it will not discuss Islamic contracts which have been discussed as alternatives to forwards, futures and options such as *salam, istisna, urbun* and *ja'alah*. These Islamic contracts are either on the verge of being approved in *Shariah* or are commonly used in Islamic finance. Therefore discussion on these contracts will not only be out of the scope of this thesis, but will also be pointless as their legal admissibility is generally not an issue.

Further, the conventional laws[13] that are discussed in this thesis are from the jurisdiction of largely UK and US laws. Other jurisdictions may be mentioned but the laws in the UK and US will be the prime focus in this thesis. The reason for this is firstly because these two countries have a rich legal history which can be traced and followed in discussing the legal objections, and further because these two countries are among the top countries in the world that have the largest market for derivative trading (Bank of International Settlements 2008, pp.31 and 109A).

[13] Conventional law in this thesis means laws enacted by a State (e.g. legislation) or judiciary (e.g. case law) and excludes *Shariah law* (Islamic law).

Also, it should be noted that derivatives can be based on different types of assets, commodities, or financial instruments, such as equities or bonds, interest rates, exchange rates, or indices. The main difference between commodity and financial futures contracts are that financial futures usually have a limited range of delivery dates based on a three-month cycle, whereas commodity futures often have monthly or seasonal delivery dates. Further, a majority of financial futures are cash settled, whereas commodity futures contracts specify a delivery location (*What are the various types of financial futures?* 2006). Financial derivatives only began to be traded in the 1970s, and since most of the legal opinions in conventional finance are featured in the late 19th century and early 20th century, most of the discussion in this thesis will be focused on commodity derivatives, in particular future commodities.

1.5 Outline of the Research Design and Methodology

The study presented here sets out to explore the laws and regulations that were passed in conventional finance in the US and UK to overcome the objections aimed at derivatives and their possible application in Islamic finance to overcome the objections in *Shariah*. This research follows the qualitative inquiry paradigm and historical and case study methods for answering the research and subsidiary research questions posed.

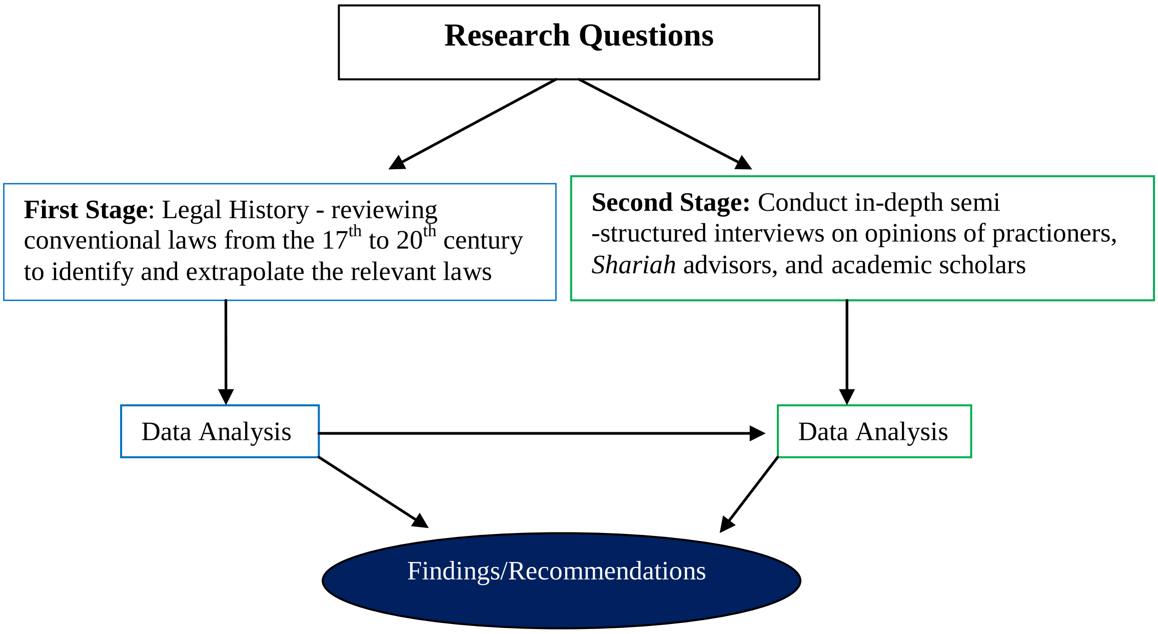
This research is conducted in two stages.

First stage will involve using the historical method and archival research to review the conventional laws from the UK and US from the 17th to 20th century to identify and extrapolate the relevant laws.

Second stage will involve conducting in-depth interviews with the appropriate Islamic finance personal as to their views on issues such as: ‘Are derivatives needed in Islamic finance?’; ‘Whether the laws passed in conventional finance would overcome the objections in Islamic finance?’; and, ‘What further recommendations are necessary?’

The data received from the interviews are analysed using the software NVivo.

Figure 1.1 Illustration of the Methodology Used in this Thesis



The above illustration represents the methodologies used in this thesis. Each method answered specific subsidiary research questions. The methodologies used will be discussed in greater detail in Chapter 5. Chapter 5 also discusses the data collection method, sampling, data analysis method, ethics, reliability and validity.

1.6 Outline of Thesis

Here a brief outline of the chapters that form this thesis is made. This chapter, which has outlined this thesis and put it into context, is excluded. This thesis comprises eight Chapters.

Chapter 1 presents the problem statement and subsidiary research questions that will be investigated in this thesis. This chapter also lays down the significance of the study undertaken, the objectives and contribution of the study. A brief outline of the methodology used is also explained.

Chapter 2 lays down the **premise or relevant background** required to understand the literature review chapter (Chapter 3). In this chapter the historical development of derivatives is outlined, a comparison between *Shariah* and conventional law is made and *Shariah* injunctions discussed.

Chapter 3 presents in detail the **literature** on the legal objections in Islamic finance of various scholars on derivatives, and compares this with the legal objections of derivatives in conventional finance. The objections of the two fields are compared, contrasted and subsidiary research question one is answered.

Chapter 4 explores **probable reasons** why there is a similarity of objections between *Shariah* and conventional laws. This chapter addresses the second subsidiary research question.

Chapter 5 presents in detail the **methodology** undertaken for the purposes of the first and second stage of the research. Here an explanation will be provided of the research design and methodology chosen. Further, the selected interviewees, the questions posed, and ethical issues will be explained in detail.

Chapter 6 presents the **historical methodology** used to review archives of laws from statutes from the 17th century to the 20th century in conventional law and finance to overcome the objections towards derivatives. This chapter answers the third subsidiary research question.

Chapter 7 presents the data, interpretation and analysis of data from **in-depth interviewing** through the case study method. This chapter answers the fourth, fifth and sixth subsidiary research questions.

Chapter 8 provides the **conclusions and implications** for each subsidiary research question and the core research question. Recommendations and further research are also discussed.

Appendices (1-10) contain the documentation to support the thesis. The appendices include (1) Human Ethics Certificate of Approval, (2) Explanatory Statement, (3) Consent Form, (4) Interview Guide, (5) Email Inviting Potential Participants to be Interviewed, (6) Email Requesting Participants to Review Transcript, (7) Table of Meeting with Participants, When and Where, (8) Email of Research Results, (9) Table 6.1, Matching Conventional Laws with Shariah Objections, (10) Glossary.

1.7 Summary

This chapter discussed the overview of this thesis. It discussed the research problems, research issues, research objectives, and contributions. This chapter also laid down the significance of the research undertaken, parameters and justification of this thesis, the methodology employed, and an outline of the chapters. The next chapter lays down the premise or background needed before the literature review is described in Chapter 3. Chapter 2 starts with the historical development of derivatives in conventional finance, thereafter *Shariah* is explained, and finally *Shariah* is compared to conventional law.

Chapter 2 History of Derivatives, and Comparing *Shariah* with Conventional Law

2.1 Introduction

This chapter will lay the premise required for a comparison to be made between *Shariah* objections and conventional law objections to derivatives, which will be discussed in Chapter 3. The history of derivatives travels back 4000 years, as do the laws regulating them. It is therefore pertinent to trace the history of derivatives to be able to locate the point from which comparison will begin. Further, the uniqueness of *Shariah* and conventional laws has to be highlighted to understand the different sources used to make the comparison. This chapter also discusses the injunctions present in *Shariah.* It is necessary to explain these injunctions so as to understand the *Shariah* objections to derivatives as laid down in Chapter 3.

2.2 Origination and Evolution of Derivatives and its Presence in Islamic Finance

While it is common to find descriptions attributing the beginnings of derivatives to the 17th century Osaka markets in Japan or the 19th century Chicago Board of Trade in America (Tickell 2000), it is a less known fact that derivative transactions were conducted in ancient Mesopotamia around 4000 years ago (Swan 2000).

2.2.1 Early Derivative Transactions

Based on a Cuneiform[14] Bearer Bond[15] from ancient Mesopotamia around 1750 BC, it can be seen that an agreement existed for the delivery of slaves in the future on a flexible settlement[16]. The agreement did not identify individual slaves, the seller even had the option

[14] 'Cuneiform' is a form of writing and was a 'unifying factor from the point of view of legal regulation of commerce' for more than two millenniums (Swan 2000), p.34.

[15] A British museum tablet number WA 92547, translated by Christopher Walker of the British Museum (Swan 2000), p.29.

[16] It is interesting to note that the earliest known written code of laws, the Laws of Bilalama, King of Esthnunna, mentioned future deliveries, these laws were written between about 2268 and 2259 BC, section19 of

to deliver slaves or to pay a sum of silver, and finally the agreement was transferable prior to the delivery date (Swan 2000). Another type of contract of this period was called the 'grain loan'. For a price paid at the time the contract was made, the seller agreed to deliver a commodity in the future (Swan 2000). This contract is very similar to the *salam* contract in Islamic finance. A *salam* contract allows delivery of an asset at a predetermined future date where the price is paid in full today. *Salam* can be compared to a forward contract except for the fact that in a *salam* contract only one party defers the obligation under the contract (Rosly 2005).

In ancient Egypt, economic life was different from Mesopotamia, because to large extent, property and agricultural commodities belonged to the ruler. However there are tomb inscriptions which provide evidence of the usage of derivatives at that time (Swan 2000).

Ancient Israel, on the other hand, was governed by the laws of the Mosaic code which originated around 1250 BC. The code consists of 613 commandments, 248 'mandatory commandments' and 365 'prohibitions'. These laws are set out in the Exodus, Deuteronomy and Numbers Books of the Old Testament (Swan 2000, p.54). What is interesting is that Mosaic Law has very similar restrictions as those found in *Shariah* and in particular on derivatives. Under Mosaic Law the sale of future goods was not possible. A valid sale required a transfer of money in exchange for existing, specified property in the seller's possession which was consummated by the buyer taking possession of it. However, there is evidence showing that where trade was required for essential commodities, contracts for future deliveries were allowed (Swan 2000).

During these ancient times most of the contracts for future deliveries resembled forward contracts rather than futures as defined in modern times. These types of markets emerged much later. These forward type of contracts for future deliveries were also traded during the era of the Greeks, and the Romans, mainly through influence of Middle Eastern lands (Swan 2000). As for derivative contracts that existed during the Roman era, they continued to have commercial uses during these dark ages (Swan 2000, p.112).

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the Laws of Bilalama refers to commodity transactions, and introduces the element of contracting for future deliveries, (Swan 2000) Another law code of Mesopotamian law, the Code of Hammurabi, of King of Babylon for 42 year between 1792 and 1750 BC, covered two important stages of development of the law of sale necessary for derivative contracts (a) sale of goods, to be delivered in the future, and (b) transferability of rights under contract of sale (Swan 2000, p.46).

With the advent of the Middle Ages economic stability returned, and by the 12^{th} century two major trading centres began to flourish on the European continent, one at northern Italy and the other in northern Europe around the region of Holland and Belgium (known as Flanders) (Teweles & Jones 1998). The latter trade centre (known as the Champagne market fairs named after the Counts of Champagne on whose land the fairs were held) developed strong economic ties with England. These trade fairs became the main centres of commodity exchange in Europe. ‘Traders came not only from Flanders and Italy but from Scandinavia, England and even Russia’ (Teweles & Jones 1998, p.7). Most of the transactions at these fairs were spot transactions. However, there was the usage of a document called a *lettre de faire* which was a forward contract that specified the delivery of goods at a later date. These documents eventually evolved into negotiable documents which could be transferred to several parties before arriving at the warehouse where the specified goods were stored (Teweles & Jones 1998).

These forward trading contracts traded by merchants at these fairs resembled closely the modern day futures market except for the fact that the trades were not standardised (Teweles & Jones 1998).

Soon other fairs emerged at Bruges, Antwerp and Amsterdam (circa 13^{th} century) (Swan 2000). In England year-round meeting places where traders could buy and sell commodities were eventually created. These meeting places were known as exchanges, an early example being the Royal Exchange, which opened in England in 1570. Later the Royal Exchange was divided into specialised exchanges like the London Commodity Exchange (Teweles & Jones 1998).

In the 1600s two significant events in the history of derivatives occurred, firstly the futures markets that emerged during the speculation of the Dutch tulip, (Garber 1989), and secondly the first organised futures exchange in the Dojima Rice Exchange in Osaka, Japan (West 2000).

2.2.2 Speculation of the Dutch Tulip

The Dutch tulip market and futures markets that arose as a result occurred during the years 1634-37. The market was for durable bulbs, that could produce beautifully patterned flowers (Garber 1989). Before 1634, the market for tulip bulbs was 'limited to professional growers' (Garber 1989, p.534). However in the beginning of 1634 non-professionals entered the tulip trade in large numbers, as a result of greater demand for bulbs in France. Speculation increased into a frenzy as more people participated in the tulip market and prices of the bulbs increased tremendously[17]. This continued until suddenly in 1637 the frenzy ended and even rare bulbs could not find buyers at '10 percent of their previous prices' (Garber 1989, p.538).

The tulip futures markets were formally developed in 1636. During this time traders began to meet in numerous taverns in groups called 'colleges' where trading was regulated by a few rules governing the method of bidding and fees. Buyers were required to pay fees to the sellers[18].

The futures market for the bulbs worked in the following way as described by Garber (1989), p.544:

> No margin was required from either party so bankruptcy constraints did not restrict the magnitude of an individual's position. Typically, the buyer did not currently possess the cash to be delivered on the settlement date and the seller did not currently possess the bulb. Neither party intended a delivery on the settlement date; only a payment of the difference between the contract and settlement price was expected. Thus, as a bet on the price of the bulbs on the settlement date, this market was not different in function from currently operating futures market.

During the period 1636-37, September–February, before the collapse of the tulip market speculation, no bulbs were delivered because of the nature of tulips, whose bulbs could only be obtained in June by exhuming them from the soil. The tulip speculation finally collapsed after the first week of February 1937 (Garber 1989).

[17] A 'single Semper Augustus bulb was sold at the height of the speculation for 5,500 guilders, a weight of gold equal to $50,000 evaluated at $450 per ounce.' (Garber 1989) p.537 Quoting Mackay in (Mackay 1852).

[18] The fees was '1/2 stuiver (1 stuiver = 1/20 guilder) out of each contracted guilder and up to a maximum of 3 guilders for each deal'. (Garber 1989), p.543. Note that 1 guilder was equivalent to approximately 10.38g of fine silver and 0.77g of fine gold.

2.2.3 The Dojima Rice Market

Another futures market that arose during this time period was the Dojima rice market. However this market, unlike the Dutch tulip market did not collapse but was the beginning of the modern day organised futures market.

The Dojima rice market began with wealthy landowners and feudal lords in Japan storing surplus rice paid to them by their feudal tenants at storage warehouses in Osaka as a source of ready cash at hand (Teweles & Jones 1998). The warehouses were managed by agents of the lords who were paid a fee. These landlords soon began issuing receipts that entitled the bearer to rice from their warehouses. ‘By issuing receipts, lords could ensure a steady income stream from their otherwise seasonal and weather-dependent product’ (West 2000, p.2580). Since rice itself was a form of currency in Japan at that time, these rice receipts acquired a currency-like status. Warehouses even ‘issued “empty” bills (*kumai kitte*) that were traded as credit instruments rather than actual entitlements to physical rice, which did not exist in the issuing warehouse’ (West 2000, p.2581). By the 1650s a functioning market existed for these rice bills (West 2000). By 1730 the imperial government of Japan officially authorised futures trading at the Dojima market. The rules at the Dojima futures market resembled closely, modern day futures markets, for example the terms of the contracts were standardised, contract term duration was limited, and all trades had to be cleared through a clearing house. However, a significant difference of the Dojima futures market from modern day derivative markets was that delivery of the commodity was never permitted (Teweles & Jones 1998).

2.2.4 Chicago Board of Trade

In 1848 one of the most striking events in the history of derivatives took place, and is often cited as the source of modern day derivatives, namely the creation of the Chicago Board of Trade (CBOT) (Tickell 1999).

Chicago’s location on Lake Michigan made it suitable as a major centre for the storage, sale, and distribution of grain (Chance, n.d). However at harvest time, the tonnes of grain that arrived at Chicago would be in excess of its storage capability. ‘The vast influx inevitably created a glutted market, forcing prices to decline sharply' (Lurie 1972, p.218). On the other hand during non-harvesting season grains were in short supply and prices of the grains inflated (Chance, n.d). This coupled with the fact that there were no uniform standards of grading the quality of grains resulting in disputes and eventual litigation, led to the creation of the CBOT (Lurie 1972).

Thus from 1848 the CBOT, a futures trading on organised exchanges, was created to allow all year buying and selling of grains 'eliminating imbalances between supply and demand' (Lurie 1972, p.219). In the first four years of existence these merchants met above the Cage and Haines flour store at 101 South Water Street (Swan 2000). Changes slowly took place from the 1840s. The CBOT began to trade in such commodities as grain, beef, wool, stone, brick, and produce. In March 1859 the CBOT was chartered by the Illinois legislature to:

(a) 'Establish rules
(b) Appoint grain inspectors
(c) Arbitrate business disputes between members who wished to submit them for arbitration; and
(d) Discipline members.' (Swan 2000, p.218).

The CBOT formed a department in 1858 to classify and certify grades of grain numerically by colour, quality and general condition. Standardisation of grain enabled the purchaser to know what type of grain he was buying. In 1864 'pits', defined as areas of trade for futures contract trading, were established, and by 1874, the state of Illinois had assumed responsibility for grain inspection and supervision of grain and warehouse facilities. Thus the CBOT introduced a system whereby there was 'an open continuous market' where there would always be buyers and sellers who would be protected from fluctuating commodity prices (Lurie 1972, p.220).

Derivatives markets continued to develop during the late 19th century and for most of the 20th (Tickell 2000).

However from the 1970s onwards the size of the derivative markets enlarged and became increasingly complex (Tickell 2000). Several main factors such as volatility in the financial markets, better computing and telecommunications, and emerging theories of managing risk led to greater financial innovation and engineering (Rusinko & Matthews 1997). Further, the event of international currencies floating freely led to the creation of the first derivative contract not based on commodities. 'In 1972 the Chicago Mercantile Exchange created the International Monetary Market which permitted trading in currency futures - the first derivatives contracts not to be based on physical products - which laid the foundations for the development of more esoteric and abstract contracts later on' (Tickell 2000, p.88).

Today there are standardised derivatives which are traded through an exchange or customised through negotiation by the parties involved, that is, OTC derivatives.

2.2.5 Derivatives in Islamic Finance

In 1997 the Shariah Advisory Council (SAC)[19] of the Securities Commission in Malaysia resolved that the futures contract on crude palm oil was permissible and in accordance with *Shariah* principles (Securities Commission 2006a). Then in 1998, the SAC resolved that the mechanism for stock index futures contracts[20] did not contradict *Shariah* principles, and that stock index trading was allowed as long as it was *Shariah* compliant, and this is done by ensuring that the index components are made up of *Shariah* compliant securities (Securities Commission 2006a).

Later in 2006 the SAC approved another derivative instrument that is, the single stock futures[21] (SSF). As long as the underlying stocks of the SSF were *Shariah* compliant the SSF was considered permissible. Five of the ten SSFs trading on Bursa Malaysia Derivatives Berhad were deemed *Shariah* compliant, namely AirAsia, IOI Corporation, Maxis Communications, Scomi Group and Telekom Malaysia (Securities Commission 2006b).

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[19] The SAC of the Securities Commission in Malaysia was established in 1996 and is responsible for 'advising the Commission on issues related to the Islamic capital market to ensure its consistency with Islamic principles. The SAC analyses *Shariah* principles which can be used for introducing new Islamic capital market and services, as well as evaluates existing conventional capital market instruments to determine the extent to which these instruments comply with *Shariah* principles', (Securities Commission 2006a), p. v. The SAC also conducts *Shariah* compliance review on securities that are already listed on Bursa Malaysia.

[20] 'A composite index futures contract is created when a total number of shares which form the index components are made the underlying asset to the instrument. The share index is a benchmark which indicates the performance of the share/equity market. The contract is an agreement between a buyer and seller to receive and hand over a certain number of shares comprising the selected share components at an agreed price and at a determined future date. However, the agreed price is not paid in full, merely a margin value until a full settlement is made' (Securities Commission 2006a), p.80.

[21] A SSF is a futures contract with an underlying of one particular stock, usually in batches of 100, there is no transmission of share rights or dividends (Farlex 2005).

In the same year, on the 12th of September, the International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) signed a Memorandum of Understanding as a basis for developing a master agreement for documenting privately negotiated *Shariah* compliant derivatives transactions. ISDA and IIFM intend that the agreement will be accepted by *Shariah* advisors and become a standard document used for *Shariah* compliant privately negotiated derivatives around the world (Marra & Haroon 2006).

Again in November 2006, Malaysia witnessed the signing of the derivative master agreement to document Islamic derivative transactions between Bank Islam Malaysia Bhd and Bank Muamalat Malaysia Bhd ('Banks Sign Islamic Derivatives Agreement' 2006).

These developments indicate that despite the objections raised by scholars (discussed under section 3.2) derivatives are present in Islamic finance and are likely to have greater presence. However, derivatives have only made their debut in Malaysia; other countries around the world have not openly accepted derivatives in Islamic finance (Kunhibava 2006).

The next section will lay down the comparison between *Shariah* and conventional law.

2.3 A Comparison - *Shariah* (Islamic Laws) and Conventional laws

The distinguishing factor between Islamic finance and conventional finance lies in the sources of law that govern the two finances. Conventional finance adheres to legislation passed by the State and Common law decisions made by judges when there is a lacuna in the law (this will be collectively described as conventional law for ease of understanding). Islamic finance too, must adhere to State and Common law decisions to operate in the modern financial markets. However the source of law upon which the principles of Islamic finance is based on is *Shariah*.

Shariah literally means ‘the way to a watering place’ (Doi 1984, p.2). It is the path that must be followed by Muslims, and governs man in conducting his life in order to realise the Divine Will. It includes all forms of behaviour - spiritual, mental and physical (Laldin 2006).

There are four fundamental sources of *Shariah* law: the Holy Book - *Al-Quran*, the *hadith*, *ijma* and *qiyas* (Doi 1984).

The first source is the Islamic Holy Book called *Al-Quran.* The Holy *Quran* is the original and eternal source of *Shariah* law. It constitutes messages that Allah (swt) inspired the Prophet (pbuh) to relay for the guidance of mankind. These messages are universal, eternal, and fundamental (Laldin 2006).

The *hadith,* the second foundation of *Shariah,* is next in importance to the *Al-Quran.* It is a piece of information, such as an account, narrative or story and constitutes a record of the *Sunnah* of the Prophet (pbuh), handed down from generation to generation and which has become the rules of faith and practice of Muslims. The *Sunnah* (pl. *sunan)* signifies the custom, habit, or usage of the Prophet (pbuh). It designates his behaviour, mode of action, his sayings and declarations under a variety of circumstances in life (Laldin 2006).

The third source of *Shariah* law is the *ijma. Ijma* means a consensus of opinion of the *mujtahids* (the learned scholars of Islam), or an agreement of the Muslim jurists of a particular era on a question of law (Laldin 2006).

Qiyas is the process of reasoning by analogy of the *mujtahids* with regard to certain difficult and doubtful questions of doctrine or practice, by comparing them with similar cases already settled by the authority of the *Al-Quran* and *Sunnah* and thus arriving at the solution of undecided questions (Laldin 2006).

As for conventional law, there are two defined sources of legal jurisdictions, known as the Common law legal system and the Civil law legal system. Whether a jurisdiction follows a Common law legal system as opposed to a Civil law legal system depends on the historical background of a nation. Common law systems usually descend from the English legal system, and therefore all Commonwealth countries including the US have Common law systems (Lee, RW 1915). Common law systems place emphasis on judicial decisions, which are considered ‘law’ just as are statutes (Long 1994).

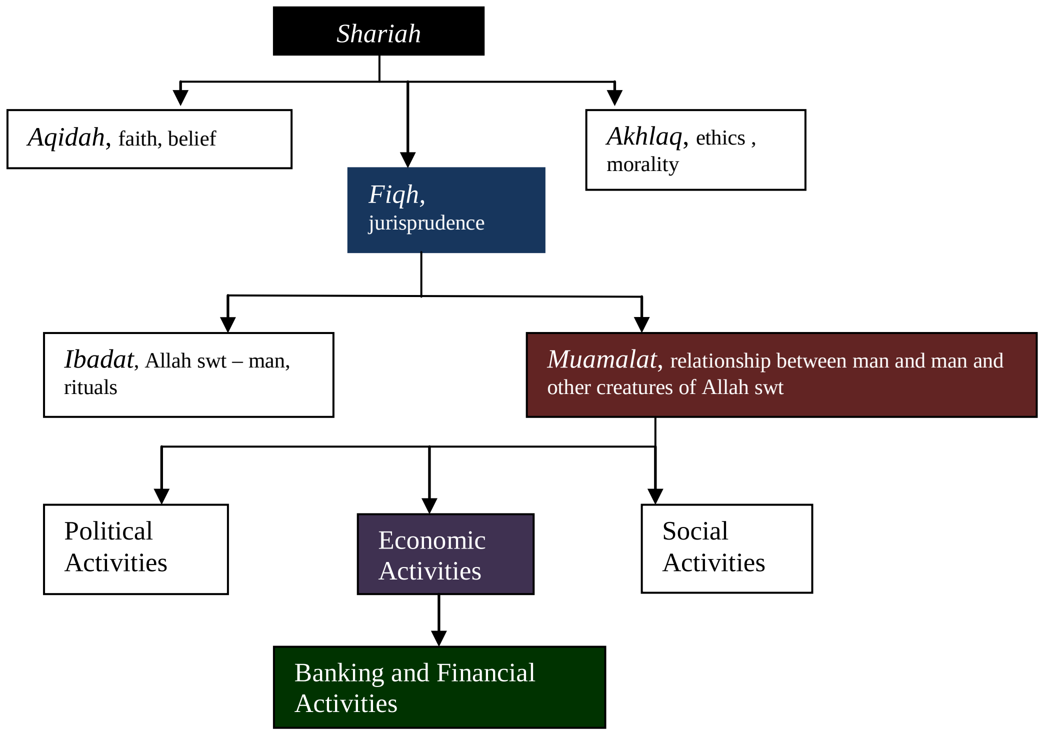
Civil law jurisdictions, on the other hand, descend from Roman law through either the Napoleonic Code or the German Civil Code and also from Canon law. Roman law itself evolved in Rome before the Christian era (Badr 1978). Canon law, on the other hand, is the body of laws and regulations made by or adopted by ecclesiastical authority, for the government of the Christian organisation and its members (Boudinhon 1910).

Under Civil law jurisdictions case law was traditionally given less weight. However, it would seem that the distinction between the two systems are becoming blurred as the importance of judicial decisions in civil jurisdictions are given more weight and with the growing importance of statute law and codes in Common law countries (Long 1994).

While the Civil law legal system descended from Roman law and Canon law, Common law is vaguely described as having been developed from customs or Roman and Canon law (Berman & Greiner 1980) and thereafter institutionalised in the 12 th century by King Henry II (Adams 1924). However Makdisi (1999, p.1638), believes that the origins of Common law are actually from Islamic law, due to the uniqueness of Common law which is separate from any other European legal system, including Roman law and Canon law, but has similarities with Islamic law. This will be discussed further in Chapter 4. Nevertheless it is safe to say that Common law and Civil law share common characteristics. They both deal with the interpretation of man-made laws whether it be case laws or statutes.

On the other hand, *Shariah* deals in religious matters and God-made laws, and therefore differs from Common law and Civil law in that respect. However it is not a religious law the way Canon law is. *Shariah* deals not only with purely religious matters but also with all those subjects which comprise the content of Common law and Civil law legal systems (Badr 1978). *Shariah* comprises of three basic elements, namely, *aqidah*, *fiqh* and a*khlaq*, (Laldin 2006). *Aqidah* concerns all forms of faith and belief in God Allah (swt) and His will, held by a Muslim. *Fiqh* is concerned with governing the relationship between man and his Creator and between man and man (*fiqh* will be further defined below). Finally, *akhlaq* covers all aspects of a Muslim's behaviour, attitudes and work ethics with which he performs his practical actions (Haron 1997). It is with the *Shariah* branch of *fiqh* that Islamic finance is governed. *Fiqh* can be further divided into two areas called *ibadat* and *muamalat*. *Ibadat* is concerned with the practicalities of a Muslim's worship of Allah, whereas *muamalat* is concerned with man-to-man relationships. Nevertheless, aspects such as political activities, economic activities and social activities fall within the ambit of *muamalat* (Haron 1997). Islamic finance, being part of economic activities, is thus linked with *Shariah* principles through *muamalat* (see figure 2.1).

Figure 2.1 Elements of *Shariah*



Sources: Rosly (2006), Haron (1997)

Injunctions relating to *aqidah*, *ibadah* and *akhlaq* are fixed and unchangeable as they are considered to be suitable to be implemented at all times and places. However injunctions of *Shariah* which regulate the relationship between man and man and other creatures change with the changes in circumstance, custom, time and place (Laldin 2006). This includes rulings relating to *muamalat* such as contractual law transactions, criminal law, the judiciary and Islamic finance. It is this feature of *Shariah* that makes it suitable to be implemented at all times as it can accommodate the needs of people in different times and situations (Laldin 2006).

The rulings in relation to *muamalat* are derived from the sources of *Shariah*. However due to the changing circumstances of the world and the needs and interests of the people (*maslahah*) many of the legal injunctions had to be formulated from the sources of *Shariah* through reason by rightly qualified Muslim Jurists. This is known as *ijtihad*, that is, ‘exerting one’s reasoning faculty to determine a point of law' (Abdal-Haqq 1996, p.9). During the time of the Prophet Mohammad (pbuh), the Qur'an was clarified and exampled by the Prophet. After the Prophet's death and the death of the *Sahaba* (Companions), Muslims confronted a number of difficult questions with the spread of Islam into new cultures and lands (Abdal-Haqq 1996). There was a need for proper guidelines on how to derive law from Islamic sources. Thus arose the legal schools or *madhab* which developed a comprehensive set of methodologies on how to interpret *Shariah* (Abdal-Haqq 1996). The process of applying and deducing laws from *Shariah* and the laws thereby deduced is collectively known as *fiqh*.

There are four *madhab* or schools of law for *Sunni* Muslims[22]. The teachings of each school depend largely on the geographical area, although there is a scattering of the followers of all four schools in most of the Muslim world (Badr 1978). The *madhabs*[23] are the *Hanafi, Maliki, Shafi'i* and *Hanbali*.

Since the 10th century the main law-making activity had ceased, and activity of the jurists remained limited to interpretation and explanation of the existing doctrines, bringing it up to date with life as the conditions changed, because it was believed that any principle that could be deduced by *ijtihad* had already been deduced or extracted (Abdal-Haqq 1996). After this time any new decision or *fatwa* (legal opinion) was based on previously recorded

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[22] Approximately 90 percentage of the Muslims in the world are *Sunni* while the remaining are Shia, the differences between the two are basically that the *Shia* principally in Iraq, Iran, Lebonon and Syria, believe that the leadership of the Muslim community the Caliph must be from the Prophets lineage, they await the emergence of a Muslim leader from the line of the Prophet who will embody wisdom and spiritual power of the twelfth Imam. Until that time his representatives, the ayatollahs provide interim leadership. As for the *Sunni* they do not believe that physical lineage is necessary to be a Caliph. The second difference is that the *Shia* continue to believe ijtihad (personal reasoning) as a legitimate source of Islamic law, whereas *Sunni* Muslim prohibit the current use of *ijtihad*. (Abdal-Haqq 1996) This thesis will focus on the legal opinions from the *Sunni* school of law.

[23] The *Hanafi* school was formed in Kufa, Iraq, under Abu Hanafi who lived from 702 to 767. It preserves many of the older Mesopotamian traditions. It based its rulings largely on ra'y - results of logic deduction of its scholars (Ashraf n.d.).

The *Maliki* school comes from Medina, under Malik ibn Anas ibn Amir who from 717 to 801. This school ruled heavily in favour of the practice (*sunnah*) of the local community of Medina, because at the time it was formed, the word *sunnah* did not yet mean "practice of the Prophet" (Ashraf n.d.).

Muhammad Idris ash-Shafi'i (760 to 820 in Egypt) was the first one to systematise Islamic Law. Originally, he studied in Madina under Malik ibn Anas ibn Amir founder of the Maliki school. In his book, the *Risala* (the Message), balancing the two trends, he laid down the sources of Law, *Fiqh*. He fixed them (in order of priority) to be: *Quran Sunnah* of the Prophet, based on: *Hadith* from the Prophet *Hadith* from the Companions of the Prophet *Ijma* and *Qiyas* (Abdal-Haqq 1996).

Ahmad Ibn Hanbal from 778 to 855 founder of the Hanbali school, the latest of the four *madhabs* had followed *Shafi'i* method with ever greater emphasis on the a*hadith*, avoiding reasoning as far as possible, but not completely denying it. Thus, the difference between the schools is primarily in the various weight given to those four components, and in some original decisions remaining from the very beginnings of these schools, and belonging to its first masters (Ashraf n.d.).

determinations made by a particular *madhab*. This concept is known as *taqlid* or conformity and is sometimes compared to the concept of *stare decisis* or judicial precedent in Common law (Abdal-Haqq 1996). However many well known scholars have argued the relevance and importance of *ijtihad* in modern times (such as Doi (1984) and Kamali (1997)).

Therefore, finding the injunctions of Islamic law requires reference to not only the sources of *Shariah* but also the books of *fiqh*. Legal opinion of scholars in Islamic finance often refers back to these sources of law when formulating an opinion on the permissibility of a contract or instrument in Islamic finance. Thus while discussion in this thesis will be on legal scholars' opinion in *Shariah,* conventional law references will be made to case laws and statutes.

Another significant feature of Islamic law which differentiates it from conventional law is the fact that not all acts done under *Shariah* are characterised as legal or illegal. There are intermediate values as to a person's action (Abdal-Haqq 1996). There are generally five categories of assessment. These are acts that are (Abdal-Haqq 1996):

i) obligatory, where performance will amount to a reward and omission will amount to a punishment from God;
ii) recommended, performance of act is rewarded but neglect is not punished;
iii) permitted, acts which neither get reward nor punishment;
iv) discouraged, acts where there is a reward for avoidance but no punishment for performance; and,
v) forbidden, where there is reward for avoidance and punishment for non avoidance.

While in other legal systems an act might be allowed, prohibited or indifferently treated, in *Shariah* an individual is not only guided as to what he is 'entitled or bound to do in law, but also what he or she ought, in conscience, to do or refrain from doing' (Badr 1978, p.189). In other words *Shariah* encompasses legal injunctions and moral or ethical injunctions whereas conventional law is concerned with legal issues alone.

Thus *Shariah* encompasses religious laws and laws other than religion. It is derived from the *Quran, Hadis, Ijma* and *Qiyas*. The process of applying and deducing laws from *Shariah* and the laws thereby deduced is collectively known as *fiqh*. *Shariah* is unwritten law like Common law. Common law legal systems and Civil law legal systems, on the other hand, both involve the interpretation of statutes and case law; they vary only in the degree of the weightage given to either statute law or case law. Hence while discussion in this thesis will be on legal scholars' opinion in regard to *Shariah,* with regard to conventional laws reference will be made to case laws and statutes.

In the following section fundamental injunctions in *Shariah* will be explained to understand the current objections of Islamic scholars towards derivatives discussed in Chapter 3.

2.4 Fundamental Injunctions in *Shariah*

Islam permits and encourages its followers to become involved in trade activities. As stated in the *Quran* in verse 275 of Surah 2: '"Trade is but like usury", but God hath permitted trade and forbidden usury.'[24]

The Prophet (pbuh) in his early life used to be a trader, and, similar to many of his eminent companions, a businessman. The Prophet (pbuh) was once conferred the title of '*amin'* or 'trusted one' because of his honesty in all dealings (Haron 1997). Likewise the principles of Islamic business include honesty and the belief that trade is to be conducted in a faithful and beneficial manner. Trade manipulations and malpractices aimed at earning undue profit through operations like hoarding, black-marketing, profiteering, short-weighting, hiding the defective quality of merchandise, and adulteration cannot be regarded as honest trade (Haron 1997). To ensure honesty, transparency and ethical dealings in trade, fundamental injunctions were established in *Shariah*, such as the prohibition of *riba, gharar, maisir, qimar* and *jahala*. Many of the objections against derivatives relate to the existence of these injunctions. To understand the objections aimed at derivatives it is necessary to describe these injunctions in the following paragraphs.

[24] Translated by, (Ali, AY 1999)

2.4.1 *Riba*, Usury and Interest

The giving and receiving of *riba* is strictly prohibited in Islam. Literally, *riba* means increase, addition, expansion or growth (Ali n.d.). However, not every increase or growth is prohibited in Islam; the prohibition is related to the manner through which an addition is gained (Bakar n.d.). *Riba,* with regards to Islamic finance is taken to mean interest paid to depositors and interest charged upon fund users, and is strictly prohibited in Islam (Usmani 1999). Interest itself is defined as 'an amount, or fee, payable for loaning money to the borrower; interest is usually expressed in a percentage' (Pelanduk 2000, pp.267 - 268).

The prohibition of *riba* is not a new phenomenon. Until a few hundred years ago any extra amount demanded by the lender in addition to his capital was called usury. Early European philosophers such as Plato (350 BC)[25] and Aristotle (350 BC)[26] condemned the practice of taking usury. Further, the issue of *riba* is an old religious issue, not only in Islam but also in Judaism, Christianity (Kharofa 1993), Hinduism and Buddhism (Wayne, Visser & McIntosh 1998).

Ancient records from *Vedic* texts in India (2,000–1, 400 BC) and later in the *Sutra* texts (700–100BC) and in Buddhist *Jatakas* (600–400 BC) show a contempt for usury (Wayne, Visser & McIntosh 1998).

However, by the 2nd century AD and afterwards, the concept of usury was less stringent where a differentiation was made between prevailing socially accepted range of interest and the amount charged above interest was termed as usury, the latter being condemned (Wayne, Visser & McIntosh 1998).

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[25] Plato (427-347 BC), Laws, Book V:
"In marrying and giving in marriage, no one shall give or receive any dowry at all; and no one shall deposit money with another whom he does not trust as a friend, nor shall he lend money upon interest; and the borrower should be under no obligation to repay either capital or interest" (Plato 360 B.C.).

[26] Aristotle (384-322 BC), Politics, Book I, Part 10:
"There are two sorts of wealth-getting, as I have said; one is a part of household management, the other is retail trade: the former necessary and honorable, while that which consists in exchange is justly censured; for it is unnatural, and a mode by which men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of any modes of getting wealth this is the most unnatural" (Aristotle 350 B.C.).

In Judaism, in the Old Testament (Torah) it is stated, ‘if you lend money to any of my people with you who are poor, you shall not be to him as a creditor; neither shall you require usury from him.’ (Ex. 22:25) (*Encyclopedia of Religion and Ethics* 1926). This statement, though, was interpreted to mean that lending through usury was not allowed between Jews but allowed to a non-Jew (Kharofa 1993).

The Christian Church also prohibited all usurious transactions (Gafoor 2002-2004), the Gospel according to Luke reads, ‘Give away to every one who begs of you, and of him who takes away from your goods, do not demand them back again’ (Luke 6:30) in (Kharofa 1993, p.16).

However this prohibition against usury changed, ‘… by the end of the thirteenth century, several factors appeared which considerably undermined the influence of the Orthodox Church. Eventually, the reformist group, led by Luther (1483-1546) and Zwingli (1484-1531), agreed to the charging of interest on the plea of human weakness’ (Gafoor 2002-2004). In the year 1545 the Act of ‘In restraint of usury’ of Henry VIII in England legalised the imposition of interest. This Act fixed a legal maximum interest; any amount in excess of the maximum was usury. The practice of setting a legal maximum on interest rates was later followed by most states of the United States and most other Western nations (Encylcopedia Britanica cited in Gafoor 2002-2004). Hence interest was legalised and usury, which was differentiated from interest only in the amount of interest charged, was not legal. Usury today is referred to as ‘a very high rate of interest’ (Pelanduk 2000, p.466).

In Islam, *riba* is categorically prohibited through both the *Qur'an*[27] and the *Sunnah*[28] of the Prophet leaving no room for any contrary or reverse opinion, (Usmani 1999). However the division of interest and usury has been claimed by a few scholars in Islam (Rahman 1964; Shafaat 2005; Farooq 2006); they believe that the *Qur’an* prohibited only usury and not interest.

[27] Surah 30, *Surah al-Rum*, verse 39, Surah 4, *Surah al-Nisa*, verse 161, Surah 3, *Surah Al-Imran*, verse 130-2, and Surah 2, *Surah al-Baqarah*, verses 275-281

[28] There are many narrations of the prohibition of *riba* through the *Sunnah* of the Prophet (pbuh), an often quoted and well known narration is from Ubada ibn al-Samit: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand” (Muslim, *Kitab al-Musaqat, Bab al-sarf wa bay al-dhahab bi al-waraq naqdan*; also in Tirmidhi quoted from (Chapra n.d.).

This view is in the minority. The majority and overwhelming view, which is the view taken in Islamic finance, is that interest as well as usury is prohibited in Islam. This was decided in the Council of the Islamic Fiqh Academy, during its second session, held in Jeddah 22-28 December 1985, resolution 10/2 (OIC Fiqh Academy 2000):

> Any increase or interest on a debt which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay and increase (on interest) on the loan at the inception of its agreement, are both forms of usury which is prohibited under *Shari'a.*

The taking or the giving of interest and usury is therefore prohibited in Islam. Therefore currency options and futures will not be included in the discussion since the overwhelming majority of jurists (such as Obaidullah (1999), Usmani (2002), El-Gamal (2006)) require currency exchange to be by spot settlement, otherwise the rule of *riba* would be infringed.

2.4.2 *Maisir, Qimar, Jahala* and *Gharar*

Qimar or gambling is strictly prohibited in Islam. As stated in verse 219 of Surah 2 of the *Qur'an*: 'They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit."'[29] *Qimar* is often described as *maisir* which means something attained through no effort (Damansari 2007). This is one of the main reasons that gambling is prohibited in Islam. Other reasons include: gambling results in the taking away of one's property without lawful or proper exchange; gambling causes anger and frustration caused by losing; gambling can be addictive and compulsive which may lead to bankruptcy; and further, gambling may cause a person to forget his duty as a Muslim (al-Qardawi 1994).

Jahala on the other hand means ignorance, and when applied to a sale, will cause the sale to be defective. For example if the object of sale or price was unknown to the buyer due to a

[29] Translation by (Ali, AY 1999) Another injunction on the prohibition of gambling in the Qur'an can be found in verse 90 Surah 5 of the Qur'an.

buyer's ignorance then it would be impossible to deliver or receive the price or object of the sale. This sale would thus be invalid due to *jahala* (Al-Zuhayli 2003).

Gharar, also prohibited in Islam, is more difficult to define (Vogel & Hayes 1998), as it is more general and encompasses a number of other elements such as *maisir* and *jahala*. *Gharar* has been defined as 'danger', (Al-Zuhayli 2003, p.82), 'risk', (El-Gamal 2001, p.2) and also a transaction equivalent to 'a zero-sum game with uncertain payoffs' (Al-Suwailem 1999 & 2000, p.1). Al-Zarqa's (1964) in Al-Zuhayli (2003, at p.83) has defined a *gharar* sale as the sale of probable items whose existence or characteristics are not certain, and due to the risky nature, makes it akin to gambling.

Gharar sales are invalid precisely because of the excessive uncertainty and risk involved. An example of such a sale can be found from the *Hadith* narrated by Abu Huraira:

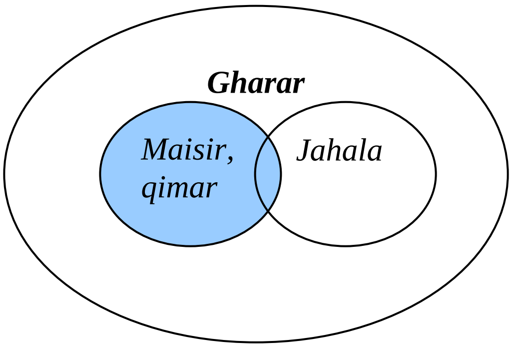
> The Prophet forbade two kinds of sales, that is, Al-Limais and An-Nibadh (the former is a kind of sale in which the deal is completed if the buyer touches a thing, without seeing or checking it properly and the latter is a kind of a sale in which the deal is completed when the seller throws a thing towards the buyer giving him no opportunity to see, touch or check it) and (the Prophet forbade) also Ishtimal-As-Samma' and Al-Ihtiba' in a single garment (Bukhari n.d.).

Maisir or gambling due its high risk and uncertain outcome, and *jahala* sales in which ignorance can lead to uncertainty, are *gharar* and invalid. It follows that *maisir*, *qimar* and *jahala* can be described as the subset of *gharar*. This is because all *jahala* transactions would amount to *gharar* because of the excessive uncertainty involved, but not all *gharar* sales are *jahala*. An example of the latter would be 'in the case of buying a runaway slave with known characteristics' (Al-Zuhayli 2003, p.109). Likewise with *maisir* or *qimar*, all *maisir* or *qimar* transactions are *gharar* because of the high risk involved and uncertain outcome, but not all *gharar* transactions are *maisir* or *qimar*. This is because the term *gharar* does not always result in a zero-sum[30] outcome; for example the sale of milk in an udder, whereas gambling always results in a zero-sum game (Al-Suwailem 1999 & 2000, p.64). Between *jahala* and *maisir* or *qimar* there would be no relationship unless in cases of extreme ignorance a person goes ahead with the transaction; then this could amount to a gamble or where a person is

[30] This is a game in which whatever one party gains is what the other loses.(Al-Suwailem 1999 & 2000)

gambling and he is ignorant of the consequences or other facts of the game. Below is a pictorial representation of the relationship between the injunctions *gharar*, *maisir*, *qimar* and *jahala*.

Figure 2.2 Relationship of *Gharar*, *Maisir* and *Jahala*



How do the above injunctions relate to derivative trading? Derivative trading has been accused of being *gharar* and a form of *maisir*, due to speculation, (Wilson 1991; El-Gamal 1999; Khan, MF 2000; Obaidullah 2001; Kahf 2002; Al-Suwailem 2006; DeLorenzo).

Speculation itself is not considered to be "unIslamic" (Khan, A 1988). This is because speculation exists in all forms of businesses, such as *mudarabah*[31] and *musharakah*[32] (Kamali 1999). The concern is when speculation turns out to be a zero-sum nature of a game that resembles *maisir* and *gharar* (Obaidullah 2002). What this means is that when speculation is used to create wealth as in *mudarabah* and *musharakah* it would be acceptable, but when speculation is used for wealth transfer only, that is, from one party to another, as in cases of gambling and loaning money based on *riba*, then this would amount to speculation which is a zero-sum game as in gambling.

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31 For Islamic financial institutions, the word *mudaraba* is basically an agreement between at least two parties, that is, a lender, sometimes known as an investor *(rabb al-mal)*, and an entrepreneur, also known as an agent-manager *(mudarib)*. The distribution of profit between two parties must necessarily be on a proportional basis and cannot be a lump sum or guaranteed return. In the case of loss where this loss is a result of circumstances beyond the control of the *mudarib*, the investor will bear all financial risk and the *mudarib* loses his time and effort only. (Haron 1997)

32 Musharaka means a joint-venture agreement between two parties to engage in a specific business activity with the aim of making profit. The termination of an agreement may be based on time or after fulfillment of a certain condition. In this principle, both parties will provide capital and the investor or lender may also participate in the management. Profit will be shared between the two parties in the agreed ratio and the ratio need not coincide with the ratio of participation in the financing of the activity. However, in the event of a loss, all parties bear the loss in proportion to their share of financing. (Haron 1997)

In Islam, wealth creation is important, rather than wealth transfer, because wealth decays and new wealth must be created to replace the old wealth (Diwany 2003). If only wealth transfer was to take place, the stock of wealth would not be enough and would eventually be held by a few fortunate human beings. Wealth creation is therefore necessary for the equal distribution of wealth and more fundamentally for the survival of mankind (Diwany 2003).

Some argue that the advantage of the speculators' presence in the market enhances liquidity which enables hedgers[33] to pass their risk on to the speculators (Kamali 1999; Smolarski, Schapek & Tahir 2006). Others argue that the benefits to the hedgers seem to be very little compared to the advantages gathered by speculators (Khan, MF 1997; Obaidullah 1998). 'According to the Office of Comptroller of the Currency (OCC), only five commercial banks account for 96% of total notational amount of derivatives in the commercial banking system in the U.S. Further, only 2.7% of total derivatives are used by end users, that is, corporations assumed to hedge their risks, while the remaining 97.3% is used by dealers (OCC, 2005) … This shows that end users, and thus hedgers, are minorities in the derivatives market. Speculators dominate the market' (Al-Suwailem 2006, p.43).

In summary *maisir*, *qimar*, *jahala* and *gharar* are prohibited in Islam. Speculation per se is not prohibited, especially where wealth creation takes place. However, where speculation leads to a zero-sum result akin to gambling it has been opined that it falls under the prohibition of *maisir*, *qimar* and *gharar* (this will be discussed further in Chapter 3).

2.4.3 *Halal* and *Haram*

Halal is that which is permitted, with respect to which no restriction exists, and the doing of which Allah (swt) has allowed. *Haram* on the other hand is that which Allah (swt) has absolutely prohibited. The principle is that all is permissible unless it has been explicitly prohibited, that is, the general rule is permissibility and the exception is those items which are *haram* (al-Qardawi 1994).

33 For a definition see glossary at Appendix 10.

The reasons why items are declared to be *haram* are due to their impurity and harmfulness. The impurity or harmfulness may be hidden or may not be discovered during one's lifetime. Examples of things which are *haram* include gambling, alcohol, prostitution and pork consumption (al-Qardawi 1994).

The legality of derivatives in Islamic finance requires that the underlying asset of the derivative is *halal*, otherwise the derivative would be outright invalid. For example in regard to equity options, the equity stocks must meet some additional criteria to conform to Islamic norms, that is, all business activities of the company issuing the stocks should be *halal* and permissible (Obaidullah 1999).

2.5 Summary

This chapter traced the history of derivatives over 4000 years in the past. Modern derivative markets as we know them today, however, only began in the late 19 th century.

This chapter also explained the sources of law of Islamic finance and compared them with conventional law sources of Common law and Civil law. *Shariah,* the source of law for Islamic finance, encompasses more than just law. It includes religious, moral and ethical injunctions. When comparing *Shariah* with conventional law the former requires one to look at Islamic scholars' opinion on new areas of finance, such as the legality of derivatives in Islamic finance. This requires interpretation by the scholars of classical *fiqh* texts to come to an opinion on the legality of derivatives; whereas conventional law requires one to search case law and legislation to find legal objections. This chapter explained the *Shariah* injunctions of *riba*, *maisir, qimar, jahala* and *gharar*. *Maisir, qimar* and *jahala* were found to be subsets of gharar, and speculation which results in wealth creation was found to be permissible unlike speculation which leads to a zero-sum outcome.

The next chapter will compare the legal objections of derivatives in Islamic finance and conventional finance.

Chapter 3 *Shariah* and Conventional Law Objections to Derivatives: A Comparison

3.1 Introduction

The previous chapter established the background necessary to compare the *Shariah* objections with conventional law objections.

This chapter will examine the *Shariah* objections of scholars of Islamic finance to the permissibility of derivatives. These objections will then be compared to the objections raised in the 17th, 18th, 19th and 20th centuries towards the adoption of derivatives by conventional finance in the UK and US.

In turn this chapter will answer the first subsidiary research question - **How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance?**

3.2 *Shariah* and Legal Objections to Derivatives

The literature in Islamic finance and conventional finance has aptly discussed the legality or otherwise of derivatives, but what has yet to be done is a comparative study on the legal objections between these two fields. This chapter attempts to fill this gap by comparing the legal objections to derivatives in Islamic finance with conventional finance. Firstly, the legal objections in Islamic finance are discussed and then the legal objections in conventional finance are discussed. Thereafter comparisons between the two are made.

When comparing the legal objections to derivatives in Islamic finance with conventional finance it should be noted (from section 2.3) that the sources of the legal objections between the two vary. In Islamic law, in areas which are not covered by the *Al-Quran* and *hadith, fiqh* must be used to derive the appropriate *Shariah* laws on the subject matter. This is conducted by highly learned scholars. In the discussion below on the legal objections in Islamic finance, scholars' opinion in regard to *Shariah* is referred to. However, with regards to conventional laws, legal objections are made from case laws and statute.

3.2.1 *Shariah* Objections in Islamic Finance

Discussions on derivatives and their legality or otherwise in *Shariah* only began from the 1980s when Islamic finance itself began to emerge and develop. Therefore, the *Shariah* objections to derivatives in this thesis are discussed from the 1980s onwards. However reference to classical *fiqh* authorities will be made to explain how and why contemporary scholars in Islamic finance object to derivatives.

The main *Shariah* grounds as to why derivatives have been objected to by contemporary scholars in Islamic finance may be summarised in the following points:

1. Futures sale being the deferment of both counter values is a sale of one debt for another, that is, *bai al kali bi al kali*, which is forbidden by *Shariah*.

2. Both counter values in future sales are non-existent at the time of the contract – neither the money, nor the goods. It is therefore not a genuine sale but merely a sale or exchange of promises. A sale can only be valid in *Shariah* if either the price or the delivery is postponed but not both.

3. Options sales are a mere right to buy or sell; charging of fees for this is not permissible.

4. For a sale to be valid there must be a transfer of ownership of the item sold, therefore if the seller does not own the item he cannot transfer ownership. The rationale behind taking possession is to prevent *gharar*. This issue is sometimes separated from another legal objection against derivatives, and that is, that futures sales fall short of meeting the requirements of *qabd* or taking possession of the item prior to resale (Kamali 1996). In this thesis these two issues will be discussed under one heading because both point to the issue of the seller not owning or possessing the goods before resale.

Further, other legal opinions have discussed these two issues under one legal objection and not two (OIC Fiqh Academy 2000).

5. Futures and option trading involves speculation and verges on *maisir, qimar* and *gharar.*

Having given an overview of the objections it is now necessary to discuss in detail how the scholars came up with these legal objections.

3.2.1.1 Futures Sale is a Sale of One Debt for Another

The exchange of a debt for a debt, also known as *bai al dayn bi al-dayn* or *bai al-kali bi al-kali*, has been generally found to be prohibited in Islamic law by Islamic scholars (Al-Zuhayli 2003, p.79). Imam Ibn Hanbal, founder of the Hanbali school, ruled that common consensus (*ijma al nas*) has forbidden the sale of debts (Kamali 1996). There also exists a *hadith* which reports that: 'Musa ibn Ubayd reported from Abd Allah ibn Umar simply that the "the Prophet prohibited *bai' al kali bi al kali*"' (Al Shawkani, p.176, translated in Kamali 1996, p.212).

An example of exchange of a debt would be where Baker A borrows 50 litres of milk from farmer B to be returned after six months. Farmer B in the meantime sells the milk (indebted to him) to Baker C in return for 5 bushels of wheat to be delivered in two months. This is an exchange of a debt by Farmer B to Baker C and is prohibited. The underlying reason being that there would be *gharar* due to the uncertainty whether there would be actual delivery (Al-Zuhayli 2003).

This general prohibition has been ascribed to futures. The sale of futures contracts, where parties can offset their transactions by selling the 'debts' owed to them by other parties (before the delivery of the underlying asset) will amount to a sale of a debt and is therefore claimed to be prohibited (Obaidullah 2001).

For example, A buys 10 bushels of wheat to be delivered in six months at the price of RM10,000. Both the price and the delivery are deferred except for the small margin amount that has to be paid by A. After three months A sells the 10 bushels of wheat at RM12,000, both counter values to be delivered in three months. The wheat has yet to be received by A and it is a debt owed to A which he is selling; this has been declared to be prohibited because it is the selling of a debt for a debt, that is, the RM12,000 payable in three months.

This objection is refuted by Kamali (1996). Kamali (1996) claims that the evidence shows that it is not possible that there exists a common consensus prohibiting the exchange of debts because the 'legal schools have recorded divergent rulings' as to the definition of what *bai al kali bi al kali* is. Even the hadith 'only appears in some collections and many prominent scholars consider it to be unreliable' (pp.212-214). Further Kamali (1996), argues that there is no clear prohibition of the exchange of debts with a number of scholars actually allowing it; and therefore in the absence of a clear prohibition on the sale of a debt the principle of permissibility must prevail provided it is devoid of *riba* and *gharar*.

Kamali (1996) turns to futures trading itself, and states that the nature of the futures contract makes it a contract between the purchaser (or seller) and the clearing house only. There is no third party involved in the transaction, thereby there are no uncertainties over clearance and delivery. 'In other words, the price was a debt on the clearing house, which is the principle party in the transaction … it acts in the capacity of a fully committed guarantor' (p.213). Therefore, future contracts involve the fulfilment of obligations and debt repayment by the debtor, which is allowed in Islamic law.

In the researcher's opinion the argument set forth by Kamali is very valid for this objection against futures, because of the nature of futures transactions. It is a fact that the clearing house acts as the seller for each buyer and the buyer for each seller in all futures transactions. Each transaction is guaranteed. There is no direct interaction of one trader with another trader. There is therefore, no exchange of a debt for a debt, as each transaction ends with the exchange of buying or selling the futures contract.

3.2.1.2 Both Counter Values in Futures and Options Sales are Non-existent or Deferred

In Islamically permitted contracts only one of the counter values of the contract is allowed to be deferred and non-existent, (for example the *salam* contract). Where both the counter values are deferred and non-existent at the time of the contract, as is in the case of futures and options, *Shariah* objects to its permissibility.

According to the Mejelle, the Ottomon Civil Code, (elaborated between 1869 and 1875 and based on the *Hanafi* law of fiqh), in art. 197 of the code provides that 'the thing sold must be in existence' and art. 205 further provides that: 'the sale of a thing which is not in existence is void' (*The Mejelle English Translation of Majallah el-Ahkam-i-Adilya and a Complete Code on Islamic Civil Law* n.d.).

Mahmassani (1983, p.327), has stated that contracts to sell future things, except for the *salam* and *istisna* contracts, are invalid in *Shariah* because such things are non-existent. In the case of *salam* or even *istisna* only one of the goods is deferred at the time of the sale. This is allowed in *Shariah.* However, the non-existence of both counter values of the contract, in the case of both futures and options, amounts to unwarranted risk-taking and *gharar* that is filled with uncertainties over the prospects of fulfilment.

This opinion is also held by the Organisation of the Islamic Conference (OIC) Islamic Fiqh Academy. The Islamic Fiqh Academy when holding its Seventh session in 1412 H (9-14 May 1992) made the following resolution:

> ... where the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. It also stipulates that it shall end with the actual delivery and receipt of the merchandise. This contract is not permissible because of the deferment of the two elements of the exchange. It may be amended to meet the well-known conditions of "salam" (advance payment). If it does so it shall be permissible (OIC Fiqh Academy 2000, resolution no. 63/1/7).

This decision of the OIC Fiqh Academy was confirmed by the European Council for Fatwa and Research[34] (*European Council for Fatwa and Research, Final Statement of the Twelfth Ordinary 6-10 of Dhul-qi'dah, 1423 AH, 31 December 2003 - 4 of January 2004* n.d).

Usmani (1996) also found futures transactions impermissible because according to *Shariah* the sale or purchase cannot be effected for a future date.

These opinions are based on a number of *hadith* and opinion of classical *fiqh* jurists of the *Shafii, Hanbalis* and *Hanafis*. According to Al-Zuhayli (2003, p.74) the 'top scholars of all schools of jurisprudence have agreed that the sale of non-existent objects and objects that may cease to exist', is not valid. For example the 'the sale of fruits and plants, before they appear … sale of pearls in shells, milk in udder, wool of the back of sheep, and a book before it is printed' (Al-Zuhayli 2003, p. 75). Examples of *hadith* prohibiting non-existing goods are as follows:

1. Jabir narrated that the Messenger of Allah (pbuh) forbade the selling of fruits until they ripen, (Sahih Muslim, 915) (Bukhari 1487).

2. Abu Bakhtari reported: I asked Ibn Abbas about selling of dates. He replied; "The Prophet (pbuh) forbad the sale of dates until they became fit for eating and could be weighed." A man asked: "What to be weighed?" Another man sitting beside Ibn Abbas replied, "Until they are estimated." (Sahih Muslim. 916), (Bukhari 2246).

3. Ibn Abbas reported: "The messenger of Allah (pbuh) prohibited the sale of fruit before its quality is known, the sale of wool on the back of sheep, and the sale of milk in a udder" Al-Tabarani Quoted in Al-Zuhayli (2003, p. 75).

The reason for ruling these contracts of non-existent assets as invalid is due to *jahala* and the existence of *gharar*. There is ignorance, uncertainty and excessive risk in the knowledge of the quality and quantity of the non-existent asset (Al-Zuhayli 2003). For example, in the case

[34] The European Council for Fatwa and Research is a 'Dublin-based private foundation, founded in London on 29 March - 30 March 1997 on the initiative of the Federation of Islamic Organisations in Europe, the European Council for Fatwa and Research is a largely self-selected body, composed by Islamic clerics and scholars, presided by Yusuf al-Qaradawi… Its fatwas often rely on the four classical Islamic law schools (four schools of Fiqh), as well as all other schools of the people of Islamic law (Fiqh) knowledge' see (Wikipedia)

of the sale of wool off the back of sheep this is uncertain as the wool is continuing to grow, making demarcation difficult (Al-Zuhayli 2003).

However Imam Malik opined in the case of the sale of milk for a specified number of days from the udder of a herd of sheep whose milk is homogeneous and productivity is known, as allowed, but not the sale of one sheep's milk from the udder. As for the wool on the back of the sheep Imam Malik also ruled it to be valid since it was observable and deliverable (Al-Zuhayli 2003). This opinion illustrates that where *jahala* and *gharar* are minimised sale of items which are nonexistent may be allowed.

Opinions of Ibn Al-Qayyaim and his teacher Ibn Taymiyah of the *Hanbali* School (*fuqaha*), permitted the sale of items that did not exist at the time of the contract, if their future existence is known according to custom. Their reasoning was based on the fact that there was no distinct prohibition in the *Al-Quran* or *hadith*, and the *hadith* that did prohibit sales of non-existent goods were describing situations of excessive risk and uncertainty, where the object may not be deliverable. They find that the sale of a non-existent object is forbidden if there is ignorance about its future existence. The prohibition is based on excessive risk and uncertainty (*gharar*) and not based on the lack of existence (Al-Zuhayli 2003).

Zahraa and Mahmor (2002) opine that although:

> A substantial majority of Muslim scholars stipulate that the subject matter must be in existence at the time the sale is concluded as an essential ingredient of the validity of the sale … the non-existence of the subject matter does not necessarily invalidate the sale. … the absence of uncertainty and the doubt regarding the qualitative and quantitative description of the subject matter as well as the safe availability rather than existence of the subject matter is the prime concern for the validity of the contract of sale, (p.397).

A similar approach is taken by Kahf (2002), who though agreeing with the OIC Islamic Fiqh Academy decision that the classical *fiqh* position of the prohibition against delaying both items in a sale contract would make futures impermissible, added a practical reservation to the decision in relation to real life contracts. The scholar states[35]:

> ... businesses require planning in advance and all parties have to contract their products and their inputs in advance regardless of the idea of financing (remember that *salam* is only a financing contract). The simplest example is the letter of credit. It always includes sale with postponement of both delivery and price and they are both affected in a future date at the same time. I believe that the evidence from the *Sunnah* against postponement of the two items is very weak and there is no claimed "*ijma*" on this issue that I find one of the necessities of life to the extent that it is impossible that our complete *Shariah* would make it unlawful. Yet this is not to say that futures are permissible because I think only genuine trade with postponement of the two exchanged items (price and goods) is permissible not the speculative practice on price change only as it is normally in commodity futures.

Therefore, Kahf (2002) is of the opinion that deferment of the two counter values should be permissible due to the necessities of life. However, due to the speculatory nature of futures ('only a small percentage, 3-4% ends implemented' (Kahf 2002)) they should not be allowed.

Kamali (1999) opines that nonexistence of the counter values in a futures or options contract will not amount to g*harar* because of the guarantee function of the clearing house, which exists for the purpose of preventing uncertainty and *gharar* over the fulfilment of the contract. 'This is an unprecedented *gharar* prevention measure in the history of commerce in that the guarantee function we have here leaves nothing to chance, to the vagarities of climate, politics, or of the market-place' (Kamali 1999, p.532).

Finally, when the Malaysian Securities Commission Shariah Advisory Council at the 11th Meeting on 26 November 1997 resolved that the futures contract on crude palm oil was permissible, it discussed the issue of buying a non-existent asset (*bai ma'dum*). They clarified that the prohibition of *bai ma'dum* was actually due to the presence of the element of uncertainty to hand over the goods sold. *Bai ma'dum* is prohibited because of the element of *gharar* rather than the element of *madum* (Securities Commission 2006a, pp. 77-78).

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[35] No page number can be provided for this quote because the legal opinion (fatwa) is taken from a web page.

Therefore, it can be seen that generally, the non-existence of the underlying asset may invalidate a contract. However, it is not the non-existence of the asset but rather the existence of *gharar* that makes the contract invalid. If *gharar* can be removed then the non-existence of the subject matter at the time of the contract should not invalidate the contract.

3.2.1.3 Options Sales is a Mere Right to Buy or Sell - Charging of Fees for this is Not Permissible

In an option contract for the right given to buy (or sell) the underlying asset at a predetermined exercise price, a payment of a premium is required.

According to Usmani, (1996, p.10), an option is a promise and such a promise itself is permissible and is 'normally binding on the promisor'. However the fact that option transactions charge fees on the promises makes them invalid under *Shariah*. This ruling, he opines, applies to all kinds of options, no matter whether they are call or put options.

This view is based on the fact that options are rights and not tangible assets and therefore cannot be the subject matter of a sale and purchase. As stated by the Organisation of the Islamic Conference (OIC) Islamic Fiqh Academy[36] when holding its Seventh session in 1412 H (9-14 May 1992) resolution no. 63/1/7:

> Option contracts as currently applied in the world financial markets are a new type of contract which do not come under any one of the *Shariah* nominated contracts. Since the object of the contract is neither a sum of money nor a utility or a financial right which may be waived, then the contract is not permissible in *Shariah*.

[36] The Islamic Fiqh Academy is a subsidiary organ of the OIC, created by the Third Islamic Summit Conference held in Makkah al-Mukarramah (Saudi Arabia) in Rabiul Awwal 1401 H (January 1981). It is based in Jeddah (Saudi Arabia). Its members and experts are selected from among the best scholars and thinkers available in the Islamic world and Muslim minorities in non Muslim countries, in every field of knowledge (Islamic Fiqh, science, medicine, economy and culture, etc.). One of its objectives are to tidy problems of contemporary life and to undertake an authentic and effective analysis thereof with the purpose of providing solutions based on Islamic Shari' and culture and open to forward looking Islamic thought' see (The Islamic Fiqh Academy) The Islamic Fiqh Academy passes resolutions which are fatwa or legal opinions, which are highly regarded in the Muslim world but are not legally binding.

This decision of the OIC Fiqh Academy was confirmed by the European Council for Fatwa and Research (see section 3.2.1.2).

This same stance is taken by Delorenzo (n.d), where the scholar opines that the sale of options is prohibited for the reason that it involves the sale to another party of nothing more than a right to buy.

Under Islamic law, trading of intangibles such as service and usufruct (*manfaah*) are recognised. However, a right given under an option may not be the same thing as an usufruct. The rights under an option do not have a tangible or material quality. They are similar to a preemptive right such as the right of custody and guardianship, which are allowed in *Shariah* but are not allowed to be sold against monetary compensation (El Gari 1993, p.13).

Kamali (1997, p.27) disagrees that a compensation is impermissible. He affirms that the concept of options is valid under *Shariah* under the concept of *al-ikhtiyarat* and that the origin of *al-ikhtiyarat* is traceable in the *Sunnah*, and has further been developed through initiative and *ijtihad*, in the juristic writings of the *ulama* (scholars learned in Islamic law). On the issue of options being a mere right and therefore incapable of sale and purchase, Kamali groups the right given under an option under intangibles such as service, and usufruct (*manfaah*) and concludes that while the *Shafii* school and the *hanbalis* have included usufruct under the definition of property, the *Hanafis* and *Malikis* have not. However, the legal jurists of the *Hanafis* and *Malikis* of later periods have generally included usufruct in the definition of property.

Kamali (1997) continues his argument on whether compensation is allowed under the *Shariah* by stating that the typical *al-ikhtiyarat* (option) that the *Sunnah* validates is the option of stipulation (*khiyar al-shart*) which grants to the buyer the option within a time frame either to ratify the contract or to revoke it. Under such options, Kamali (1997) maintains that the *Sunnah* entitles the parties the freedom to insert stipulations that meet their,

> legitimate needs and what may be of benefit to them. Nevertheless, the liberty that is granted here is subject to the general condition that contractual stipulations may not overrule the clear injunctions of *Shariah* on *halal* and *haram*. Provided that this

> limitation is observed, in principle, there is no restriction on the nature and type of stipulation that the parties may wish to insert into a contract (p.29).

Based on this argument of freedom to contract, Kamali (1997) opines that the freedom to insert stipulations in contracts includes the request for monetary compensation. Thereby Kamali concludes that the imposition of a fee for the right granted by options is valid under *Shariah*.

Obaidullah strongly disagreed with this stance taken by Kamali. Obaidullah (1998) does not dispute the validity of a sale with a condition where the condition is a stipulation of an option, *khiyar al-shart*. Obaidullah even states that the contractual price is valid if it includes any compensation for the benefit provided by the seller for being at a disadvantage. However in conventional options,

> trading would imply separation of the compensation component and its up-front payment to the option writer or seller under a separate contract … a promise or obligation cannot be the object of sale according to an overwhelming majority of scholars … In classical *Shariah* law, before *daman* (compensation) can operate one needs to show some illicit act (*taaddi*) or negligence (*tafrid*) by the party required to compensate ... Kamali also fails to cite a single reference of the great *fuqaha* (an expert in *fiqh*) of the past on the use of *daman* in the *bai wa shart* framework (Obaidullah 1998, p.80).

In other words some disadvantage must have occurred before payment of compensation is allowed.

In the researcher's opinion the only issue here is whether a right given in an option is valid under a sale and purchase agreement as the subject matter of the sale. A 'right' being intangible is argued to be not a property by the Fiqh Academy (1992), El-Gari (1993) and Obaidullah (1998). However if a service and usufruct is considered to fall under property and therefore allowed to be a subject matter of a sale why shouldn't a right provided under an option? The differentiation of a right from services and usufruct seems artificial, especially when an option is used to hedge and provides the buyer the right to prevent losses. Kamali's (1997) view is preferred. Further the argument that the seller has to experience a disadvantage for compensation to be given applies in options. Since the options buyer is not obliged to buy or sell the underlying commodity, he may let the option lapse, in which case his greatest loss would be the premium. However, the seller’s gain would be the premium alone and losses could be unlimited depending on the price movement of the underlying asset. It is therefore a more disadvantageous position that the seller or the writer of the option takes and therefore, the giving of compensation should be allowed under the circumstances.

3.2.1.4 Futures Sale Falls Short of Taking Possession of the Item Prior to Resale

In futures and options transactions the majority of buyers and sellers reverse out of their position before delivery or maturity. This means that in futures and options physical delivery hardly ever takes place. For example 99% of all contracts are settled before maturity in futures (Al-Suwailem 2006, p.43). This feature of derivative trading, that is, of selling before delivery is made, and selling something which one does not possess, has been subject to intense criticism by Islamic scholars (as discussed below), and has been one of the grounds on which derivatives has been objected to.

Khan A. (1988, p.98) states that in a futures market only 1% of the contracts actually mature into physical delivery. Therefore commodities are non-existent, there is no physical transfer or delivery, and successive sales are made without anyone actually owning the commodity. Therefore, he concludes that all transactions in the chain are unlawful**.** Khan A. (1988) gives his reasoning that a number of intermediaries make money without adding any time, place or form of utility to the commodity. Thus, some people earn money without giving anything in recompense. Actual physical delivery of the commodity is good because it creates jobs from storage, transport and packaging.

The Islamic Fiqh Academy at its Seventh session in 1412 H (9-14 May 1992) resolution no. 63/1/7 came to the following legal opinion - where,

> the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. The contract, however, does not stipulate that it shall end with the actual delivery and receipt of the merchandise, and thus it may be terminated by an opposite contract. This type of contract is the most

> prevalent in the commodity markets. It is not at all permissible', moreover, 'it is not permissible to sell a merchandise purchased under "salam" terms with advance payment unless the merchandise has already been received' (OIC Fiqh Academy 2000).

This decision of the OIC Fiqh Academy was confirmed by the European Council for Fatwa and Research (*European Council for Fatwa and Research, Final Statement of the Twelfth Ordinary 6-10 of Dhul-qi'dah, 1423 AH, 31 December 2003 - 4 of January 2004* n.d).

A similar opinion was formed by the Islamic Fiqh Academy (India)[37], Ninth Seminar (year was not given), when discussing buying and selling before getting possession, although the Indian Academy did not specifically name futures and options contract in particular. However, they did opine that a, 'selling deal before getting possession' is prohibited because there is always a risk of rescission. This means that unless the sold off property does not come under the real possession of the first buyer it may be possible that the sold off property may not come under his ownership at all and hence he might not be able to hand over the same to the second buyer (The Islamic Fiqh Academy n.d.).

Usmani (1996) contends that in most future transactions, delivery of the commodities or their possession is not intended. In most cases the transaction ends up with the settlement of difference of price only, which is not allowed in *Shariah*.

Naughton and Naughton (2000) and Chapra (1985) opine that short selling or the sale of securities that the seller does not own at the time of the sale or does not intend to deliver, serves no proper economic function and the public interest would be better served by prohibiting short sales and requiring a 100% margin.

This same stance is taken by El Gari (2006), where he states that a commodity bought under a forward or future contract must be delivered before being disposed off by sale, that is, the buyer must wait until delivery to be able to sell the same:

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[37] Islamic Fiqh Academy in India was established in June 18, 1990 through registration as a trust. The Islamic Fiqh Academy Council of Founders comprises of 17 distinguished and renowned Scholars. An eleven member Academic Council has been constituted to supervise, monitor and improve the academic programs of the Academy. A three member organizing committee looks after the arrangement and organizational aspects of the *Fiqhi* Seminars. The central office of the Academy is situated at Jamia Nagar, New Delhi (Islamic Fiqh Academy (India)).

> Commodities in organised futures markets are bought and sold several times before actual delivery, otherwise the market will fail to provide liquidity, which is an essential part of the mechanism. But from a *Shariah* perspective, even in standard sale contracts, it is not permitted that the buyer sells before actual receipt of the purchased item (El Gari 2006, p.16).

These legal opinions are based on a number of *hadith*. Examples of the *hadith* are as follows[38]:

1. Hakim b. Hazzam relates that he asked the Prophet (pbuh): "A man comes to me and asks me to sell him something that I do not have. Should I sell it to him and then go and acquire it for him from the marketplace?" The Prophet (pbuh) replied: "Do not sell what you do not have." [Sunan al-Tirmidhi (1232), Sunan Abu Dawud (3503), Sunan al-Nasai (4611), and Sunan Ibn Majah (2187)] (quoted in Al-Suwailem, n.d).

2. Ibn Abbas narrated that the Messenger of Allah (pbuh) said: "He who purchases food should not sell until he takes possession of it." Ibn Abbas said: Every sale is subjected to this condition (Sahih Muslim, 909).

3. Abu Hurairah asked Marwan: "Have you legalised usury?" Marwan said: "No", then Abu Hurairah said: "You have legalised selling promissory notes whereas the Messenger of Allah (pbuh) forbade selling foodstuff unless received by the seller." Marwan then addressed the people and forbade selling such notes. Sulaiman said: I saw the guards taking them away from the hands of people (Sahih Muslim, 910).

Scholars of the different legal schools differ regarding the meaning of what actually should not be sold before receiving possession.

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[38] Kamali (1996) separated his analysis and discussion of the first *hadith* (do not sell what is not with you, pp.205-208) from the rest. The latter three *hadith* he explained under the requirement of *qabd* or possession (pp. 208-211). However other scholars have made no distinction between these two types of *hadith* (see for example Al-Zuhayli (2003, p74 – 76)). This thesis takes the latter approach i.e. all the *hadith* will be discussed under one category because both point to the issue of the seller not owning or possessing the goods before resale, further the legal opinions discussed in 3.2.1.4 have discussed these two issues under one legal objection and not two.

The *Hanafis* have ruled that it is not permitted to resell a movable object of sale prior to receiving it. The *Malikis* ruled that it is not valid to sell foodstuffs prior to receipt whether or not their genus is subject to *riba*. The *Hanbalis* ruled that the sale of food prior to its receipt is not permissible if the food is measured by volume, weight or number, and finally the *Shafii* ruled that it is not permissible to sell items, movable or immovable, where the seller's ownership is not complete (Al-Zuhayli 2003, pp.121-122).

According to Al-Suwailem (n.d.)[39] Ibn Taymiyah's, a Hanbali jurist, opinion is preferred. According to Ibn Taymiyah the 'meaning of "what you do not have" is: "what you are unsure that you will be able to acquire." It may be that the product being sold is not readily available in the marketplace or may only be available at a price higher than the one that it is being sold for. In such circumstances, either the buyer or seller will be injured by the sale. [Refer to Ibn al-Qayyim, Zâd al-Ma`âd]'.

Therefore, according to this opinion, if the product being sold is not in the possession of the seller then he may not sell it, but what he should do is request his customer to give him some time to verify the availability and price of the product and if he wants to purchase it afterwards he can do so. On the other hand 'if the product is easily available to the seller from some other vendor or supplier at a known price, then from a legal standpoint it is effectively – though not literally - in the seller's possession. In this case, such a sale does not come under the Prophet's prohibition' (Al-Suwailem, n.d).

Kamali (1996) highlights that contemporary writers such as Musa (1954), al-Qadir (1982), and al-Qardawi (1987), have drawn attention to the fact that the marketplace of Madinah during the Prophet's time was so small that it could not guarantee regular supplies at any given time; this could therefore explain the prohibition stated in the *hadith*, that is, uncertainty with regard to the ability to deliver. However, in modern times where the seller can find the goods at almost any time and make the necessary deliveries, such a prohibition would no longer be applicable; the fear of not being able to find the goods and make delivery 'is now irrelevant' (Kamali 1996, p.208).

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39 No page number can be noted because this is from a webpage.

To summarise the legal opinions stated above - for a sale to be valid there must be a transfer of ownership of the item sold, therefore if the seller does not own the item he cannot transfer ownership. The paramount reason for this prohibition would seem to be due to *gharar,* or the uncertainty about delivery of the goods purchased (Obaidullah 1998). However according to Ibn Taymiyah if the item is easily available in the market then the prohibition would not apply. This opinion fits well with the reason for the prohibition, that is, to prohibit *gharar*; if the commodity or asset is easily available there will not be an issue of *gharar*. This opinion also has practical utility, in that a person prohibited from selling items he did not possess but knew he could easily obtain, but would have to first possess the item before reselling it, would cause a delay in the completion of commercial transactions. Further, international business would be highly hampered and difficult to complete, especially global trade between countries.

3.2.1.5 Futures and Options Trading Involves *Maisir, Qimar* and *Gharar*

The issue of *gharar* has been raised numerous times in the foregoing discussion; it has been the underlying reason why scholars have objected to:

- the sales of one debt for another;
- sales of non-existent objects; and
- sales of items before taking possession of them.

The following discussion on *gharar,* on the other hand, is linked to the issue of gambling, the zero sum nature of derivatives, and pure uncertainty of the outcome of the contract.

Khan A., (1988) states that in an Islamic framework, speculation per se is not unlawful. However speculators cannot 'thrive' in an Islamic framework because each transaction requires physical delivery. Furthermore, speculation often requires borrowed funds on interest which is not allowed in Islam. Also, in an Islamic economy the liability of the borrower is unlimited; this would not favour speculators who would not want to expose all their assets to an infinite risk. 'Therefore we believe that the Islamic framework leaves little room for speculators' (Khan, A 1988, p. 101).

Wilson (1991, 2007) discusses the validity of futures and options under *Shariah*. Wilson explains that under *Shariah,* the highest moral standards are expected from traders. The responsibilities of traders include not only behaviour which is free of exploitation, and honesty in all dealings, but also that the trade itself should be productive and socially desirable. Wilson opines that these requirements automatically preclude speculative behaviour. For speculative behaviour is 'both unproductive and socially undesirable because of its potentially exploitative nature' (Wilson 1991, p.209). It is for this reason Wilson concludes that forward, futures and option dealing are viewed as 'potentially corrupting', (p.209). Wilson also opines that 'options and futures contracts cannot be traded under *Shariah*, as they are too remote from the underlying assets' which is *gharar* (Wilson 2007, p.14)

Obaidullah (1998, p. 84) asserts that excessive uncertainty or *gharar* leads to the possibility of speculation which is forbidden and 'speculation in its worst form, is gambling'. Obaidullah then goes on to question whether conventional options involve excessive risk. He notes that in options the buyer and seller have diametrically opposite expectations. The gains of the buyer equal the losses of the seller and vice versa; the sale of options is a risky zero-sum game. Obaidullah explains that the possibility to speculate on the future direction of the price of the underlying asset due to the random fluctuation in prices causes the gains and losses to the parties to be random too, resulting in the options contract being nothing more than a game of chance. The gains are therefore in the nature of *maisir,* and the possibility of massive losses indicates a possibility of default by the loser and hence, *gharar*. Obaidullah concludes his discussion on options by stating that 'option as an independent contract may not be suitable forms of hedging or managing risk … these can be used for speculating on price movements and generate unearned income, which violates Islamic norms of financial ethics.' (Obaidullah 1998, p.100).

Obaidullah reiterates this argument in his articles (2001) and (2002) where he extends this argument to futures as well. He states that in the case of options and futures in conventional financial markets the presence of large scale speculation is tolerated on the grounds of providing liquidity and ensuring active markets. The speculators' presence is seen to improve operational efficiency of the market by bringing transaction costs down. However this trade off between tolerance of *qimar* and *maisir* with hedging facility will not apply in the Islamic framework. The zero-sum nature of the game is objected to.

A similar stance is taken by DeLorenzo (n.d). The scholar believes options and futures, both being intangibles, are part of the zero sum markets where gains take place when there are corresponding losses. DeLorenzo opines that this sort of economic activity is clearly forbidden in *Shariah*. The scholar adds that proponents of futures and options markets may argue that these activities perform the function of stabilising prices and regulating risk, but, as far as the *Shariah* is concerned these markets produce nothing of value. He concludes that 'options and futures amount to bets on the direction the market is moving in. Obviously, the ethics of this market are unacceptable' (DeLorenzo, n.d).

El-Gamal (1999) stresses that financial options are pure *gharar*. He goes on to explain that this does not mean that they are necessarily going to be considered invalid forever because if jurists find the benefit for allowing them to be overwhelming, then they may be endorsed. As an example, El-Gamal, explains that the *salam* contract contains *gharar* since the object of sale does not exist at the time of the contract, however it is considered as permissible due to the need of this contract to improve economic efficiency.

Khan, F. (2000) opines that the current futures markets (and option markets), which developed from the forwards market, are a total departure from the original concept and philosophy of forward sales. The futures market today allows traders to sell and purchase futures contracts without the intention of making or receiving delivery. Khan, F., feels that the producers or farmers are forced to compete with the pure speculators and that the futures markets today is an independent industry where traders can earn income by trading risks without getting involved in actual production or delivery of any commodity. Speculators use futures markets to make a great deal of profit by guessing future prices. They make profits without rendering or getting involved in any productive efforts. Khan, F., feels this type of profit through speculation discourages producers and farmers, since when it is possible to make profit without producing then why bother about production? He argues that Islamic economic philosophy does not permit pure speculation. The primary concern in Islam is commodity exchange and not merely financial exchange for the purpose of making economic gains. The Islamic spirit of exchange is totally against this philosophy that isolates the producers from the markets.

Kahf (2002) believes that futures markets are very speculative and only a small percentage ends up implemented, therefore these contracts are inadmissible in Islamic finance.

Al-Suweilam (2006, p.73), explains that in a zero-sum game, one party gains at the expense of the other', it is a 'transfer of wealth for no counter-value'. This he opines is 'condemned in the *Qur'an*'. He explains that in a zero-sum game there is a direct conflict of interest which may create hatred between the two parties which is one of the reasons why *maisir* is prohibited in the *Qur'an*. In the *Qur'an* (6:91) it is stated 'Satan only wants to plant enmity and hatred among you through wine and *maisir*.' Al-Suweilam argues that derivatives are clear examples of zero-sum games. They are obligations to exchange goods with money or just certain amounts of money at a future date. In the latter type of contracts the difference between prices at the time of contract and at maturity is debited from one party and credited to the other, and that is why they are called contracts for differences. Al-Suweilam suggests that to achieve desirable risk transfer, Islamic finance must utilise structures that allow for mutual gain, in other words, nonzero-sum games. 'Such games, while imply the possibility of zero-sum outcome, permit a positive-sum outcome, and thus provide room for mutual benefits' (Al-Suwailem 2006. p.85).

Contrary to the above arguments, Bacha (1999), Kamali (1999) and Smolarski et al (2006), and the Malaysian Securities Commission's *Shariah* Advisory Council (SAC) (2006) opine that speculation per se on the futures and option markets is not impermissible in Islamic finance.

Bacha (1999) believes that elimination of speculative activity would hurt rather than help, because without speculators, hedgers would be hurt.

A similar view point is taken by Kamali (1999). In Kamali's opinion speculation cannot be altogether eliminated, even Islamic transactions such as *mudarabah* and *musharakah* are highly speculative. Kamali opines that 'speculation deals in risks that are necessarily present, but gambling creates the risk that would otherwise be non-existent' (p. 533). Kamali argues that in a futures market risk shifts from those who are unwilling to take it to those who are, and that even if the motivations of a speculator could be identical with those of a gambler there are differences between the two because futures speculation 'reallocates risk from those who do not want it to those who do' (p.534).

Kamali further contends that derivatives lack the vital element of gambling which is the wrongful misappropriation of the property of others. He claims that derivatives facilitate price discovery, hedging 'production planning', 'create trading vehicles', and an 'arena for profitable commerce that can avert the flight of much needed funds to foreign markets' (p.535).

These advantages of derivatives are also highlighted by Smolarski et al (2006) where they claim that the criticisms that options are *gharar* and *qimar* do not take into account its risk reduction utility, where options are bought and sold to prevent losses. The authors further argue that each option contract is 'standardized in terms of duration, quantity, type of option and so on' (p.437). This also means that mutual consent between the parties exist throughout the trading and settlement and clearing processes. Further, the third party which monitors the trading, settlement and clearing process ensures that the terms of the contract agreed to by mutual consent are carried out as promised, which ensures fairness. 'These processes help to ensure that *gharar* prevention is maximized, since there is a substantial reduction in the risk within the financial system. Thus the requirement that functional and operational *gharar* be avoided is largely met' (p.437).

The SAC at the 11th Meeting on 26 November 1997 resolved that the futures contract on crude palm oil was permissible and in its 13th meeting on 19th March 1998 resolved that the mechanism for stock index futures contracts does not contradict *Shariah* principles. As long as the index component is made up of *Shariah* compliant securities the SAC ruled that stock index trading is allowed. In making their ruling the SAC had to deal with issues of gambling, *gharar, jahala* and speculation before ruling that the two types of futures contracts were permissible in *Shariah*.

On the issue of gambling, the SAC explained that the requirement imposed on a market player to place a deposit as a margin of payment before he begins trading did not constitute a bet as some opined. The fluctuation of the value of the commodity (crude palm oil) occurs due to the change in demand in the crude oil futures market and is not a gambling activity because 'gambling activities depend solely on luck and are not related to demand and offer' (Securities Commission 2006a, p.76).

As for the buying and selling of index the SAC ruled that it is not gambling because it has no similarity with losing a bet. The SAC explained that in gambling, the player loses all his money if he makes a wrong guess and the SAC opined that this does not happen in index trading as the total index point has its own inherent value. 'What happens is, the investor will experience a decrease or increase in the value depending on the demand for the total number of shares that comprise the index component. Index trading does not involve any element of betting' (Securities Commission 2006a, p.81).

As for *gharar* the SAC defines *gharar* as something that is not certain. The SAC opined that profit and loss in business is a common factor and that a trader should take steps to minimise it. When a crude oil futures contract is offered, specifications such as quantity, type, price and delivery date are made known to the market players. Therefore there is no element of *gharar* in the contract. 'All specifications are made clear in the contract, and surveillance and regulation are provided to ensure there is no cheating' (Securities Commission 2006a, p.77).

As for stock index futures contracts, the SAC opined that they do not contain elements of *jahala* and *gharar* as they are traded in clear quantities and no vagueness in price or quantity exists. 'The price is determined by the market based on demand and supply' (Securities Commission 2006a, p.81).

On the issue of speculation the SAC stated that speculation exists in all forms of businesses and is not unique to futures transactions.

It is the researcher's opinion that the underlying reasons of the ruling of the SAC seem to have been made in a total vacuum, oblivious to the surrounding *Shariah* scholarly opinion of derivatives at that time. Firstly, as this resolution was made in 1997, the SAC should have known of the arguments by Khan F., Khan, A., the OIC Fiqh Council and Kamali at the very least; none of these authors' arguments were countered or supported. Secondly, none of the arguments of these authors have been dealt with appropriately except for the headings *gharar*, gambling etc. Thirdly, the SAC had not discussed the reality of futures trading. Even though it involves trading in commodity futures most of the players do not take possession. This pertinent feature was not dealt with. If the SAC had sufficiently discussed the various scholarly opinions present at that time, its resolution would definitely have been more persuasive and of heavier weight with regard to the admissibility of derivatives in Islamic finance.

In summary, the majority of scholars believe that speculation in derivatives leads to excessive uncertainty which amounts to gambling. They opine that derivatives are clear examples of zero-sum games, and are mere contracts of differences - a means of gambling and betting. The counter-argument seeks to highlight the advantages of derivatives such as price discovery, creating trading vehicles and as an arena for profitable commerce. Further, they argue that standardisation of the contracts, monitoring by third parties and mutual consent between the parties of the contract help minimise *gharar*.

The various scholars who have objected to the use of derivatives and their reasons for doing so are summarised in table 3.1.

Table 3.1 The Reasons behind the *Shariah* Objections of Scholars in Islamic Finance

Legal Objections	**1**	**2**	**3**	**4**	**5**
Islamic Scholars - legal opinion					
Al-Suwailem					**x**
Chapra				**x**	
DeLorenzo			**x**		**x**
El Gamal					**x**
El Gari			**x**	**x**	
European Council for Fatwa & Research		**x**	**x**	**x**	
Kahf		**x**			**x**
Khan, A					**x**
Khan, F				**x**	**x**
Mahmassani		**x**			
Naughton, S., Naughton, T				**x**	
Obaidullah	**x**		**x**	**x**	**x**
OIC Fiqh Academy		**x**	**x**	**x**	
Usmani		**x**	**x**	**x**	
Wilson					**x**
Total Number of Objections :	**1**	**5**	**6**	**8**	**8**

Key:

1 = A sale of one debt for another

2 = Counter values non-existent

3 = Options sales is a mere right to buy or sell, charging of fees for this is not permissible

4 = Seller does not own or possess the item being sold

5 = Futures and options trading involves speculation and verges on *maisir*, *qimar* and *gharar*

This table illustrates that the highest number of scholars (discussed in this chapter) objected to derivatives based on reasons number 4 and 5 stated above. Another interesting fact is that the main underlying reason for the objections is *gharar.* More on this will be discussed in section 3.3.

The next section discusses the legal objections towards derivatives in conventional finance followed by a comparison with the objections in *Shariah*.

3.2.2 Legal Objections to Derivatives in Conventional Finance

The legal objections to derivatives are not a recent phenomenon in conventional finance. As the history of derivatives began thousands of years ago (see section 2.2), so did the legal objections.

As early as 1250 BC the Israeli laws of the Mosaic code prohibited the sale of future goods. A valid sale required a transfer of money in exchange for existing, specified property in the seller's possession, which was consummated by the buyer by taking possession (Swan, 2000).

Again in the 7th century BC Greek law givers, who transmitted laws through verbal verse form, forbade transactions in commodities for future dealings. It would seem the reason for this was to reduce litigation in the event of default (Swan 2000). Even writings from Plato's Laws reflect that when a contract for exchange takes place, the transfer and the receiving of the price should be made on the spot and no delay in the sale or purchase is allowed:

> When goods are exchanged by selling and buying, a man shall deliver them, and receive the price of them, at a fixed place in the agora, and have done with the matter; but he shall not buy or sell anywhere else, nor give credit. And if in any other manner or in any other place there be an exchange of one thing for another, and the seller give credit to the man who buys from him, he must do this on the understanding that the law gives no protection in cases of things sold not in accordance with these regulations (Plato 360 B.C., Book X)[40].

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[40] Translated by Benjamin Jowett.

However, going so far back into the legal past would not only be beyond the scope of this thesis but would also not be in consonance with the aim of this thesis which is to compare the *Shariah* objections to derivatives with the conventional legal objections to derivatives. The *Shariah* objections from the 1980s are based on the modern type of derivative exchange of futures, and options. The history of derivative usage (Chapter 2) shows that it was in the 17th century that futures traded had similar features with the futures traded on the exchange markets today. It is also at this point in history where legislation on derivatives can be seen to emerge.

Hence, the main starting point in this thesis on the comparative analysis of the legal objections to derivatives and the *Shariah* objections, will be from the 17th century onwards.

The main legal grounds why derivatives have been objected to in conventional finance can be summarised in the following points:

1. Futures sales involved the mere sale of promises which is unenforceable; that is, future sales do not involve the simultaneous transfer of possession and there is a lack of physical delivery.

2. Futures sales are contracts for differences. This amounts to wagering and is therefore illegal.

3. Futures and option sales are gaming contracts which involves wagering and betting and are therefore illegal.

Prima facie it can be established that the above legal objections to derivatives are similar to, if not the same as, the *Shariah* objections discussed under section 3.2.1. However in *Shariah* there exist two more objections not raised in conventional finance, that is, futures sale being the deferment of both counter values is a sale of one debt for another, that is, *bai al kali bi al kali,* which is forbidden; and option sales is a mere right to buy or sell, and charging of fees for this is not permissible. However a proper comparative analysis of the objections in *Shariah* and conventional finance is only possible by firstly discussing in detail the legal objections in conventional finance.

3.2.2.1 Futures Sales Involves the Mere Sale of Promises

Historically a sale of promises or an executory contract could not be enforced because the promisor had received no benefit (McGovern 1969). This is seen in Glanville (1185-1190)[41] where it is stated that a sale is,

> enforceable only when (1) the thing sold has been delivered, or (2) all or part of the price has been paid, or (3) earnest has been given. In the first two cases neither party can withdraw from the contract, but where only earnest has been given, the seller can retain any earnest given but has no remedy for a buyer's breach (Glanville, quoted in McGovern, 1969, p. 176).

The requirement that a sale of promises is unenforceable affects derivatives because at the time of contract promises are made without the exchange of any counter values. In the case of futures where a small margin is deposited, this would be the same as an earnest described above, where no action is possible even if an earnest has been given.

The application of the principle in Glanville is seen in the case of *Bryan v Lewis* (1826) 171 Eng Rep 1058 *('Brian v Lewis')* where a sale of promises was held to be unenforceable. In this case the plaintiff (in February) sold nutmegs which were not in his possession, to the defendant (a minor) to be paid and delivered at a future date (6th May). The plaintiff thereafter bought the nutmegs (in March) to deliver it to the defendant. On the date of delivery, 6th of May, the defendant was unable to pay. Abbott LCJ held that:

> ... if a man sells goods to be delivered on a future day, and neither has the goods at the time, nor has entered into any prior contract to buy them nor has any reasonable expectation of receiving them by consignment, but means to go into the market and to buy the goods which he has contracted to deliver, he cannot maintain an action upon such a contract. Such a contract amounts, on the part of the vendor, to a wager on the price of the commodity, and is attended with the most mischievous consequences (p. 1059).

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41 Glanvill's *Tractatus de Legibus et Cunsuetudini bus Angliae,* written between 1185 and 1190, is regarded as the one of the first in the series of books on English Common law (Adams 1924).

Thus the case of *Bryan v Lewis* prohibited sales of promises where the goods are non-existent at the time of the contract, even where the plaintiff had already had in his possession the commodity at the date of delivery. This objection seems to be similar with the orthodox *Shariah* view in *Shariah* of Mahmassani (1983), the OIC Fiqh Academy fatwa in 1992, confirmed by the European Council for Fatwa and Research in 2004, and Usmani's (1996) view that deferment of both counterparts of the exchange will invalidate the contract (section 3.2.1.2).

The judge, Abbott LCJ (who was made Lord Tenterden in 1827), even went so far as to explain that the reason for the invalidity of the contract was due to the fact that the seller would be wagering on the price of the commodity. On this point Lord Tenterden stated:

> If two persons enter into a contract under the semblance of a sale of goods, not intending really to buy or sell the commodity but merely as a gambling speculation, and to pay the difference of the market price on a particular day, like a time bargain in stocks, such a contract is illegal at Common law, and no action will lie to enforce it. *Wells v Porter* (1936) 132 Eng Rep 278, p.280 ('*Wells v Porter'*).

The decision in *Bryan v Lewis* was not to remain as law and ten years later was distinguished in the case of *Wells v Porter*.

In *Wells v Porter* the plaintiff, a broker, sued for failure of payment of debts owed by the defendant as a result of the plaintiff arranging options to make or take future delivery of foreign government bonds. The presiding judge Bosenquet J held that firstly Lord Tenterden's decision in *Bryan v Lewis* was a mere dictum and thus not binding. Secondly, in that case the fact that the defendant was a minor had made the judge look unfavourably on the claim (though no mention of this was made by Abbot LCJ). Thirdly, in the *Bryan v Lewis* case there was no reasonable expectation of obtaining the object of the contract, which was not the case here as the defendant had a reasonable expectation of obtaining the object of the contract.

What can be seen from this case is that Bosenquet J has distinguished *Wells v Porter* from *Bryan v Lewis*[42]. When Bosenquet J laid down the test of whether there was a reasonable expectation that the object matter of the contract would be obtained, what he meant was whether there was a reasonable expectation that the object matter of the contract would be obtained **at the time of the contract**. The fact that the plaintiff had already obtained the nutmegs after the time of the contract but before the date of delivery, in *Bryan v Lewis,* did not satisfy the test.

Comparing the conventional law objections with the *Shariah* objections, it can be seen that two objections in *Shariah* have similarities with the 'reasonable expectation test'. The reasonable expectation of obtaining the object of the contract test is very similar to the more lenient opinion of Ibn Taymiyah, Zahraa and Mahor (2002), and Kahf (2002). In *Shariah* the scholars opined that it is prohibited to sell non-existent goods where the object may not be deliverable. It is not the non-existence of the object per se but the excessive *gharar* involved; where the object is defined and known and there is a possibility of obtaining it, then the prohibition does not apply. This is similar to the 'reasonable expectation test' laid down in *Wells v Porter*. It is opined that the two tests developed are similar.

Further, the reasonable expectation test laid down in *Wells v Porter* is also similar to the other objection of *Shariah* scholars in section 3.2.1.4. That is, the objection that a futures sale falls short of meeting the requirements of taking possession of the item prior to reselling. Here Al-Suwailem (n.d) following the opinion of Ibn Taymiyah, opined that if the product or counter value is easily available to the seller from some other vendor or supplier at a known price, then from a legal standpoint it is effectively in the seller's possession and therefore valid.

Nevertheless, the reasonable expectation test in conventional law was extended in the case of *Hibblewhite v M'Morine* (1839) 5 M & W 462 ('*Hibblewhite v M'Morine'*), where the judgment made by Abbot LCJ in *Bryan v Lewis* was severely criticised[43].

[42] The decision in *Wells v Porter* also involved the issue whether the contract between the plaintiff and defendant was void at statute under the Stock Jobbing Act 1734, which barred option dealings and futures contracts in stocks. This Act was repealed in 1860, (Ferguson 1984)
Tindal CJ in *Wells v Porter* held that the Stock Broking Act did not apply to foreign securities. This decision was confirmed by the same court in *Oakely v Rigby* (1836) 5 Law J Rep (NS) CP 256 and *Elsworth v Cole* (1836) 6 Law J Rep (NS) Exch 50.

[43] The case of *Bryan v Lewis* was overruled in *Thacker v Hardy* (1878) 4 QBD 685.

All three judges in *Hibblewhite v M'Morine* - Parker B, Alderson B and Maule B - unanimously agreed that the decision made by Lord Tenterden was wrong. In this case an agreement was made between the plaintiff and defendant for the sale by the plaintiff to the defendant of 50 shares to be transferred and paid for in the future. At the time of the contract the plaintiff was not in possession of the shares but was ready to deliver and transfer the shares at the future date. The defendant did not accept nor pay for the shares. The defendant argued that at the time of the contract, the plaintiff neither had in his possession the shares nor had a reasonable expectation of obtaining them and therefore the contract was void. The court held in favour of the plaintiff.

Alderson B, p.197 held:

> I think the dictum of Lord Tenterden cannot be supported. There is no principle in its favour. It would put an end to half the contracts made in the course of trade. Suppose a vendor makes a contract for the delivery of goods, which may be performed by the delivery of any goods of the kind bargained for: whether he has them in possession at the time of the contract or not, can make no difference, if he has them ready to be delivered at the time the contract is to be fulfilled.

This case therefore has extended the test of reasonable expectation in that as long as the commodity is available and in the seller's possession at the time of delivery the contract would be valid. Therefore the sale of a promise was allowed so long as the seller could deliver the commodities at the future date. This rule seems to have surpassed the objection in *Shariah* since the requirement of minimising *gharar* still has to be fulfilled before a contract can be made valid.

In conventional law, notwithstanding the uncertainty or risk of obtaining the subject matter of the contract or being able to fulfil the contract, it would be valid if the seller was able to perform the contract at the future date. This view seems to be similar to the *Shariah* view of Kamali (1999) who opined that in relation to futures or options the guarantee function of the clearing house exists for the purpose of preventing *gharar* and therefore the non-existence of the counter values in futures or options contracts would not amount to *gharar*.

The approach in England was followed in the US Supreme Court case of *Clews v Jamieson* (1900) LEXIS U.S. 2758 where it was held that a contract for the sale of goods to be delivered at a future day is valid, even though the seller does not have the goods, nor any other means of getting them than to go into the market and buy them.

To summarise, the legal history and development of whether the fact that parties do not possess the counter value of the contract causes the contract to be invalid very closely mirrors the *Shariah* objections of scholars in Islamic finance.

As seen over time, in conventional finance, the issue of selling an item which one does not have nor has any reasonable means of getting has been recognised as acceptable in the UK and US. However, there still was an issue of the intention of the parties, whether the parties really intended to deliver the underlying asset, because if there was no such intention then the contract would be null and void. The next section turns to this issue.

3.2.2.2 Futures Sales being Contracts for Differences Amounts to Wagering

Futures sales is very often completed with the paying of the difference of the contracted future price with the spot price of the underlying asset at the future time, and no physical delivery takes place. This act of paying the difference was interpreted as being nothing more than a wager with no intention of delivery of the underlying asset ever existing. Both the English courts and the US courts extensively dealt with the legality of these transactions. The following discussion starts with the UK courts' approach and then moves on to the US court cases.

In the case of *Greenland v Dyer* (1828) 6 Law J Rep KB 345 ('*Greenland v Dyer*') Lord Tenterden held that a contract for future differences would be void[44].

However in the case of *Morgan v Ferber* (1837) 6 La J Rep CP 75 ('*Morgan v Ferber'*) Tindall CJ held that contracts which were intended to be settled by payment of differences were indeed a wager but at Common law wagers were considered to be valid (at that time

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[44] Though in the case at hand the bills of exchange were valid because they were not contracts for future differences.

with certain exceptions) and therefore a contract that was intended to be settled by payment of differences was valid.

This seemingly liberal view on contracts of differences being valid, albeit a wager, was short-lived, for in 1845 The Gaming Act was passed which rendered all contracts or agreements which were wagers as null and void and unenforceable in the courts. According to s.18 of this Act:

> 18. Wagers not recoverable at Law. All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law and equity for recovering any sum of money or valuable thing alleged to be won upon any wager ...[45].

Since the court in *Morgan v Ferber* had already held that futures contracts that were settled by differences were wagers, they were unenforceable in the courts after the Gaming Act 1845. In effect sales for future delivery where no intention of delivery was present, but settled by payment of differences, was considered as void and unenforceable.

This statute gave rise to the 'intent test' which was applied in both England and US courts to distinguish between lawful and unlawful futures.

In the case of *Grizewood v Blane* (1851) 11 CB 526 ('*Grizewood v Blane')* the plaintiff and defendant entered into a contract for the sale of railway company shares at a future date. The parties agreed that there would be no actual delivery of shares and that settlement would be by the payment of differences. The defendant failed to pay the difference, and the plaintiff sued the defendant. The defendant in defence claimed that the contract was illegal wagering under s.18 of the Gaming Act 1845. Evidence showed the there had been former dealings between the parties where they had settled only the difference in the contract price and no delivery had taken place. At the trial the jury were told by the Lord Chief Justice Jervis that it was up to them to decide what the plaintiff's intention and the defendant's intention were at the time of making the contracts. Whether either party really meant to purchase or to sell the shares in question; and if there was no intention then the contract was a gambling transaction and void.

[45] This section 18 of the Gaming Act 1845 was repealed only in 2005 under the Gaming Act 2005 c. 19 s.334(1)(c).

The jury found in favour of the defendant, in other words the transaction was a gambling transaction. All three judges in the case, Cresswell J, Talfourd J and Jervis CJ, approved of the decision..

Jervis CJ stated:

> I thought the evidence abundantly justified the conclusion the jury came to. I certainly meant to ask the jury what was the intention of the parties, as understood by both of them, at the time of entering into the contract. That was the whole contest throughout the trial. The transaction was clearly gambling, and a practise which every one must condemn (*Grizewood v Blane,* p.584).

From this case emerged the '**intent test'** which determined the intention of the parties - whether the parties intended to buy and sell the underlying asset or just settle through differences. This case was approved in the case of *Barry v Croskey* (1861) 2 J. & H. 1 ('*Barry v Croskey*') where the Vice Chancellor William Page Woode cited with approval *Grizewood v Blane* and reiterated the test as 'a *bona fide* intention to purchase or deliver the shares' (*Grizewood v Blane,* p.957).

The 'intent test' *Grizewood v Blane* established was adopted, shortly thereafter, by the House of Lords in *Universal Stock Exchange v Strachan* (1896) A. C. 166 ('*Universal Stock Exchange v Strachan').* In this case the House of Lords was required to decide, *inter alia*, whether the trial judge, Cave J, had appropriately briefed the jury when he had stated 'the question which you have to try is whether these transactions were real bargains for purchase of stock, or whether they were simply gambling transactions intended to end in payment of differences …' *(Universal Stock Exchange v Strachan,* p.167). The Law Lords (Lord Halsbury L.C., Lord Herschell, Lord Macnaghten, and Lord Morris) concurred that the trial judge had appropriately briefed the jury. As per Lord Hershell: 'As to misdirection, I can see none. The learned judge appears to have laid down the law certainly not too favourably for the plaintiff' (*Universal Stock Exchange v Strachan,* p.172).

Comparing the 'intent test' with *Shariah* objections, it can be seen that two objections in *Shariah* can be found to have similarities with this objection in conventional law.

Firstly, under section 3.2.1.4, according to *Shariah* requirements there must be physical delivery or taking of possession of the commodity before the reselling of the item. This is similar to the requirement imposed by the various courts starting with *Grizewood v Blane* that there has to be intent to deliver the underlying asset for the futures contract to be valid, if not the contract would be invalid.

Secondly, under section 3.2.1.5, the *Shariah* objection that futures and options trading verges on *maisir*, *qimar* and *gharar* would also seem to overlap with the underlying reason why the 'intent test' was developed. The 'intent test' was developed to distinguish those futures and options contracts which were mere contracts of differences or gambling contracts from those which were true contracts where there was an intention to deliver.

Therefore, one may deduce that this objection raised in conventional finance has parallel or similar objections in Islamic finance.

As for the intent test which was developed in the UK, it was followed in a number of US cases[46], as highlighted below.

A significant case which summarises the position of the US courts at that point in time is *Irwin v Williar* (1883) 110 U.S 499 ('*Irwin v Williar*') in the US Circuit Court. In this case the plaintiffs sued the defendant for the difference in price due to them from the sale of wheat for future delivery. The defendant claimed, *inter alia*, that the contract was void because it was a wager. The court noted that it was the practice at the Corn and Flour exchange at Baltimore (the Exchange) where the transaction had taken place that a commission merchant or broker would often enter a buying or selling contract on behalf of his customer in his own name and thereby become personally liable to the contract, and in many cases the principal was unknown. The court also noted that it was a practice of the Exchange that purchases or sales orders of customers were usually made on the floor of the Exchange by open public offer to the members of the board there assembled. The court also noted that two commission merchants as between themselves often set off one contract against another and mutually

[46] *In re Chandler (1874)* Fed. Cas. No. 2,590*; In re Green (1877)* Fed. Cas. No. 5,751*; Justh v Holiday (1883)*Mackey 2 D. C. 346*; Pickering v Cease (1875)* 79 Ill. 328*; Rumsey v Berry (1876)* 65 Me. 570*; Gregory v Wendell (1878)* 39 Mich. 337*; Williams v Tiedman (1878)* 6 Mo. App. 269*; Cassard v Hinman (1857)* 1 Bosw. 207 N. Y. Super. Ct.*; Yerkes v Salomon (1877)* N. Y. Super. Ct.*; Bra's Appeal* 55 Pa. 294*; Marshall v Thurston (1879)* 3 Lea 740*; Noyes v Spaulding (1855)* 27 Vt. 420*; Barnard v Backhaus (1881)* 52 Wis 593.

surrendered or cancelled them be settling between them the difference in price and substituting in their books the name of the new customer. The court therefore took note of the fact that the payment of difference was a customary practise in the exchanges where the transaction took place.

Notwithstanding this, Justice Mathews for the court decided that:

> The generally accepted doctrine in this country is … that a contract for the sale of goods to be delivered at a future day is valid, even though the seller has not the goods, nor any other means of getting them than to go into the market and buy them; but **such a contract is only valid when the parties really intend and agree that the goods are to be delivered** by the seller and the price to be paid by the buyer; and, if under the guise of such a contract, **the real intent be merely to speculate** in the rise or fall of prices, and the goods are not to be delivered, but one party is to pay to the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, **then the whole transaction constitutes nothing more than a wager, and is null and void**. And this is the law in England by force of the statute of 8 & 9 Vict c.109, s.18, altering the Common law in that respect (*Irwin v Williar,* pp.508-509). (Emphasis added).

Thus the court in *Irwin v Williard* concluded that the payment of differences where no intention to deliver the commodities is present amounts to a wager and is null and void. Therefore the speculation on the exchange where there is no intention to deliver is clearly seen as a gambling contract. Comparing this with the *Shariah* objections it can be seen that this is exactly the same view which is taken by various scholars on the *Shariah* objections to futures. In *Shariah* speculation on the futures and options exchange is generally considered to be a zero-sum game where no delivery of the commodity is intended. Such use of futures and options in the scholars' opinion is impermissible because there is no intention to deliver the underlying commodity. The intention of the parties was to gamble on the prices of the commodities and not to manage their risks.

Justice Mathews for the court in *Irwin v Williar* also added that even though the broker is innocent of any violation of the law, but since the broker is privy to the 'unlawful design of the parties, and brings them together for the very purpose of entering into an illegal agreement' (*Irwin v Williar*, p.510) the broker cannot recover for services rendered or any losses he has suffered as a result.

The intent test was written into the statute of almost every state in the US[47] (Taylor 1933). An example of this can be seen in The Michigan Penal Code Act 328 of 1931, s.311 (formerly section 1 of Act 199 of 1887):

> 750.311 Gambling in stocks, bonds, grain or produce.
>
> Sec. 311. Gambling in stocks, bonds, grain, etc.— It shall be unlawful for any corporation, association, firm, co-partnership or person to keep or cause to be kept by any agent or employee within this state, any office, store or other place, wherein is conducted or permitted the pretended buying or selling of the shares of stocks or bonds of any corporation, or petroleum, cotton, grain, provisions or other produce, either on margins or otherwise, without **any intention of receiving and paying for the property so bought or of delivering the property so sold**; or wherein is conducted or permitted the pretended buying or selling of such property on margins,

[47] 'Whether such legislation purports to outlaw bucket-shops, or wagering contracts in general, it is, for the most part, merely a reiteration of the common-law test of intent at the time of making the contract -
Statutes declaring criminal the maintenance of a bucket-shop: ALA. CODE (Michie, 1928) *5* 3579; ARIZ. CODE (Struckmeyer, 1928) 0 4677; CAL. GEN. LAWS (Deering, 1923) tit. 75, **8** 2; Colo. Laws 1931, c. 57, § I ; COXN. GEN. STAT. 61930) ***s.5*** 6345, 6346; D. C. CODE (1929) tit. 6, §§ 158, 159; FLA. COMP. LAWS (1927) s.8 7889, 7899; ILL.REV. STAT. (Cahill, 1931) c. 38, §§ 317, 318; IND.ANN. STAT. (Burns, 1926) § 2691; IOWACODE (1931) §§ 9895, 9899, 9901 ; KAN. REV. STAT. ANN. (1923) C. 50, s. 122; ME. REV. STAT. (1930) C. 136, s.0 14, 15; MASS. GEN. LAWS (1921) C. 271, §§ 35, 36; Mich. Acts 1931, no. 328, s.8 126-28; MINN. STAT. (Mason, 1927) §§ 10488, 10489; Mo. REV. STAT. (1929) s.04316-18; MONT. REV. CODE (Choate, 1921) § 11159; KEB. COMP. STAT. (1929) s.8 28-955, 28-956; K. H. PUB. LAWS (1926) c. 384, s. 23; K. Y. PENAL LAW (1909) s. 390; K. D. COMP. LAWS ANN. (1913) 8 9699; OHIO GEN. CODE (Page, 1932) s.8 13071, 13079 ; Ore. Laws 1931, c. 395, 0 2; PA. STAT. ANN. (Purdon, 1930) tit. 18, § 1011; R. I . GEN. LAWS (1923) C. 406, 8 I ; S. D. COMP. LAWS (1929) 3925; VT. GEN. LAWS (1917) s. 7081; VA. CODE ANN. (Michie, 1930) §§ 4714, 4715; WASH. CODE (Pierce, 1919) 8932 ; W. VA. CODE (1931) c. 61, art. 10, 18; WIS. STAT. (1929) 348,175; WYO. REV. STAT. ANN. (1931) 32-924.
Statutes declaring gambling contracts criminal: ALA. CODE (Michie, 1928) s 3576; ARIZ. CODE (Struckmeyer, 1928) 4680; FLA. COMP. LAWS (1927) 7890; KAN. REV.S TAT.A NN. (1923) C. 50, s. 121; LA. CONST&. STAT.(Wolff, 1920) CONST.a, rt. 189; *id.*, p. 452; MINX. STAT. (Mason, 1927) s.0 10223-1, 10223-2; Mo. REV. STAT. (1929) 4324; S. D. COMP. LAWS (1929) 3925; TENN. CODE (1932) 7821.
Statutes declaring gambling contracts void: ALA. CODE (Michie, 1928) 6816; CAL. CONST. art. 4, § 26; ILL. REV. STAT. (Cahill, 1931) c. 38, s. 309; MASS. GEN. LAWS (1921) C. 137, 4; K. J. COMP. STAT. (1910) pp. 2623-24; N. Y. PENALLAW (1909) 992; OHIO GEN. CODE (Page, 1932) s. 5965; PA. STAT. ANN. (Purdon, 1930) tit. 18, 1016; S. C. CIV. CODE (1922) § 5165; S. D. CORIP. LAWS (1929) § 3929; TENN. CODE (1932) § 7819, 7820; VA. CODE ANN. (Michie, 1930) s. 5558; W. VA. CODE (1931) C. 55, art. 9, I ; WIS. STAT. (1929) s. 241.24; WYO. REV. STAT. ASS. (1931) 48-201. In Missouri, if *either* party to a contract intends not to deliver or receive, irrespective of the other party's intent or knowledge of such intent, the contract is criminal and void. Mo. REV. STAT. (1929) s.8 4324-25;' ('Legislation Affecting Commodity and Stock Exchanges' 1932) p.917.

> when the party selling the same or offering to sell the same does not have the property on hand to deliver upon such sale; or when the party buying any of such property, or offering to buy the same, **does not intend actually to receive the same if purchased or to deliver the same if sold; all such acts** and all purchases and sales, or contracts and agreements for the purchase and sale of any of the property aforesaid in manner aforesaid, and all offers to sell the same or to purchase the same in manner aforesaid, as well as all transactions in stocks, bonds, petroleum, cotton, grains or provisions in the manner as aforesaid, on margins for **future or optional delivery**, **are hereby declared gambling and criminal acts**, whether the person buying or selling or offering to buy or sell acts for himself or as an agent, employee or broker for any firm, co-partnership, company, corporation, association or broker's office. (Emphasis added).

As can be seen from the wording of the statute, where no intention is intended between the parties that delivery would take place the contracts would be considered as gambling contracts and criminal. This injunction applies also to those acting as agents and brokers.

However, the intent test was to be ‘stretched’ in the following case.

In *Board of Trade of the City of Chicago v Christie Grain and Stock Company* (1904) 198 U.S 236 Supreme Court (‘*Board of Trade of the City of Chicago v Christie Grain and Stock Company’),* the CBOT brought a suit to prevent the defendant from using and distributing quotations of prices on the Board (collected by the Boards and distributed only to persons approved by it), without the Board's consent and contrary to its regulations. The defendant pleaded that the Board was a gambling institution whose operations violated the Illinois statutes against bucket-shops and gambling contracts, and that therefore the Board had no property right in its quotations which a court of equity should protect. Justice Holmes in the Supreme Court held that, the intent of brokers to close out their contracts by ‘setting-off’ or ‘ringing-out’ did not invalidate their transactions:

> The fact that contracts are satisfied in this way by set-off and the payment of differences detracts in no degree from the good faith of the parties, and if the parties knew when they make such contracts that they are very likely to have a chance to satisfy them in that way and intend to make use of it, that fact is perfectly consistent

> with a serious business purpose and an intent that the contract shall mean what it says. (*Board of Trade of the City of Chicago v Christie Grain and Stock Company,* p.248)

The judge held that firstly a Board of Trade was not illegal, nor were the contracts that took place illegal, notwithstanding that physical delivery did not take place, because 'setting off' and 'ringing' constituted delivery. Further implied in Holmes J's judgement is the fact that contracts established on the Board of Trade were entitled to be regarded as serious regardless of whether the parties intended their futures contracts to transfer physical commodities. This case in essence seems to have set aside the 'intent to deliver for validity' test in *Grizewood v Blane* and replaced it with a much more liberal test of whether the contract was made for a serious business purpose.

However this liberal view was short-lived. In the case of *Dickson et al. v Uhlmann Grain Co.* (1933) 288 U.S. 188 ('*Dickson et al. v Uhlmann Grain Co.*'), the respondents Uhlmann Grain Company brought an action against Dickson claiming that Dickson had employed it as a broker to purchase and sell grain on the Chicago, Winnipeg and Minneapolis exchanges and had agreed to pay commission for any services and reimburse it for any advances made. This Dickson had failed to do. Dickson on the other hand claimed that the transactions under which the indebtedness was claimed were wholly gambling contracts and were thus illegal under the laws. He further claimed that it was the intention that the contracts would be settled for differences in market prices and that the transactions were not actual dealings by him in grain futures but were pretended, mere gambling on the rise and fall of the market prices of grain. The company counter argued that the transactions of sale of grain for future delivery were commonly conducted on the boards of trade of Chicago and Minneapolis which had been legally established under The [Federal] Grain Futures Act 1922, and all the transactions made by the company were legal under the Act.

Dickson replied that none of the alleged contracts made on the boards of trade was entered into on his behalf; that they were devices employed by the company on its own behalf. This was claimed because the company had established a branch in Carrollton from where Dickson had made an order to purchase. This was communicated by the branch to its Kansas City branch, and the company would then enter into contracts on some other board of trade for future purchase or sale of grain. Dickson claimed that the branch in Carrollton was actually a bucket shop which was set up to gamble against the laws of the State of Missouri[48]. It was also understood that no grain was ever delivered, and that the manager of the branch at Carrollton had actually assured Dickson and others that they would never have to deliver or receive the grain.

Justice Brandeis on behalf of the Circuit Court of Appeals for the Eighth Circuit held the following[49]:

Firstly, that the contracts entered between the Grain Company Uhlmann and the exchanges may be assumed to be valid as they were validly entered into under the Federal Law, that is, The Grain Futures Act 1922 (this law is discussed in Chapter 6 below). Here the contract which has to be looked at is the contract between Dickson and the branch in Carrollton. The former transaction with the exchange did not necessarily make the latter transaction with Dickson valid.

Secondly, the evidence showed that the transactions in the branch at Carrollton were not 'in fact orders to enter into contracts on behalf of the defendants to purchase or sell for future delivery but were devices knowingly employed by the company solely to enable them to gamble,' (*Dickson et al. v Uhlmann Grain Co*., p. 194), in other words the branch was nothing more than a bucket shop and therefore illegal under Missouri law. The company was therefore a party to an illegal contract and could not therefore claim for the commissions.

Lastly, the Grain Futures Act 1922 (discussed in Chapter 6) did not supersede any applicable laws in Missouri making gambling in grain futures illegal.

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48 The Missouri Bucket Shop Law, Rev. Stat.(1929) ss. 4316-4323, defines transactions in grain declared to constitute gambling and makes it punishable either to enter into such transaction or to keep an establishment to enter into such transactions. Section 4317 declares that a bucket shop is a place where there is buying and selling of commodities on behalf of other parties which is pretended and a shop is gambling and illegal.

49 However Justice Butler dissenting opined, the contracts carried out in Carrollton were not governed by the Missouri laws. Further that the branch in Carrollton was not a bucket shop and was therefore not illegal. In other words the respondents should have been able to claim their commission. At p.206 *Dickson et al. v Uhlmann Grain Co*. Butler J stated – 'There is no evidence of any violation of the bucket shop laws, nor is there any suggestion that the transactions shown can b held illegal except by force of the Missouri statute. I do not disagree with the majority that the Federal Grain Futures Act has not superseded the statutes of Missouri applicable to these transactions.'

In effect *Dickson et al. v Uhlmann Grain Co*. tried to discourage speculation by declining to enforce speculative contracts.

As a result of many cases and litigation, a number of Federal legislation in US and Statutes in the UK were passed, which attempted to remedy speculative activity on the exchanges. These will be discussed in the Chapter 6.

In summation, the researcher opines that there is definitely a strong similarity in sentiment between *Shariah* scholars and their objections and the objections seen here in these conventional law cases. Speculation, if the intention is to hedge, is permissible in *Shariah* and conventional law, but where there is evidence of non-intention to deliver the goods, but merely a payment of differences akin to gambling, both *Shariah* and conventional laws object to this. In *Shariah* the majority of scholars believe that speculation in derivatives leads to excessive uncertainty which amounts to gambling; they opine derivatives are clear examples of zero-sum games, and are mere contracts of differences - a means of gambling and betting. One can thus conclude that the objections raised in *Shariah* are similar to those raised above in relation to futures contracts where no delivery is intended and mere speculation is carried out. In other words, this amounts to no more than a mere gamble or wager and is void and illegal or *haram*.

3.2.2.3 Futures and Options Sales are Gaming Contracts which Involve Wagering and Betting

The parliamentary debate on the passing of the bill of the Sir John Barnard's Act 1733 or Stock Jobbing Act 1733 in the UK illustrates how deeply divided the opinion even at that time was about the speculative effects of derivatives.

The Sir John Barnard's Act 1733 was passed as a result of speculative trading in shares of a company called the South Sea Company that was allegedly supposed to get profitable trading concessions in Spanish America. Many people were involved in the excitement of share trading. However the Spanish concessions never occurred and the stock of the South Sea Company crashed in September 1720. Many investors were ruined (Swan 2000).

The investigations held in the aftermath attributed the crash to brokers and stock jobbers (speculators) who dealt in options to take or decline future deliveries of shares (Swan 2000).

As a result of the findings, debate in parliament arose for and against the abolishment of speculative transactions. The following are arguments (in sequence as they occurred) by members of the House of Commons for or against the passing of legislation that would restrict stock jobbers and time bargains (futures), in the House of Commons in 1733 (Chandler 1742, pp.375-401)[50].

Glanville argued that there would be 'great hardship' and 'restraint' on creditors of the public if the bill was passed. He argued that while 'every Man may dispose of his Property by a Bargain for Time, or in whatever Manner he pleases' creditors of the public would face severe hardship and be restrained by the passing of the bill on disposing their property. He opposed the passing of the bill.

Glanville's view's were seconded by Bowles, and backed by George Caswall[51].

John Barnard who sponsored the bill spoke next. He believed that the passing of the bill would cause inconveniences but the evils which it intended to wipe out were greater on balance than the inconveniences caused by its passing. He then went on to explain the harms of speculation in stock and how it was gambling of the highest order:

> It is a Lottery, or rather a Gaming-House, publickly set up in the Middle of the City of London, by which the Heads of our Merchants and Tradesmen are turned from getting a Livelihood or an Estate, by the honest Means of Industry and Frugality; and are enticed to become Gamesters by the Hopes of getting an Estate at once. It is, Sir, not only a Lottery, but a Lottery of the very worst Sort; because it is always in the Power of the principal Managers to bestow the Benefit-Tickets as they have a mind. It is but

[50] The exact page numbers for the quotations made under this section are unknown because they are were taken from a website http://www.british-history.ac.uk/report.asp?compid=37746, however they are within the pages of 375 – 401 in Chandler (1742).

[51] Bowles believed that it was 'evident, that this Bill will be extremely inconvenient to all the Proprietors or Dealers in any of our Publick Securities: The Words of it are so general…'
George Caswall claimed that there were so many inconveniences that would arise out of the passing of the bill 'that, in my Opinion, the Title of the Bill ought to be altered, and instead of calling it a Bill for preventing the scandalous Practice of Stock-jobbing, it ought to be called a Bill for the destroying of Publick Credit.' (Chandler 1742) pp. 375-401

> lately since, by the Arts and Practices of Stockjobbing, the East-India Stock was run up to 200£. per Cent. and in a little Time after it tumbled down again below 150£. several Millions were lost and won by this single Job, and many poor Men were undone; so bare-fac'd were some Men, at that Time, in the infamous Practice of Stockjobbing, that, after that Stock began to fall, they sold it cheaper for Time than for ready Money; which no Man would have done, unless he had been made acquainted with the Secret which came afterwards to be unfolded, but was then known to a very few.

Brooksbank spoke up next and despite agreeing that the practice of stock jobbing was a form of gamble, believed that the bill should not be passed because the bill would not be able to prevent stock jobbing from taking place and further that not much benefit could be expected from such a bill.

Robert Walpole spoke next, for the passing of the bill which he believed would cut out speculative activity and stabilise prices of stocks:

> If we destroy the Cause, the Effects must cease; and of Consequence the Price of all publick Stocks will become more certain and fixed, which will, I am sure, make them more valuable to all honest Purchasers. The fluctuating of the Price can be no Advantage to any but Brokers, and to those who have a Mind to make indirect Advantages by Stockjobbing: Those Practices will, I think, be prevented by this Bill; consequently it will tend to the Improvement of publick Credit, and therefore I shall be for its passing.

Lord Hervey spoke against the passing of the bill because he believed that if the law was passed no seller could sue for any difference upon the stock that was sold, nor could he recover damage, ‘unless he has the Stock in his Possession the whole Time of the Suit’. And this he believed would be a great hardship upon all stock holders.

Next William Yonge spoke for the bill. He believed that it was of no consequence whether or not a seller could recover a difference or damage because what was important was the fact that where a person sold something in the future he was either ‘endued with something of the Spirit of Gaming’ or he knew ‘a Secret’ which gave him an unjust advantage against the person he was selling to or purchased from and this practice must come to a final end by the passing of the bill.

Bootle finally concluded the debate as follows:

> In short, Sir, from all the Objections that have been started, and all the Cases that have been put, I can see nothing but pretended or imaginary Difficulties; and as the Bill now before us will, in my Opinion, put an End to many real Evils, which are of the most dangerous Consequence both to the Trade and Credit of this Nation, therefore I shall with all my Heart be for its passing in this House, and I hope it will be passed into a Law.

Eventually legislation was passed in 1733 known as the Sir John Barnard's Act 7 Geo 2 c. 8 (discussed in Chapter 6).

These arguments seem to be diametrically opposite. Those who oppose the futures and option instruments believe that it is no more than gambling; a great evil that causes losses, whereas those who support the continued usage of futures believe that passing a law would not stop its practice and further the passing of the bill would cause great hardship to the public who should have the right to dispose of their property as they wish. These arguments for and against futures mimic closely the objections in *Shariah*. In *Shariah* the majority of scholars believe that speculation in derivatives leads to excessive uncertainty which amounts to gambling. They opine derivatives are clear examples of zero-sum games, and are mere contracts of differences - a means of gambling and betting. The counter-argument seeks to highlight the advantages of derivatives such as price discovery, creating trading vehicles and as an arena for profitable commerce. Further they argue that standardisation of the contracts, monitoring by third parties and mutual consent between the parties of the contract help minimise *gharar*. One may conclude therefore that this objection in conventional finance is similar to the last objection in *Shariah* under section 3.2.1.5. That is, futures and options trading involves speculation and verges on *maisir*, *qimar* and *gharar*.

Having laid down in detail the objections to derivatives in *Shariah* and conventional finance it is now necessary to complete the comparison of the objections between these two fields, and answer the first subsidiary research question.

3.3 Comparing the Objections - First Subsidiary Research Question Answered

This section will answer the first subsidiary research question **– How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance?**

To answer this question table 3.2 lays down a summary of all the objections and a comparison which is then depicted in diagrammatic form for better illustration and understanding.

Table 3.2 Comparing the Objections in *Shariah* with Legal Objections in Conventional Finance on Derivatives

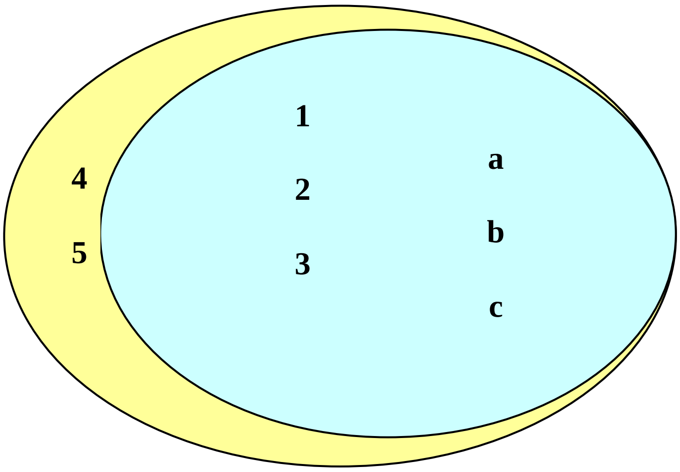
***Shariah* Objections**	**Conventional Law Objections**	**Comparison**
1. Both counter values in futures and options sales are non-existent or deferred at the time of the contract Explanation: Generally the non-existence of the underlying asset may invalidate a contract (Mahmassani, 1983, European Council for Fatwa and Research, Usmani, 1996, OIC Fiqh Academy, 2000, Kahf, 2002). However it is not the non-existence of asset but rather the existence of *gharar* that makes the contract invalid (Kamali 1999). If *gharar* can be removed then the non-existence of the subject matter at the time of the contract should not invalidate the contract (Kamali 1999)	**a. Futures sales involved the mere sale of promises which is unenforceable.** Explanation: Sales of promises where the goods are non-existent at the time of the contract is void, even where the plaintiff had already had in his possession the commodity at the date of delivery, *Bryan v Lewis* (1826).	Initially the conventional law objection seems to be harsher then the *Shariah* objection on the non-existence of the counter values at the time of the contract. In *Shariah* if *gharar* can be removed from the contract even where there is non-existence of the subject matter, the contract would be valid. This harsh test evolved in conventional finance to the 'reasonable expectation' test. This test laid down in *Wells v Porter* (1836b) was – 'whether there was a reasonable expectation that the object matter of the contract would be obtained at the time of the contract'. If there was such a reasonable expectation then the contract would be valid even though the goods did not exist at the time of the contract. This 'reasonable expectation' test is very similar to the test in *Shariah* where if the object is defined and known and there is a possibility of obtaining it even though it does not exist at the time of the contract, then the prohibition does not apply. It is opined that the two tests developed are the same.
2. Futures sales fall short of meeting the requirements of taking possession of the item prior to resale.	**b. Futures sales are contracts for differences; there is no intention to deliver, this amounts to wagering and is therefore illegal**	Comparing the 'intent test' in conventional law with *Shariah* objections, it can be seen that two objections in *Shariah* can be found to have similarities with this objection in conventional law. Firstly in *Shariah* the requirement that there

Shariah Objections	Conventional Law Objections	Comparison
Explanation: For a sale to be valid there must be a transfer of ownership of the item sold, therefore if the seller does not own the item he cannot transfer ownership (Chapra, 1985b, European Council for Fatwa and Resarch, Khan, A., 1988, Usmani, 1996, OIC Fiqh Academy, 2000, Naughton and Naughton, 2000, El Gari, 2006). The paramount reason for this prohibition would seem to be due to *gharar*, or the uncertainty about delivery of the goods purchased (Kamali 1996). However according to Ibn Taymiyah's opinion if the item is easily available in the market then the prohibition would not apply. This opinion fits well with the reason for the prohibition i.e. to prohibit *gharar*; if the commodity or asset is easily available there will not be an issue of *gharar*.	Explanation: In effect sales for future delivery where 'no intention' to deliver was present but settled by payment of differences was considered as a wager and therefore void and unenforceable. This was known as the 'intent test'. *Greenland v Dyer*, s.18 The Gaming Act 1845, *Grizewood v Blane*, *Barry v Croskey*, *Universal Stock Exchange v Strachan*, *Irwin v Williar*, *Board of Trade of the City of Chicago v Christie Grain and Stock Company*, *Dickson et al. v Uhlmann Grain Co*.	be physical delivery or taking of possession of the commodity before the reselling of the item is similar to the requirement imposed by the various courts starting with *Grizewood v Blane* that there has to be intent to deliver the underlying asset, for the futures contract to be valid, if not the contract would be invalid. Secondly, the *Shariah* objection that futures and options trading verges on *maisir*, *qimar* and *gharar* would also seem to overlap with the underlying reason why the 'intent test' was developed. The 'intent test' was developed to distinguish those futures and options contracts which were mere contracts of differences or gambling contracts from those which were true contracts where there was an intention to deliver.
3. Futures and options trading involves speculation and verges on *maisir, qimar* and *gharar.* Explanation: Speculation in derivatives leads to excessive uncertainty which amounts to gambling, derivatives are clear examples of zero-sum games. They are obligations to exchange goods with money or just certain amounts of money at a future date. They are contracts of differences and a means of gambling and betting. (DeLorenzo, Khan, A. 1988, El-Gamal 1999, Obaidullah, 1998, 2001, 2002, Kahf 2000, Khan. F, 2000, Suwailem, 2006, Wilson 1991, 2007).	**c. Futures and options sales are gaming contracts which involve wagering and betting and are therefore illegal.** Explanation: The arguments that arise here are that futures transactions are nothing more than gambling transactions - a great evil that causes losses, whereas those who support the continued usage of futures believe that passing a law to halt the usage of futures would not stop its practice, further, the passing of such law would cause great hardship to the public who should have the right to dispose of their property as they wish. Parliamentary debate at the House of Commons in 1733.	These arguments for and against futures in conventional law mimic closely the objections in *Shariah*. In *Shariah* the majority of scholars believe that speculation in derivatives leads to excessive uncertainty which amounts to gambling, they opine derivatives are clear examples of zero-sum games, and are mere contracts of differences - a means of gambling and betting. The counter-argument seeks to highlight the advantages of derivatives such as price discovery, creating trading vehicles and as an arena for profitable commerce. Further, they argue that standardisation of the contracts, monitoring by third parties and mutual consent between the parties of the contract help minimise *gharar*.

Shariah Objections	Conventional Law Objections	Comparison
4. Options Sales is a mere right to buy or sell, charging of fees for this is not permissible. Explanation: Options are rights and not tangible assets and therefore cannot be the subject matter of a sale and purchase (El Gari 1993; Usmani 1996; Obaidullah 1998; OIC Fiqh Academy 2000; DeLorenzo n.d., European Council for Fatwa and Research). **5. Futures sales being the deferment of both counter values is a sale of one debt for another, *bai al kali bi al kali,* which is forbidden. A sale of one debt for another.** Explanation: The exchange of a debt for a debt also known as *bai al dayn bi al-dayn* or *bai al-kali bi al-kali* has been generally found to be prohibited in Islamic law by Islamic scholars, (Obaidullah 2001).		**No comparison** **No comparison**

The table above is depicted in diagrammatic form below.

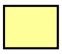
Figure 3.1 Relationship of Objections to Derivatives in *Shariah* and Conventional Law

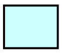


Key:

1 – 5: Represents the *Shariah* objections listed in table 3.2 above.

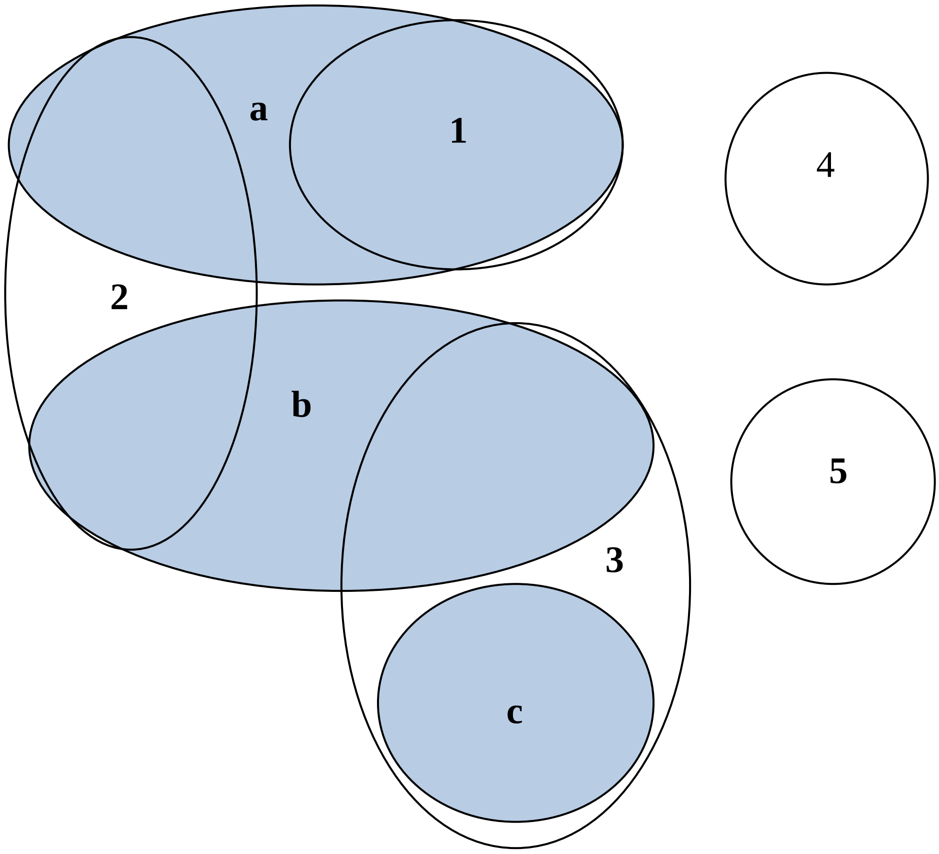
a – c: Represents the objections in conventional law listed in table 3.2 above.

 - ***Shariah***

 - **Conventional law**

It can easily be seen from the diagram that *Shariah* and conventional law share similar objections against derivatives. The objections in conventional law actually overlap with more than one *Shariah* objection. This phenomenon is captured in the following diagram. As for objections 4 and 5 under *Shariah* there are no parallel objections in conventional law.

Figure 3.2 Matching the Objections in *Shariah* and Conventional Law



Key:

1 – 5: Represents the *Shariah* objections listed in table 3.2.

a – c: Represents the objections in conventional law listed in table 3.2.

□ - ***Shariah***

■ - **Conventional law**

The following discussion refers to the *Shariah* objections as numbered in table 3.2 (that is, 1-5) and conventional law objections as referred to in table 3.2 (that is, a – c).

What the above diagram depicts is the overlap of more than one *Shariah* objection per conventional law objection. While *Shariah* objections 1 and 2 are similar to objection (a) of the conventional law, *Shariah* objections 2 and 3 are similar to objection (b) of conventional law and objection (c) of conventional law is similar to objection 3 under *Shariah*. Another observation is that in both *Shariah* and conventional law the paramount objections seem to be similar. In conventional law the paramount objection against derivatives was the gambling nature of derivatives. In *Shariah* the paramount reason is *gharar*; however since *maisir* is a subset of *gharar* (see section 2.4.2), it would mean that *gharar* includes *maisir*. In other words *maisir* or gambling falls within the definition of *gharar*. Taking this further, gambling is a subset of *gharar*. This means that *gharar* includes elements beyond gambling, such as *jahala* or ignorance. Following this reasoning, since the underlying objections towards derivatives in *Shariah* is *gharar* and the underlying objection towards derivatives for conventional law is gambling, it follows that the objections towards derivatives in Islamic finance are broader or wider than in conventional law. Further, in a comparison of *Shariah* objections and conventional law objections towards derivatives it was discovered that there were two objections in *Shariah* that did not have a similar parallel objection in conventional law. That is, futures sales being the deferment of both counter values is a sale of one debt for another, and options sales is a mere right to buy or sell; charging of fees for this is not permissible.

Nevertheless, these two objections can be overcome by following the reasoning given by Kamali[52]. Firstly, it is a fact that a clearing house acts as the seller for each buyer and the buyer for each seller in all futures transactions; each transaction is guaranteed, there is therefore no direct interaction with another trader, and there is therefore no exchange of a debt for a debt, since each transaction ends with the buying or selling of a futures contract by the exchange. Therefore it is opined that this objection can be dismissed as being not applicable to modern day futures. Secondly, if a service and usufruct is considered to fall under property (that is, tangible property) and therefore allowed to be a subject matter of a sale, a right provided under an option should also be so allowed, therefore the charging of a fee should be allowed for a right provided under an option, and again this objection can be dismissed.

Thus Islamic finance can learn from the legal history of derivative development in conventional law in relation to objections which relate to excessive speculation and gambling.

Since both *Shariah* and conventional law objections have been concluded to be similar in relation to excessive speculation and gambling it is now possible to study firstly why there are similarities between the two fields and secondly the laws that were passed in the UK and US to overcome these objections. The relevant laws will be discussed in Chapter 6 and useful measures which were taken to overcome the objections in conventional finance will be

52 Kamali (1996, 1997), *supra*.

extrapolated to see whether they can be used in Islamic finance to overcome similar objections.

3.4 Summary

In this chapter the subsidiary research question - How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance? - was answered in the following manner:

The *Shariah* objections raised were divided into five criteria, namely futures sales being the deferment of both counter values is a sale of one debt for another, that is, *bai al kali bi al kali,* which is forbidden; both counter values in future sales are non-existent at the time of the contract, neither the money nor the goods, it is therefore not a genuine sale but merely a sale or exchange of promises. A sale can only be valid in *Shariah* if either the price or the delivery is postponed but not both; options sales is a mere right to buy or sell, charging of fees for this is not permissible; for a sale to be valid there must be a transfer of ownership of the item sold, therefore if the seller does not own the item he cannot transfer ownership; and lastly futures and options trading involves speculation and verges on *maisir*, *qimar* and *gharar*. The most popular objections in *Shariah* towards derivatives were the last two objections, and the underlying reasons for most of the objections was the need to minimise or eliminate *gharar*.

As for conventional law the objections raised were divided into three criteria, namely futures sales involved the mere sale of promises which is unenforceable, that is, future sales do not involve the simultaneous transfer of possession, there is a lack of physical delivery; futures sales are contracts for differences and this amounts to wagering and is therefore illegal; futures and options sales are gaming contracts which involve wagering and betting and are therefore illegal. The most popular objection in conventional law was due to the fact that futures sales are contracts for differences that amount to wagering.

Thus to answer the first subsidiary research question – **How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance?**

A comparison of *Shariah* objections and conventional law objections showed that all three conventional law objections were similar with *Shariah* objections. However, there were two *Shariah* objections, namely futures sales being the deferment of both counter values, is a sale of one debt for another, and options sales is a mere right to buy or sell, charging of fees for this is not permissible, which do not have any parallel objections in conventional law.

In the following chapter the main issue tackled will be the probable reasons why there is a similarity of objections in *Shariah* and conventional law against derivatives.

Chapter 4 Similarity of Objections to Gambling and Speculation in *Shariah* and Conventional Law

4.1 Introduction

In the previous chapter the literature review showed that there were fundamental objections in *Shariah* towards derivatives which were very similar to the objections that occurred in conventional law. The next question is what could the possible reasons be for this phenomenon? In other words, the second subsidiary research question will be answered in this chapter - **Why are there similarities in objections towards gambling and speculation in *Shariah* and conventional law?**

This chapter is therefore devoted to exploring probable reasons for the similarity of the objections in *Shariah* and conventional laws towards derivatives. There are a few factors that may explain this similarity:

- Islamic origins of Common law
- The concept of stewardship
- Christianity and morality
- Ethics and gambling

These factors are explored below.

4.2 Islamic Origins of Common law

Since both the English legal system and the US legal system are from a Common law legal system, and since the above comparison between *Shariah* has been with the UK and US case laws, the following postulation may possibly explain the reason why there is a similarity of objections in Islamic and conventional law towards derivatives.

As stated in section 2.3, while the Civil law legal system can easily be traced as having descended from Roman law and Canon law, Common law's origin is more opaque.

Historians have vaguely described Common law as having been developed from customs (Adams 1924), or Roman and Canon law (Berman & Greiner 1980) and thereafter institutionalised in the 12^{th} century by King Henry II. However Makdisi (1990, 1999) examines in detail the origin of Common law and that of Roman law and Canon law and has made an interesting discovery. He claims that the origins of Common law are found in Islamic law. He argues that 'the legal institutions of the Common law fit within a structural and functional pattern that is unique among western legal systems and certainly different from that of Civil law' (Makdisi 1999, p. 1638).

Makdisi (1999) claims that it was natural for the more primitive legal system in England before the Common law to look to the more sophisticated Islamic legal system to develop its own legal system. Notably, Makdisi (1999) identifies three unique and highly important features of Common law that were different from Roman and other Western types of legal systems and only existed in *Shariah* or Islamic law at that time, which serves as proof of Common law's origination from Islamic law.

The three institutions Makdisi (1999) identifies as existing for the first time in English history are as follows:

1. English law permitted the transfer of property ownership on the sole basis of offer and acceptance through the action of debt. This idea that ownership of property of goods passed at the time of agreement had no similar concepts in Germanic law or even Roman law. For Roman law the agreement in itself 'did not transfer ownership of the goods until the buyer received the goods and paid the price' (Makdisi 1999, p.1647). However a comparison with *Shariah* revealed that in Islamic contract law the concept of *aqd* (agreement) existed, that transferred the movable or immovable property upon an offer and acceptance. This is very similar to the concept of English legal system of offer and acceptance.
2. A speedy means for the loss of land ownership known as the 'assize of novel disseisin' provided landowners with security under the law by shortening the time period for obtaining recovery of their land. The assize of novel disseisin was an action

'bought in the king's court and was authorised by a writ purchased from the king' (Makdisi 1999, p.1659). Twelve jurors were then picked to study the case, and declare the facts to the court. The court would determine on the jurors' declaration whether the plaintiff had been removed (disseised) unjustly or not. This origin of the assize was a mystery in that it came neither from Normandy nor from Anglo-Saxon law. As for Canon law and Roman law there were procedures for actions for the maintenance of peace and quiet (Makdisi 1999, p.1664). However, the English assize was for the protection of property rights. In Islamic law however, a replica existed at the time called *istihqaq* whereby an action for recovery of land was bought before a *qadi* (judge) where a jury of twelve witnesses was called upon to provide truth of the matter. There existed other similarities between the assize and the Islamic *istihqaq* such as:

> (2) the action lay against the disseisor as well as against any third party who may have taken the property from the disseisor, though the third party need not be included in the action; (3) the defendant was compelled to appear in court; (4) if the defendant was not available, his bailiff was attached, and if the bailiff was not available, then the action would proceed in their absence; (5) excuses by the parties for being absent were not allowed to delay the proceedings unduly; (6) if the defendant confessed the disseisin, the action was settled on the basis of the confession without a verdict being rendered, (7) defences could be entered against defects in the juridical process … (Makdisi 1999, p.1667).

3. The Common law system instituted the settling of disputes through trial by jury. This was similar to the Islamic *lafif* witnesses which appeared in the practice of Maliki law. Makdisi compares nine characteristics of the English jury with the Islamic jury (*lafif*) and concluded that eight are the same. The eight characteristics are that the jury:

> (1) was a body of twelve witnesses drawn from the neighbourhood and sworn to tell the truth, (2) who were bound to give a verdict, (3) unanimously (and if twelve did not agree, more would be found until there were twelve who agree), (4) about matter from what they had personally seen or heard, (5) binding on the judge, (6) to settle the truth concerning facts in a case, (7) between ordinary people, and (9) obtained as of right by the plaintiff (Makdisi 1999, p.1695).

> There was only one characteristic, number (8), that existed in the English jury system but not Islamic law which was the judicial writ directing the jury to be summoned and directing the bailiff to hear its recognition. However Makdisi concludes that 'No other institution in any legal system studied to date shares all these characteristics with English jury' (Makdisi 1999, p.1695).

Having identified three major similarities of the Common law with the *Shariah* Makdisi (1999) studies the three legal systems of Civil law, Common law and Islamic law and comes to the conclusion that there are a number of differences between Civil law systems with Common law. Common law however, shares similarities in both structure and function with Islamic law; 'Islamic law and the Common law demonstrated a remarkable kinship, while Civil law was a stranger to both' (Makdisi 1999, p.1717).

Makdisi (1999) explains that the opportunity of transplant of Islamic law to Common law occurred through Sicily. The spread of the *Maliki* School of law throughout North Africa and Spain during the Middle Ages continued to the 12th century. This area included Tunisia and Sicily. These two areas which were ruled by the Muslims for over 200 years were conquered by the Normans around 1061. In the 12th century England and Sicily were the only two states that had Norman kings. England was ruled by King Henry II and Sicily was ruled by Norman King Roger II. According to history the reign of both kings shared many similarities. Makdisi explains that it was during this period that transplanting of Islamic law took place in the form of Common law. 'Motive, method and opportunity existed for King Henry II to adopt an Islamic approach to legal and administrative procedures' (Makdisi, 1999, p. 1731).

However, it is not Makdisi alone who identifies a similarity between Common law and Islamic law. Badr (1978) also noted the parallels between Common law and *Shariah*. The author has found a similarity in the concept of the principle of agency in these two fields. Badr notes that agency did not exist in Roman law whereas 'Islamic law, like Common law later, had no difficulty in accepting agency as one of its institutions in the field of contacts and of obligations in general' (Badr, 1978, at p.197). Badr also highlights the claim of Cattan (1955)[53] on the derivation of English trusts from the Islamic institution of *waqf*, including the

[53] (Cattan 1955) Cited in - (Badr 1978) p.196.

claims of French and Italian[54] writers that the concept of *aval* in medieval French law was derived from *hawala*[55] of Islamic law.

Another writer Gaudiosi (1988), also claims that the institution of trusts in English law originated from the Islamic *wakaf.* The author states 'The *waqf* and the trust are remarkably similar in form, and ample opportunity for transmission of the Muslim institution existed at the very time the trust began to emerge in England. Surely so many coincidences should not be dismissed without further examination' (p.1247).

El-Gamal (2006) has also noted that there are factors to show the similarities and influence of Islamic law on Common law, such as the methodology of *stare decisis* or legal precedent in English Common law and the reasoning by analogy in Islamic law known as *Qiyas*[56].

Another author, a judge in the Court of Appeal of Nigeria, Abdullah (2007) highlighted a number of similarities between Common Law and *Shariah*; such as the concept of fair hearing or a fair trial and the rule of law under Common law and *Shariah* and the fact that from evidence proof of the facts may be made in both Common law and *Shariah*.

Having stated the above as proof to show the link of Common law to Islamic law, it is now possible to explain the similarities between the objections to derivatives in conventional law and *Shariah*. Makdisi (1999) states that the true nature of the transplant of Islamic law to Common law has yet to be discovered and that he only explored the starting point. It is therefore highly possible that the reason for the similarity in the objections in conventional law explored in this thesis which is based on the Common law system is because Common law has its origins in Islamic law or *Shariah*. This would fully explain the similar objections in the two seemingly different legal systems.

This is one possible explanation for the similarities to the objections in both systems of law.

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[54] Huvelin (1901) in *Annales de Droit Commercial*. Cited in (Badr 1978) p.196.

[55] This is the transfer of debts.

[56] (El-Gamal 2006) P. 16.

4.3 The Concept of Stewardship

There is another reason or basis for the strong dislike or prohibition of gambling and highly speculative activity that is common in *Shariah*, as well as in conventional law. The researcher while researching on this topic uncovered that the concept of duty of stewardship exists not only in conventional finance but also exists as a similar concept known as '*khalifa'* (vicegerent) in Islamic law. Could the concept of stewardship and *khalifa* be a reason for the similarity of objections? This is explored next.

Newton (1993) investigated the reason why business gambling and highly speculative activity is considered as 'wrong' by the business world, especially in situations where an economic crisis has occurred. Newton (1993) argues that the reason is not because gambling injures the gambler or even the gambler's family, but rather the origin of the moral condemnation of gambling lies with the duty of stewardship. As a steward, property is entrusted to him to be taken care of by the owner.

Newton (1993) raises three arguments to prove that the origin of why gambling is considered wrong is from the concept of stewardship:

- Firstly, the property that the human race has known to own has been the land farmed on and the animals kept for their wool, milk and food. Land and animals had to be cared for to reap benefits. Life depended on a careful balance of saving and liquidation. Communities that did not 'understand the duties of ownership presumably died out in hard times' (Newton 1993, p.406). Therefore Newton (1993) concludes that the necessities of survival created a situation where those who did not adopt certain minimum survival skills failed to transmit their culture to descendants. Therefore the gambler by ignoring the duties of ownership of property was violating this established norm. Therefore gambling was considered to be wrongful and bad.

- Secondly, Newton (1993) argues that from the point of view of religion in general, the earth is God's, and humans are considered to hold the property within it in trust for

God. The concept of stewardship is present in Judaism (Vogel, D 2001)[57] and Christianity (Chen 1975; Stivers 1979; Pratte 1985). According to these religions, resources were created by God and man has only the right to use these things for common use. Since man has been given the resources for common use it is man's duty to administer the resources and property not exclusively for his own purposes but for the purposes to serve the needs of the society as a whole. Thus man has the responsibility to use the property properly (Chen 1975; Stivers 1979; Pratte 1985; Vogel, D 2001). Thus gamblers who gambled property and money alike were committing acts against religious principles and thereby from a religious point of view, they sinned.

- Lastly Newton (1993) presents that there is a 'strong social interest in the care and conservation of all property in the commonwealth, that gives the public a justified and lively concern with the way people dispose of wealth that by law is their private property' (Newton, 1993, p.407). Thus gamblers who do not heed the need to care and conserve property would be committing acts which are wrongful in the eyes of the public.

Newton (1993) concludes that the concept of stewardship is the reason why gambling is thought to be wrong. Newton comes to this conclusion because the author believes there is no other 'source' be it from the Bible or from rights theory or even utilitarian warrant other than the concept of stewardship for this public prohibition of gambling.

In Islam reference to man being a *khalifa* occurs in two places in the Qur'an, Surah 2 verse 30:

> Behold, thy Lord said to the angels: "I will create a vicegerent on earth." They said: "Wilt Thou place therein one who will make Mischief therein and shed blood? - Whilst we do celebrate Thy praises and glorify Thy holy (name)?"

57 '…a classic rabbinical midrash on this passage suggests a more nuanced interpretation: "When God created Adam he led him past all the rees in the Garden of Eden and told him, 'See how beautiful and excellent are all My works. Beware lest you spoil and ruin My world. For if you spoil it there is nobody to repair it for you.' Moreover, it is followed in verse 30 by a clear restriction on man's domination of nature: people are permitted to eat only plants. And in the second creation story in Genesis 2:15, God places man in the Garden of Eden and instructs him "to works it and watch it" – which explicitly invokes the principle of stewardship.' (Vogel, D 2001).p. 353

He said: "I know what ye know not."[58]

And Surah 38 verse 26:

> 'O David! We did indeed make thee a vicegerent on earth: so judge thou between men in truth (and justice): nor follow thou lusts (of thy hearts), for they will mislead thee from the Path of God: for those who wander astray from the Path of God, is a Penalty grievous, for that they forget the Day of Account.'[59]

Man in Islam is considered the creation of God who is a vicegerent on earth and whose actions and conduct are governed by the 'terms of the contract and covenant of vicegerency of God's *Shariah*' (Ammara 2007).

According to Islam the true and absolute owner of the world's riches and property is God. As a vicegerent to God, man is required to fulfil his commission of vicegerency and adhere to the terms of the contract and covenant of vicegerency. This means that man has the right and freedom to possess this wealth for the benefit of society and to develop, invest and profit from it. However he is bound by this covenant of vicegerency and cannot gamble away or undertake highly risky behaviour when dispensing his responsibility (Doi 1984; al-Mawdudi n.d., as cited in Idris, 1990).

According to the online Merriam-Webster Dictionary (Merriam-Webster Dictionary & Thesaurus n.d) 'stewardship' is defined as 'the conducting, supervising, or managing of something; *especially***:** the careful and responsible management of something entrusted to one's care', whereas a 'vicegerent' is defined, by the same source, as 'an administrative deputy of a king or magistrate'. Both terms relate to responsibility bestowed on one by another or higher authority to take care of the property of the latter. It is submitted that both 'stewardship' and 'vicegerent' have a similar meaning in that in both cases man is required to prudently take care of the responsibility bestowed on him. The difference between the two terms or concepts would be the source of authority given to the steward or vicegerent. In conventional law the source is not necessarily divine whereas in Islam, God is the One to whom the duty is owed. Consequently, in both *Shariah* and conventional thought man has a

58 Translated by Abdullah Yusuf Ali
59 Ibid

responsibility to take care of the wealth and property bestowed on him, and thus gambling and highly risky behaviour is seen in both *Shariah* and conventional thought as wrong.

However, it should be noted that some scholars believe that the '*khalifa'* as explained in the *Quran* specifically refers to 'one who succeeds'[60]. In other words '*khalifa*' refers to a ruler and not every human being. If this interpretation is taken then the concept of vicegerency in Islam is not the same as stewardship in conventional thought.

Nevertheless in Islam there are clear injunctions which make gambling and excessive speculation *haram* (see section 2.4.2). In other words, while in conventional thought the concept of stewardship explains why gambling is considered wrong, in Islam there are clear injunctions which prohibit gambling. Thus this may be one reason why there is a similarity between objections to gambling, uncertainty and highly speculative activity that is common in *Shariah*, as well as in conventional law.

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[60] The scholar Jaafar Sheikh Idris in his article (1990) explored the meaning of '*khalifa'* and after quoting early commentators' views such as Al-Tabari, Al-Zamakhshari, Al-Razi, Al-Qurtubi and Ibn Kathir, the author comes to the conclusion that '*khalifa'* as mentioned in the Qur'an does not mean the popular interpretation that man is a vicegerent of God. Rather the author gives the following summary of what '*khalifa'* means based on the Qur'an, *sunnah* and early commentors' views of what *khalifa* means -

(i) 'The general meaning of *khalifa* is 'one who succeeds another'.
(ii) More particularly it means one who succeeds another as a ruler, a head of state
(iii) If the verse is interpreted according to the first general meaning, the *khalifa* would be Adam in particular but also all generations of mankind.
(iv) And they would be *khulafa* either in the sense of being successors of earlier inhabitants of the earth, or in the sense that each generation of them follows the other in inhabiting the earth.
(v) But if it is interpreted according the second meaning, the *khalifa* must be Adam in particular, but that can include all generations of rulers after him who assume his responsibility in implementing the Divine laws.
(vi) Adam and those rulers would be *khulafa* either in the general sense of succeeding others in assuming responsibility and having authority, or in particular sense of being the *khulafa* of God.' (Idris 1990)p.102.

4.4 Christianity and Morality

Another less easier to prove but possible angle as to why there are similarities between objections of gambling and highly risky and speculative activity in *Shariah* and in the history of conventional law is the possible influence of Christianity on Common law and the similarity of principles in *Shariah* and Christianity[61].

It would be hard to deny the similarities in the fundamental beliefs of two monotheistic religions, that is, Islam and Christianity.

Islam and Christianity are interlinked because both are, in reality, worshipping the same One God (Lewis & Algaoud 2001).

Islam is the only non-Christian religion that mentions Jesus[62] and Mary[63] and makes it compulsory for Muslims to believe in Jesus as a Prophet and Mary as the virgin mother of Jesus. Christians are called the people of the book and were generally allowed to practice their beliefs freely in the Islamic empire (Lewis & Algaoud 2001).

With all these similarities between the faiths it should be possible to find similarities in the objections of gambling and highly risky speculative activity.

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[61] Research was also conducted on the possibility of Judaism's influence on Common law and the possible prohibition of gambling within Judaism. Judaism's link to Common law was difficult to find. The only link is Judaism's influence through Christianity. This influence is based on the fact that the old Testament in Christianity is also known as the Torah in Judaism. As for the prohibition to gambling there is no clear prohibition found in the holy books of Judaism as to the prohibition of gambling. According to Schechter and Greenstone (2002) among the ancient Israelites no mention is made of games of chance, and no provision was made against them. This was until the period of the *Mishnah*. Schechter and Greenstone (2002) explain the status of gambling during this period –
With the introduction of foreign customs and amusements in the latter period of the Second Temple, playing with dice, was adopted by the Jews. The Rabbis were bitterly opposed to these imported fashions, and looked upon them with intense aversion (see Midr. Teh. to Ps. xxvi. 10, which speaks of "those that play at dice, who calculate with their left hand, and press with their right, and rob and wrong one another"). Mishnah means the beginning of the third century of the common era.The reason for the strong dislike of gamblers was because they were thought to be guilty of robbery. Gamblers were considered to be wasting their time in idleness as they were not interested in the welfare of humanity. While the general tendency of the Rabbis was to forbid all manner of gambling games, they distinguished between those who played for pastime and those who made gambling their profession. Games for pastime were allowed, especially for women and children, even on Sabbath (Schechter & Greenstone 2002).

[62] For example from the Holy *Quran* – 6:85; 3:45-47; 3:49-51; 3:52-53; 5:111-115, 3:55-58.

[63] For example *Ibid* – 3:35-37; 3:42-51; 4:156; 19:16-21; 19:23-26; 19:27-33

Here, two important elements must be proven:

- Evidence or proof that Common law was influenced by Christianity
- The existence of similarities in the objections towards excessive speculation in *Shariah* and Christianity.

Starting with the evidence that Common law was influenced by Christianity, research by the researcher showed that Canon law[64] is cited as one of the possible sources of Common law. Canon law. as defined in section 2.3, is the body of laws and regulations made by or adopted by ecclesiastical authority for the government of the Christian organisation and its members (Boudinhon 1910).

Hale (1713) when explaining the history of law in England, divided the sources of law in England into Lex Scripta or written law which Hale explained as statutory law and Lex non Scripta, the unwritten law of England which he explained as the sources of Common law. On the sources of Common law, Hale (1713) explained them as being derived from customs, Civil law and Canon law.

According to Seipp (1993) Common law lawyers made continuous reference to Canon law as early as the 1300s, through the 1600s, and beyond Common law lawyers either stated propositions of Canon law or reported opinions from Canon law in their pleadings. It is therefore possible these pleadings were accepted by the judges and essentially incorporated into Common law (Seipp 1993).

Evidence that reference by Common law lawyers to Canon law found its way into case law (and therefore Common law) can be seen as early as the mid 1600s. In the UK case of *Rex v Taylor* (1676) 27 and 28 Car. 11 3 Keble 607 the presiding judge Mathew Hale recognised that Christianity was part of Common law when in his judgement he stated:

> An indictment lay for saying the Protestant religion was a fiction, for taking away religion, all obligations to God by oaths, etc. ceaseth, and **the Christian religion is part of the law itself**, therefore injuries to God are as punishable as to the king or any common person. (Emphasis added).

[64] See section 2.3 above

This statement made by Matthew Hale was subsequently adopted in *Rex v Hall* 7 Geo. I and in *Rex v Woolston* 2 Geo.II (Wintersteen 1890). In the case of *King v Willaims* (1797) 26 Howell's State Trials 653 Lord Kenyon advised the jury that Christianity was part of the land. In the judgement of the court Justice Ashhurst at p.714 stated:

> All offences of the kind are not only offences to God, but crimes against the law of the land, and are punishable as such, inasmuch as they tend to destroy those obligations whereby civil society is bound together; and it is upon this ground that **the Christian religion constitutes part of the law of England**. (Emphasis added).

Further, Berman (1986) traced one of the sources of contract to be Canon law. Sibley (1984) on the other hand. in his analysis of religion and law finally comes to the conclusion that inevitably there will be points of 'intersection' between law and religion (p.66).

Thus the probable influence of Christianity on Common law may be established.

Next, the possible existence of a similarity in the objections towards excessive speculation between *Shariah* and Christianity is explored.

In Islam gambling is strictly and clearly prohibited in the *Quran*. As stated in verse 219 of chapter 2 of the *Qur'an*: 'They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit."'[65]

However, in the holy books of Christianity there is an absence of any Biblical condemnation of gambling (Newton 1993, p.407; Gospel Communications International 1995-2008). Although protestant churches have condemned gambling (Newton 1993) there is no clear prohibition found in the holy books of Christianity (Newton 1993; Gospel Communications International 1995-2008; Schechter & Greenstone 2002).

In Christianity, although as stated above there is no Biblical condemnation of gambling per se, there are those who believe that gambling violates principles in the Bible (Pratte 1985; Hoffmann 2000).

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[65] See section 2.4.2.

According to Pratte (1985) gambling is immoral in Christianity because it does not fall within any of the legitimate ways for money or possessions to pass to another. The Bible only authorises three legitimate ways for money or possessions to pass from one owner to another. The three ways are through compensation for work done[66], through normal law of exchange where each party is paid fairly or compensated fairly by receiving possessions of fair value in return for what he gives up[67], and thirdly through charity where a person through his own free will unconditionally gives something away as an expression of good will or kindness with no obligation for the receiver to offer any compensation in return[68]. Pratte (1985) argues that gambling does not fall into any of these lawful ways of transferring property and is therefore immoral.

The second reason why gambling is immoral in Christianity, Pratte (1985) argues, is due to the Bible's condemnation of covetousness and greed.

The Bible repeatedly warns against greed and covetousness[69]. This, Pratte (1985) claims is indicative that gambling is immoral. Gambling is where a gambler wants to take someone else's property without their consent and without returning a fair value in exchange; the gambler is guilty of covetousness.

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[66] Examples from the Bible are - 1 Timothy 5:18 - The labourer is worthy of his wages. [Luke 10:7]
Ephesians 4:28 - Do not steal but labour at good (beneficial) work.
1 Thessalonians 4:11,12 - To meet our needs, we should do our own business and work for an income (not take what other people earned). [Matt. 20:1-15; James 5:4]
2 Thessalonians 3:10-12 - Like Paul, people should work so they can eat their own bread (not other people's bread). If they will not work, they should not eat.
We must not try to live off the labours of others. We can expect goods or services from others only as compensation for work we do that produces something of benefit (that which is good - Eph. 4:28) (Pratte 1985).

[67] Bible examples are: Genesis 23:1-18 - Abraham bought a field and a cave for money.
Matthew 13:45, 46 - A merchant sold possessions to buy a pearl.
John 4:8 - Disciples bought food. (Pratte 1985).

[68] Bible examples are:
Ephesians 4:28 - One who has earned goods by his own labour may choose to give to others in need.
2 Corinthians 9:6, 7 - We should give willingly and cheerfully, not grudgingly. Note: If gambling fits this, then we should all gamble bountifully!
Acts 20:35 - It is more blessed to give than to receive. Do gamblers consider giving to be more blessed than receiving?
1 John 3:17, 18; 1 Corinthians 13:3 - Giving must be motivated by love, compassion, and desire to help others. Is this what motivates gamblers? No, they agree to give (if they lose) only because they want to win what others possess! (Pratte 1985).

[69] For example Ephesians 5:5-7; 1 Corinthians 6:9-11 - Those who covet will not receive the kingdom of God, but God's wrath abides on them.
Romans 1:29-32 - They are worthy of death, and so are those who approve or encourage their conduct.
1 Corinthians 5:11 - Church members who practice it should be disciplined. (Pratte 1985).

The third reason is because of the principle of stewardship. According to the Bible, as stewards, humans hold the possessions and property of the world in trust for the master and must use it to achieve the master's purposes[70]. Gambling wastes or risks losing possessions or property and therefore, a gambler is an unfaithful steward (Pratte 1985).

Another reason given by Pratte (1985) as to why gambling is immoral is because it violates the commandment in the Bible to 'love thy neighbour as yourself'[71]. Also gambling involves money and money is a root of all kinds of evil[72], such as poverty, neglect of families, quarrelling and divorce. Further, gambling lures gamblers into moral dangers such as temptation and evil influence which the Bible advises against[73]. Finally gambling is immoral

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[70] For example: 1 Peter 4:10, 11 - We are stewards of God's manifold blessings and should use these blessings to glorify God "in all things." A steward is a servant who has been entrusted to use his master's property to achieve the master's purposes. The master will judge the steward for how well he used the property. [Luke 12:42-46; 2 Chron. 28:1; 1 Cor. 4:1,2]
Psalm 24:1, 2; 50:10-12 - Material property is part of our stewardship in that God ultimately owns all physical things but has entrusted them to us.
1 Timothy 6:9, 10, 17-19 - Instead of being greedy and loving physical things, we should use them to accomplish God's purposes. This includes providing for the needs of ourselves and our families, giving to the church, preaching the gospel, and helping the needy. Our material possessions are not ours to use as we please. We must use them to do God's will and then give account to Him for our use of them. (Pratte 1985).

[71] For example: Matthew 22:39 - The second greatest command is "love your neighbour as yourself." Does the gambler love his neighbour as he loves himself?
Luke 6:27; 1 John 3:16-18 - Loves leads us to do good, not harm, even to our enemies. Note that coveting violates the law of love because it does harm our neighbour (Romans 13:8-10). Love does not seek to profit by taking what belongs to others against their will and without compensation. But the very essence of gambling is hoping other people will lose, so you can profit at their loss.
Matthew 7:12 - Do to others as you want them to do to you. Does the gambler want the other players to take his possessions? No! Then he must not try to take theirs! By definition, gambling violates the law of love because a gambler tries to do to others what he does not want them to do to him.
1 Corinthians 13:5 - Love seeketh not its own.
Philippians 2:4 - We should seek, not just our own interests, but the interests of others. Gambling, by its nature, is selfish and self-seeking. The gambler seeks personal gain and profit by taking other people's possessions without requiting them. Such is completely contrary to love. (Pratte 1985).

[72] Examples from the Bible – 1 Timothy 6:9, 10 - Love of money is a root of all kinds of evil. Greed leads to many foolish and hurtful lusts, many sorrows, etc. If gambling is greed, as we have claimed, then we should expect to find it associated with all kinds of sin and immorality.
Matthew 7:16-19 - A tree is known by its fruits. A corrupt tree will surely produce corrupt fruits. If so, it should be destroyed (v19). Hence, if gambling produces many forms of evil, this will confirm our conclusion that gambling is evil of itself. (Pratte 1985).

[73] Examples in the Bible – 1 Timothy 6:9 - Those who love money (v10) and are minded to be rich fall into temptation, a snare, and many foolish and hurtful lusts. Surely no one can deny that temptation is associated with gambling.
Matthew 6:13; 26:41 - We should pray to avoid evil and temptation. Watch and pray lest you enter into temptation. Is it right to pray to avoid temptation and then deliberately subject ourselves to it, simply for the sake of passing pleasure? Note James 4:3; Matthew 18:6-9.
1 Corinthians 15:33 - Evil companions corrupt good morals. Yet all gambling puts us in the company of evil men and tempts us to participate in other sins.
Proverbs 13:20 - Keeping company with wise men will make us wise, but associating with morally and spiritually foolish people will cause us to suffer. [24:1,2]. (Pratte 1985).

because gambling tempts and influences others to sin, and this is contrary to what is stated in the Bible[74].

Pratte (1985) concludes that gambling is immoral according to the Bible even though not explicitly prohibited.

Hoffman (2000) states that gambling is opposed by many denominations in Christianity because gambling is seen as idolatrous; relying on luck or fate is similar to worshipping pagan gods. Secondly, biblically-based work ethics reject get-rich-quick schemes which are part of gambling and thirdly, because gambling is habit forming, Christians are supposed to be temperate and have self control at all times (General Council of the Assemblies of God 1983; Commission on Theology and Church Relations 1996).

Since there are general prohibitions to gambling in Christianity one might infer that like in Islam gambling is considered wrong. This may explain the similarity of the objections between Common law and *Shariah*.

However, this inference may not be strong because there are many others who believe gambling in the religion of Christianity is not at all prohibited[75] (Schwartz 2005; Wein n.d.).

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[74] For example - 1 Timothy 4:12 - Set a good example in word, manner of life, love, faith, and purity. Does the gambler set this kind of example?
Matthew 5:13-16 - Our lives should be like a light so others may see our good works and glorify God. Who will glorify God from seeing you gamble?
Matthew 18:6, 7 - Woe to one who tempts others to sin. It is better to be drowned than to be guilty of this. (Pratte 1985).

[75] ‘The question of gambling arose again in Eastern European Jewish society in connection with the government-sponsored lotteries that came into vogue in twentieth-century pre-World War II times. Jews participated very heavily, as the poor always do, (after all, it is the only way that they feel that they can instantaneously become rich) in purchasing tickets and chances in these lotteries. The question basically arose as to what was considered gambling in Talmudic and/or rabbinic terms. Here again, the people ran ahead of the rabbinic devisors, and purchasing a lottery ticket soon became unquestioned legitimate behaviour in the Jewish world. The reasoning justifying this type of gambling as opposed to other forms of gambling - such as Las Vegas for instance - was pretty tortured but eventually it was seen as a voluntary tax paid by the lottery ticket buyers to the government. This mitigated the issue of gambling and allowed the poor Jews to lose their money happily at million to one odds in state-run lotteries. The Mifal haPayis - the state-run lottery here in Israel - has hundreds of thousands of religious Jewish buyers every week without a pang of conscience or a rabbinic objection.
Further issues regarding gambling began to complicate the Jewish world especially in North America later in the twentieth century. There the Catholic Church for decades on end sponsored "Bingo" -a mild but fairly addictive form of gambling - as a means of raising funds for its institutions. Jewish synagogues and schools soon initiated their own "Bingo" games to raise funds for their needs. Many rabbis opposed this type of fundraising activity, saying that holiness should not seek to find its support in basically unholy projects. However, the practicalities of the expenses of operating synagogues and especially schools soon overwhelmed any moral objections and Jewish sponsored "Bingo," raffles, and even Las Vegas nights became accepted practices in Jewish institutions

4.5 Ethics and Gambling

According to McGowan (1997) there are two schools of thought towards the ethics of gambling. There are the ‘pro’ and ‘anti’ gambling groups. Those who are pro-gambling believe in tolerance and that nobody has to sacrifice their basic freedoms in order to achieve some goal of public welfare. This entails that society has to tolerate the ‘right’ of an individual to perform actions which might be destructive to that society, as long as that right to perform those activities is guaranteed by law. This is known as the ‘ethics of tolerance’ and can be explained as follows – the ‘means’ that a person uses to achieve a goal is more important than the goal itself (McGowan 1997).

Then there is the other school of thought, the anti-gambling school. Those who oppose gambling take the view that gambling preys on the poor or those who become addicted to gambling. This school argues that gambling contributes to crime, hurts the local economy by increasing bankruptcies and reducing disposable income, and exposes children to immoral activities (Winkler 1994; Ethics and Religious Liberty Commission 1997a, 1997b, 1997c; Kennedy 1999 as cited in Hoffmann 2000).

An example of a proponent of this school would be Bentham (1876) (as cited in Skolnick 1988, p.10). Bentham argues that heavy risk taking is morally wrong on utilitarian principles. The pain of losing would exceed the pleasure of winning when betting one’s last money.

It is thus argued by anti-gambling activists that in the interest of society, gambling should be outlawed. This anti-gambling school of thought has been described as the ‘ethics of sacrifice’ (McGowan & Brown 1994; McGowan 1997). Ethics of sacrifice is where sacrifice is used as a moral concept to advance ‘the merits of a particular public policy issue, public policy makers must be able to persuade the public that it must give up some benefit or “right” to achieve a noble goal or end’ (McGowan 1997, p.281). McGowan (1997) argues that it has been used by religious leaders and political leaders as well, and quotes John F. Kennedy’s famous ethics of sacrifice phrase: ‘Ask not what your country can do for you; Ask what you

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in the United States and Canada. The objections raised to this type of fundraising have never disappeared. They have merely been ignored.’(Wein n.d.).

can do for your country!’ (McGowan 1997, p. 282). The good end would be a harmonious society (McGowan 1997).

This school of thought that advocates ‘ethics of sacrifice’ and therefore anti-gambling might also point to the reason why there are similarities between prohibitions towards excessive speculation in *Shariah* and conventional finance. Those who fall within this school of thought could have influenced the passing of law and public policies which were anti-gambling and speculation.

However, as noted and explored by Sklonick (1988), there has been a shift in society’s perception of vice. In the case of gambling there has been a shift in the attitudes towards it. For example, in 1964 no lotteries existed in the United States. Today, lotteries are found in a number of states, largely for the purpose of raising revenue (Skolnick 1988). In other words there has been more acceptance of gambling. Therefore, there are more who fall within the ‘ethics of tolerance’ school of thought. Skolnick (1988) notes that the conflicting opinions in a pluralistic society and the acceptability of vice depends on a number of factors such as, the rise and fall of puritan values, government financial needs and pressures, freedom of choice, and government exploitation of moral weakness.

One may infer that in the past those from the ‘ethics of sacrifice’ school of thought may have influenced laws and policies which were anti-gambling and anti-speculation. This would explain the similarities between the prohibitions towards derivatives in conventional law with *Shariah* in the past. However, with the change in attitude towards vice due to a number of reasons listed above, there has been a general trend of many more policy makers following the ethics of tolerance school of thought. This would explain why conventional law’s tolerance of gambling and speculation is much higher than *Shariah* today.

4.6 Answering the Second Subsidiary Research Question

The second subsidiary research question – Why are there similarities in objections towards speculation in *Shariah* and conventional law? – was investigated by researching the probable links between *Shariah* and conventional law.

Four probable links were found between *Shariah* and conventional law and thought. Firstly, the influence on or origination of Common law from Islamic law; Secondly, the concept of stewardship which exists in *Shariah* and conventional thought; thirdly, the influence of Christianity in Common law and the similarity of objections towards gambling within Christianity and Islam; and lastly, the ethical condemnation of gambling which is similar to the objections in *Shariah* towards *maisir* and *qimar*.

It is opined that to prove that one reason overrode the rest and was the only source for explaining the similarities between the objections to derivatives in *Shariah* and conventional law is not possible. Rather it is opined that all four possible explanations may have worked severally but in unison to cause conventional law to have similarities in objections towards derivatives with *Shariah*.

4.7 Summary

This chapter attempted to answer the second subsidiary research question. The probable reasons were investigated and explained. It was concluded that no one specific reason investigated could be conclusively determined to be the reason for the similarities in the objections in *Shariah* and conventional law.

The next chapter lays down the methodology used for the first and second stage of this qualitative research.

Chapter 5 Methodology

5.1 Introduction

This chapter presents the research design and methodology for this study. In the previous chapters it was established, firstly that the objections in *Shariah* towards derivatives are similar to the objections that existed in conventional finance towards derivatives in the past. The reasons why this similarity occurred in the two divergent and different fields were also explored in Chapter 4.

In this chapter the research paradigm, research methods, sources of data and data collection methods will be described. Thereafter, data management and analysis will be explained.

5.2 Research Design and Research Questions

The study presented here sets out to explore the laws and regulations that were passed in conventional finance in the UK and US to overcome the objections aimed at derivatives and its possible application in Islamic finance to overcome the objections in *Shariah*. This research follows the qualitative inquiry paradigm and historical methods, and case study methods for answering the following research questions:

- Problem Statement - **How can the objections towards derivatives in Islamic finance be overcome by adapting laws from the legal history of derivative usage in conventional finance?**
- Subsidiary research questions –
  1. How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance?

2. Why are there similarities in objections towards speculation in *Shariah* and conventional law?
3. What laws passed in conventional finance can be used to overcome the objections to derivatives in Islamic finance?
4. Are derivatives needed in Islamic finance?
5. Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?
6. Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?

5.2.1 Research Paradigm and Justification – Interpretivism, Qualitative Research

Interpretivism, or the qualitative approach, is a way to gain deeper understanding through discovering meanings by improving one's comprehension of the whole (Neill 2006).

Scholars have defined qualitative research as 'a situated activity that locates the observer in the world' (Denzin & Lincoln 2005, p.3), and also as: 'qualitative research begins with assumptions, a worldview, the possible use of a theoretical lens, and the study of research problems inquiring into the meaning individuals or groups ascribe to a social or human problem' (Creswell 2007, p.37). Thus qualitative research is concerned with creating an understanding of phenomena studied in their natural setting (Berg 2007).

Qualitative research seeks to create meaning from reality and it is best used for investigating phenomena which is not well known. It emphasises the quality and processes rather than measurement in terms of quantity, amount, intensity or frequency (Denzin & Lincoln 2005). Qualitative research asks questions such as how and why, while quantitative research explores questions such as who (how many), and what (how much) (Perry 2002).

This research attempts to ask questions such as, How do *Shariah* objections compare with conventional finance?; Why was there a similarity in the objections?; How can the laws passed in conventional finance be used in Islamic finance? Rather than answering questions of how much or how many, this thesis attempts to describe depth and explore deeper issues. This thesis therefore undertakes a qualitative inquiry.

5.2.2 Research Methods

Qualitative research involves a variety of approaches such as narrative research, phenomenology, grounded theory, ethnography, case study and historical method (Denzin & Lincoln 2005; Neill 2006; Berg 2007).

Research carried out in this thesis utilised the historical method, and investigated past historical laws from the early 17th century to the 20th century and then extrapolated from these, the relevant laws that could be used in *Shariah*. Thereafter, the possible use of these laws in the current Islamic finance industry was explored through in-depth interviews with those practicing Islamic finance. Therefore, the research methods employed in this thesis comprise two stages:

- The first stage used the historical method to identify the relevant laws in conventional finance that could overcome the objections in *Shariah.*

- Thereafter the second stage collected data to analyse whether conventional laws could be used in Islamic finance by using the case study method. Interviews were conducted, and participants questioned on the need for derivatives, the applicability of laws, and other recommendations in Islamic finance through semi-structured interviews.

The two stages are illustrated below in figure 5.1. The two methods used, that is, historical method and case study method, are further explained below.

Figure 5.1 Flow Chart Illustrating Research Methodologies

Problem Statement/Research Question - **How can the objections towards derivatives in Islamic finance be overcome by adapting laws from the legal history of derivative usage in conventional finance?**

↓

STAGE 1:
Historical Method: Review laws from the 17th to 20th centuries. Identify, extrapolate, and match these laws with *Shariah* objections.
This first stage will answer
Subsidiary research question **#3:**
What laws passed in conventional finance can be used to overcome the objections to derivatives in Islamic finance?

↓

STAGE 2: Case study method: laws identified possible practical use in Islamic finance in Malaysia. Conduct in-depth semi-structured interviews.
This second stage will answer the following subsidiary research questions:
4#: Are derivatives needed in Islamic finance?
5#: Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?
6#: Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?

5.2.2.1 Historical Method

The historical method is a technique for discovering, from records and accounts, what happened during some past period, but it is not simply fact-centred; it seeks to offer theoretical explanations for various historical events (Gall, Borg & Gall 2003). Scholars have described the historical method as follows: it involves systematic collection and objective evaluation of data relating to ‘past occurrences in order to test hypotheses concerning causes, effects, or trends of these events that may help to explain present events and anticipate future events’ (Neill 2006). Historical research involves the examination of elements of history, by discovering from records what happened during some past period (Marshall & Rossman 1999; Berg 2007).

The strength of historical content analysis is that it is ‘unobtrusive and nonreactive: It can be conducted without disturbing the setting in any way’ (Marshall & Rossman 1999, p.117).

The historical method is used in a wide variety of fields in social science (Grubb 2001), such as consumer research (Smith & Lux 1993), political history, economic history, urban regional, environmental history and cultural history (Oberwittler 1997), education (McCullough & Richardson 2000), and even in the arts (Wood 2000). It is a useful methodology to discover the past and through it predict or shape the future.

In this thesis the first stage of research employed the historical method. A review of laws in the UK and US that were created to overcome objections against derivatives in conventional finance from the 17th century to the 20th century was carried out in Chapter 6.

Laws were reviewed from the 17th century because the history of derivative usage (as shown in Chapter 2) shows that it was in the 17th century that derivatives and particularly futures were traded on exchanges. It was during this time that futures trading had similar features with the futures trading in the futures exchange markets today. It is also at this point in history where legislation on derivatives can be seen to emerge. Thus legislation from the 17th century was the starting point where this thesis began analysis for the historical method.

From the laws that were reviewed only relevant provisions which may overcome the objections in *Shariah* against derivatives were selected, enumerated and discussed in Chapter 6.

Selection of the laws was done by searching statutes and amendments that were passed. The relevant statutes were located through archival research via online indices of the statutes passed and through search engines by subject matter. The relevant statutes were also located by reviewing articles which highlighted the legal objections towards derivatives and the relevant legislation which sought to amend speculative and other abuses in the derivative exchanges (more on this in section 5.4.1).

5.2.2.2 Case Study Method

'Case Study' has been considered as a methodology as well as an object of study, and is quite popular in fields such as medicine, political science and law (Miller & Salkind 2002). A case study can be loosely defined as 'the exploration of a "bounded system", something identifiably set within time and circumstance' (Schram 2006, p.107).

Yin (1981, p.3) explains that: 'As a research strategy, the distinguishing characteristic of the case study is that it attempts to examine: (a) a contemporary phenomenon in its real-life context, especially when (b) the boundaries between phenomenon and context are not clearly evident.' Yin (1981) further explains that a case study can be done using either qualitative or quantitative data, further, the evidence for the case study can be from fieldwork, verbal reports, observations, archival records or any combination of these. Case study methodology is used when questions such as why, how and what are being asked (Yin 2003).

In this PhD research the research question and subsidiary research questions use 'what', 'why' and 'how' enquiries. Also this research studies a contemporary phenomenon which is whether the objections towards derivatives which are being raised currently in Islamic finance can be overcome. The evidence for this is derived through interviews of Islamic banking and finance professionals.

According to Gerring (2007, p. 40), case studies may be more useful when a subject is being encountered for the 'first time or is being considered in a fundamentally new way'. Applying this, in this research the subject - using conventional laws to overcome objections to derivatives in Islamic finance - is a new or first encounter; this type of study or research has hardly been undertaken and therefore a case-study approach would seem to be the right methodology to use.

The type of case study can be distinguished in terms of the size of the bounded case, that is, whether the case involves one individual, several individuals, a group or even an activity (Creswell 2007).

Yin (1981) divides a case study research into three types, exploratory, explanatory or descriptive. Exploratory cases are sometimes considered as a preface to social research. Explanatory case studies may be used for carrying out causal investigations. Descriptive cases require a descriptive theory to be developed before starting the project (Tellis 1997).

Stake (1995) included three others distinctions – intrinsic case study, instrumental case study and collective case study. An intrinsic case study is where the researcher has an interest in the case itself where the researcher draws out what can be learned about that particular case; an instrumental case study is where the case can be used to facilitate an understanding of something else; and the collective case study is where an instrumental case study is extended to a number of cases. In other words the research may use the case studies to theorise about a more general phenomenon (Stake 1995; 2008).

Tellis (1997) explains that in all types of case studies classification, there can be single-case or multiple-case applications. Further, one of the important sources of case study information is interviews. The interview can be open-ended, focussed or structured (Tellis 1997).

In this thesis, if Yin's (1981, 2003) classification is followed, the case study approach taken can be described as exploratory and descriptive. It is exploratory because the researcher is seeking to explore whether Islamic finance professionals believe that derivatives are needed in Islamic finance; whether conventional laws can be used to overcome the objections; and whether other further laws or recommendations need to be adapted. It is also descriptive because this research required a detailed description of the comparison between the objections in conventional finance and Islamic finance, and then a detailed description of the historical laws from the 17^{th} century onwards, before the case study methodology could be carried out.

On the other hand, if Stakes's (1995, 2008) classification on the type of case study approach is followed, then this research can be described as an instrumental case study approach, where the researcher focuses on the issue and then selects one bounded case to illustrate the issue. Applying this research technique to this thesis, the applicability of the laws identified in the historical research (the issue), is illustrated or tested in one bounded case which is the field of Islamic finance. Therefore, the case studied will be the applicability of the laws extrapolated on derivatives in Islamic finance.

In this thesis Yin's classification is followed since under section 5.7 below, the criteria to judge the quality of research design also follows Yin's (2003) criteria. Thus for consistency purposes Yin's (1981, 2003) approach is followed, that is, the case study approach taken in this thesis is exploratory and descriptive.

5.3 Sources of Data and Sample Selection

Sources of data for the first stage of the research were all laws passed in the UK and US which involved trading in forwards, futures and options, from the 17^{th} century to the 20^{th} century. These are secondary sources of data as they are provisions taken from the source documents, that is, legislation passed by the government during that period of time.

The laws in the UK and US were the prime focus in this thesis. The reason for this is firstly because these two countries have a rich legal history which can be traced and followed in discussing the legal objections, and further, these two countries are among the top countries in the world that have the largest market for derivative trading (Bank of International Settlements 2008, pp.31 and 109A).

Laws were reviewed from the 17^{th} century because the history of derivative usage (Chapter 2) shows that it was in the 17^{th} century that futures traded had similar features to the futures traded in the futures exchange markets today. It is also at this point in history where legislation on derivatives can be seen to emerge. Thus legislation from the 17th century was the starting point at which this thesis started analysis for the historical method.

Sources of data for the second stage of the research were semi-structured interviews. Purposive sampling was the sampling method used in this research. This form of sampling was used so that those with specific knowledge in the area of Islamic finance could be sought. Purposive sampling is where the sample is chosen carefully within the parameters of a population that a researcher is interested in (Silverman 2006).

The criteria for inclusion in the interviews for this research were:

1. Persons who were approximately mid 30s and above,
2. Having specific knowledge in Islamic finance, and conventional finance and/or law, through work experience or through academic research for approximately five years, and
3. Able to converse in English.

The age of professionals was set at around the mid 30s and above. This was to ensure that the interviewees would be adequately experienced and knowledgeable in the area of expertise sought by the researcher. The yardstick for measuring expertise of the respondents was that they were required to have approximately five years of experience in the area of Islamic finance and conventional finance and/or law. These requirements posed a challenge to the researcher in finding professionals with knowledge in these two fields for the specified period of time.

A list of potential interviewees was compiled. They were identified mainly from personal acquaintance of the researcher through attendance of conferences, and from writings in journal articles (some *Shariah* scholars have written extensively on derivatives in Islamic finance from Malaysia) and through the technique of snowballing. This means where the initial or first interviewees were asked if they knew others who had knowledge in the required fields.

A proportional mix of academics and industry people were sought to give their opinions on the interview guide discussed below. The sample size was 30 respondents[76].

5.4 Data Collection

Two forms of data were collected, for stage one, archival research of historical laws and for stage two. in-depth semi-structured interview responses from respondents.

5.4.1 Archival Research

The laws of the US and UK were retrieved from databases mainly through archival sources of the laws at the University Malaya law library, through the internet and/or through Monash catalogue databases. The online databases that were used are as follows:

For UK statutes:

- English reports, full reprint (1220-1865)
- Justis
- Westlaw.Australia
- Acts of the UK Parliament and Explanatory Notes at www.opsi.gov.uk/acts
- Her Majesty's Stationery Office (HMSO) at http://portal.unesco.org/education/en/ev.php-URL_ID=12851&URL_DO=DO_TOPIC&URL_SECTION=201.html

For US State and Federal laws:

- HeinOnline
- LexisNexis : total research system
- US law.com

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[76] Case-studies which involve in-depth interviews do not have a specific number of persons that have to be interviewed, (Lincoln & Guba 1985; Marshall & Rossman 1999; Yin 2003). In this research 30 respondents were interviewed taking the following factors into consideration - the number of persons with the required knowledge, the purpose of this research, and the time available for the researcher to do the research.

The following laws and sections of the following statutes were reviewed and analysed under the first methodology:

UK Legislation:

- William III, 1696-7: An Act to restrain the Number and Ill Practice of Brokers and Stock-Jobbers.
- Statute Charles II, An Act for prevention of Frauds and Perjuryes (1677).
- Sir John Barnard's Act or Stock Jobbing Act 7 Geo 2 c. 8 (1734)
- Gaming Act 1845
- Banking Companies' (Shares) Act (30 & 31 Vict c. 29) 1867
- Prevention of Frauds (Investment) Act 1939 (2 & 3 Geo. 6)
- Financial Services Act 1986 c.60
- Financial Services Modernisation Act 2000

US Legislation:

- Cotton Futures Act STAT. 694 (1914), re-enacted, 39 STAT. 476 (1916)
- Grain Standards Act 39 STAT. 482 (1916)
- Warehouse Act 39 STAT. 486 (1916)
- Futures Trading Act 42 STAT. 187 (1921)
- Grain Futures Act 42 STAT. 998 (1922)
- Commodity Exchange Act Ch. 545 49 Stat. 1419 (1936)
- Commodities Exchange Act Amendment 49 Stat. 1491
- Commodities Futures Trading Commission Act 88 Stat. 1389 (1974)
- Futures Trading Act 92 Stat 865 (1978)
- Futures Trading Act 96 Stat. 2294 (1982)
- Futures Trading Act 100 Stat. 3556 (1986)
- Futures Trading Practices Act 1992
- Commodity Futures Modernization Act of 2000 114 Stat. 2763, 2763A-365
- Select US state laws

The statutes were identified through, firstly, journal updates which summarised new statutes and amending statutes on futures and options markets, such as Dealings in Futures (1927) and Legislation Affecting Commodity and Stock exchange (1932) from the Harvard law Review. Secondly, through journal articles where the authors reviewed recent amendments made to the futures and options markets, such as Parker (1911), McMath (1921, 1925), Patterson (1931), Taylor (1933), Lower (1938), Rosen (1983), Markham (1991), Schlegel, (1993), Tickell (1999, 2000), Kloner (2001), Harrison (2004), and the US Commodity Futures Trading Commission (2007). Thirdly through books that discussed the historical and legal development of derivatives, such as Swan (2000). Lastly through the statutes themselves, which had amending Act numbers with years, which the researcher used, to find past statutes dealing with futures and options.

This first stage, that is, the historical methodology, started in September 2007 and was completed at the end of February 2008.

5.4.2 Interview Questions, and Semi-structured Interviews

Exhaustive semi-structured interviews, face to face, or where necessary, through phone and email were conducted on a sample of key academic and industry people in the field of Islamic banking and finance. A sample of the email sent out to potential participants is found in Appendix 5. Participants of face to face interviews were given a small token of appreciation (Monash University gift items such as mugs). Prior approval from the Standing Committee on Ethics in Research involving Humans (SCERH) Monash University was obtained (Appendix 1). This second stage of the case study methodology begun after ethics approval was obtained on 28th of February 2008 and ended in the first week of September 2008.

5.4.2.1 Converting Research Questions into Interview Questions

When formulating interview questions one must revisit the core research and the subsidiary research questions. It is interesting to note that Wengraf (2001, p.72), has stated ‘a theory question is never an interview question’. This means that the interviewee must understand what information is being asked from them and to do so they must understand the question. A theory question may not be understood by the interviewee, further the interviewee may not be able to answer a theory question or may find such theory questions intimidating. Therefore the interview questions formulated attempted to ask questions which extracted the relevant answers without being too theoretical or complicated. Explained in figure 5.2 is the formulation of the interview questions from the research question and the subsidiary research questions.

Figure 5.2 Research Question to Interview Questions

Research Question:
How can the objections towards derivatives in Islamic finance be overcome by adapting laws from the legal history of derivative usage in conventional finance?

Subsidiary question #4

Are derivatives needed in Islamic finance?
Explanation
This research question seeks to find out whether derivatives are actually needed in Islamic finance from those practising Islamic finance .

Interview Questions

1. In the light of Islamic finance, do you think futures/options in *halal* (permissible) commodities, should be allowed in Islamic finance? If yes why? if not why not?

2. In your opinion how acceptable are futures in Islamic finance compared to options?

3. In your opinion are futures/ options more useful or harmful?

4. If all the objections against futures/options can be overcome in *Shariah*, do you think they would be accepted in Islamic finance?

Subsidiary research question #5

Can laws from conventional finance be used in Islamic finance to overcome similar objections?
Explanation:
This research question seeks to explore firstly the possible acceptability of derivatives by those in Islamic finance and secondly the perception of the interviewee on the acceptability of past and existing laws in conventional finance in Islamic finance.

Interview questions

5. Do you think laws can be used to regulate futures/options?

6. What is your opinion of using conventional laws in Islamic finance to regulate derivatives?

7. Do you think restricting derivative trade activity by enacting laws, such as limiting the number of days for future delivery, or imposing taxes on each future or option sale, would address excessive speculation and risky behaviour at an exchange?

8. In your opinion would laws that require licences to be issued to boards of trade and those who carry out investment business help in minimising speculation at an exchange?

9. What is your opinion of designating a regulating body to oversee functions of boards of trade, exchanges and others who engage in derivative trading?

10. Do you think training those who provide services to investors on ethical and *Shariah* principles would curb excessive speculation and uncertainty?

11. Could laws that provide investor protection such as punishing dishonest behaviour overcome excessive speculation and uncertainty?

12. Would banning or illegalising options ensure genuine sales take place and excessive speculation is curbed?

13. Would imposing stiff penalties for violations of laws relating to derivative trading ensure compliance with *Shariah* principles?

Subsidiary research question #6

Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?
Explanation:
This research question explores what further laws and/or recommendations can be postulated to admit derivatives into Islamic finance.

Interview Questions

14. Are there any special laws that, in your opinion, would help in the acceptability of futures/options in Islamic finance?

15. Is there anything else in your opinion that should be done that can help to admit futures/options in Islamic finance?

16. Are there alternatives to hedging in your opinion that would be a better choice in Islamic finance as compared to futures/options?

The interview questions started with the interviewee's opinion of derivatives in Islamic finance:

> In the light of Islamic finance, do you think futures/options in halal (permissible) commodities, should be allowed in Islamic finance?

The questions then narrowed down to the interviewee's specific acceptance of certain laws that were proposed by the interviewer:

> In your opinion would laws that require licences to be issued to boards of trade and those who carry out investment business help in minimising speculation on an exchange?

The interviewer attempted to further prompt the interviewee where interesting issues or information were being described. To a question whether imposing taxes on each futures or options sale would reduce objections towards derivatives, such as *gharar, maisir* and *qimar*, the following discussion took place:

> … Another thing is that this is not an Islamic issue. (Interviewer: no it is not an Islamic issue; this is more on whether these types of laws can reduce speculation) I mean it would definitely reduce speculation but it would also reduce hedging. (Interviewer: But do you think it would reduce speculators more or hedgers more or equally?) It's hard to say, it depends on how much benefit the hedging party would get, right? (Interviewer: Dr. what about having laws where you only impose taxes if they don't fulfill certain conditions?) I think it would be very hard to come up with the conditions like 'safe-harbour' from conditions, right, and also remember presumably if someone is hedging any profit they make on the hedging transaction is off-set by a loss on the underlie, only speculators should be having that profit that loss position, and presumably you would take care of that with the income tax, right, so I don't think it makes much sense to regulate this with taxation.

Abstract of an interview with a *Shariah* Scholar.

The interview questions also sought to extract the interviewees' opinions of other alternatives to hedging:

> Are there alternatives to hedging in your opinion that would be a better choice in Islamic finance as compared to futures/options?

The small sample of laws that were used in the interview questions (questions 7 to 13 in figure 5.2) were not all the laws which were uncovered through the first methodology. The interviewees were not asked for their opinion on all the laws that were extracted through the first methodology because there were too many laws that were extracted and recommended in the first phase of the methodology. Instead a sample was taken to illustrate the interviewees' opinion on the sample of laws. The samples of laws were selected in the following manner: under the first methodology the laws that were extracted were grouped into eight different categories, from each category sample laws that would be easy for the interviewee to understand were chosen for the interviewees to comment on. The laws that were chosen are found in the second column in table 5.1 below:

Table 5.1 Sample Laws taken to ask Interviewees

Laws extracted through first historical method	Sample laws taken to ask interviewees' opinion on
1. Laws regulating derivative trading activity	
a. Limiting number of days for future delivery	a. Laws that limit the number of days for future delivery.
b. Oral exchanges of promises/executory promises unenforceable	
c. Taxes levied on each future/ option sale	b. Imposing taxes or fees to use futures or options
d. Trading limits imposed	
2. Laws on licensing	
a. Licensing requirement subject to prerequisites	c. Enacting laws that require licenses to be issued those who carry out investment business.
3. Laws on the regulating body	
a. Designation of regulating body to oversee functions of the boards of trade/exchanges, enforce laws etc	d. Designating a regulating body to oversee functions of boards of trade, exchanges and others who engage in derivative trading.
b. Regulating body's emergency powers	
c. Regulating body's power to conduct regular investigations	
d. Decisions made by regulating body subject to review	
4. Laws regulating boards of trade/ exchanges	e. Enacting laws that require licenses to be issued to boards of trade
a. Boards of trade/exchanges required to regulate derivative trade	
b. Boards of trade /exchanges required to maintain records	

Laws extracted through first historical method	Sample laws taken to ask interviewees' opinion on
5. Laws regulating those who facilitate derivative trading	
a. Regulation of those who advise/invest on behalf of others	
b. Training of those involved in derivative trading	f. Training those who provide services on ethical and Islamic law principles
6. Laws on investor protection	
a. Punishing dishonest behaviour	g. Imposing laws that punish dishonest behavior on an exchange.
b. Statements issued on the conduct and financial standing expected of persons	
c. Ensuring investor protection	
d. Powers to restrict business	
7. Prohibitions	
a. Prohibiting options dealings	h. Banning or illegalising options totally or on certain commodities.
b. Wagers not recoverable at law	
c. Set-off/ ring settlement prohibited	
8. Penalties for violations	
a. Penalty imposed for violation of laws/ rules/ regulations	i. Imposing stiff penalties for violations of laws relating to derivative trading.
b. Penalty imposed on boards of trade/ exchanges	

To ensure the interview questions would be easy to understand and also generated the desired information, two pilot interviews were conducted, one with an academic and one with an industry participant, who fitted the criteria of selection. A pilot study helps to refine data collection in regards to the content of the data to be collected and also the procedures to be followed (Yin, 2003). The pilot study identified that some of the questions asked were too lengthy and had to be repeated to be understood. Consequently, the interview guide was simplified by reducing the length of the questions to be asked of each interviewee. The interview guide used can be found in Appendix 4.

Invitations to take part in interviews were sent to 67 key industry and academic scholars in Malaysia, of which 25 agreed to be interviewed. These 25 participants were interviewed face to face, their opinions, views and insights were recorded both in written form and digitally (where the participant agreed) using a digital voice recorder (Olympus WS 320M). Out of the 25 participants three (3) were participants from overseas. They were interviewed when they attended conferences in Malaysia, the remaining participants (22) practised Islamic banking and finance in Malaysia as industry or *Shariah* advisors or academicians. Twenty-eight (28) participants abroad were contacted through e-mail, out of which five (5) agreed to participate in the research. The 5 who participated were interviewed either through the phone or through emails, where the explanatory statement, questions and consent form were sent beforehand to the participants.

Thus in table format the respondents interviewed are as follows:

Table 5.2 Respondents Interviewed

	Number of Respondents Contacted	**Number of Respondents Consented to be Interviewed**
Interviewed face to face in Malaysia	**67**	**25 (out of which 3 originated from outside Malaysia)**
Interviewed by phone and/or email outside Malaysia	**28**	**5**
Total Interviewees		**30**

5.4.2.2 Overview of Participants

The demographics of the 30 participants is illustrated in table 5.3. As the criteria for selection of each participant was approximately five years of experience in Islamic finance and conventional law or finance, the ages of the participants were not included. Nevertheless the gender, profession, level of education and place of origin were recorded for the purposes of analysis.

For the purposes of more meaningful analysis the column on ‘profession’ was categorised into two criteria, that is, whether the participant was working in the industry or whether the participant was a scholar as in a *Shariah* advisor or an academic in an institution of higher learning. The two classifications were industry or scholar/academic (figure 5.6 below). Each participant is represented as P1, P2, P3 etc. so as to ensure privacy requirements are adhered to.

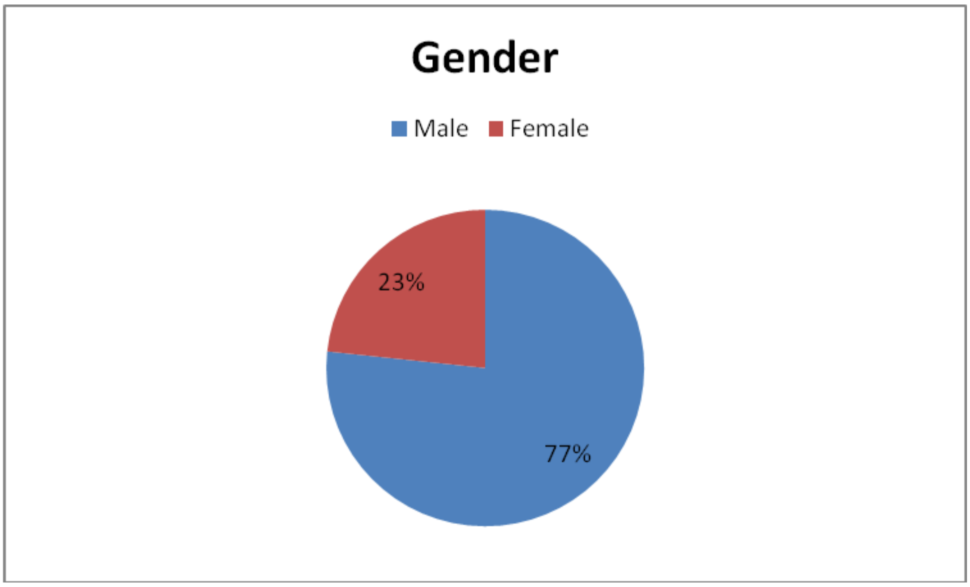
Table 5.3 Attributes of Participants

Partici - pant	Gender	Highest level of education	Place of origin	Profession
P1	Male	Masters	Kuwait	CEO, Director of a company providing consultation in Islamic banking and finance - Industry
P2	Male	Masters	Yemen	Lecturer Scholar/Academic
P3	Male	Masters	Malaysia	Vice President in an Islamic Bank Industry
P4	Female	Bachelor	Malaysia	Director in an Islamic bank Industry
P5	Male	Masters	Malaysia	CEO of an Islamic Bank Industry
P6	Female	PhD	Malaysia	Associate Professor and *Shariah* Advisor Scholar/Academic
P7	Female	PhD	Malaysia	Lecturer and *Shariah* Advisor Scholar/Academic
P8	Male	PhD	Malaysia	Partner in a legal firm, specialization Islamic banking and finance Industry
P9	Male	PhD	Malaysia	Associate Professor Scholar/Academic
P10	Male	PhD	Saudi Arabia	Associate Professor Scholar/Academic
P11	Male	Masters	Malaysia	Lecturer Scholar/Academic
P12	Male	Masters	Saudi Arabia	Researcher and author at an International Islamic financial Institute Scholar/Academic
P13	Male	PhD	Malaysia	Professor Scholar/Academic
P14	Male	Masters	Malaysia	Lecturer Scholar/Academic
P15	Male	Bachelor	Malaysia	Vice President in an Islamic Bank

Partici - pant	Gender	Highest level of education	Place of origin	Profession
				Industry
P16	Male	Masters	Malaysia	Marketing and IT Consultant Industry
P17	Male	Bachelor	Germany	Consultant for Islamic Banking and Finance Industry
P18	Male	PhD	Canada	Assistant Professor Scholar/Academic
P19	Male	PhD	USA	Associate Professor Scholar/Academic
P20	Male	Masters	Malaysia	Lecturer Scholar/Academic
P21	Male	Masters	Malaysia	Deputy General Manager of an Islamic Bank
P22	Male	PhD	Malaysia	Professor and *Shariah* Advisor Scholar/Academic
P23	Male	PhD	Malaysia	Managing Director of a Consulting Firm in Islamic finance Industry
P24	Male	Bachelor	Malaysia	Managing Partner of a legal firm specialising in Islamic Banking and Finance Industry
P25	Female	Masters	Malaysia	Lecturer Scholar/Academic
P26	Male	Bachelor	Malaysia	Director of an Islamic Bank Industry
P27	Female	PhD	Malaysia	Lecturer and Shariah Advisor Scholar/Academic
P28	Female	Masters	Malaysia	Lecturer Scholar/Academic
P29	Male	Bachelor	Iran	Financial Analyst Industry
P30	Female	Masters	Malaysia	Lecturer Scholar/Academic

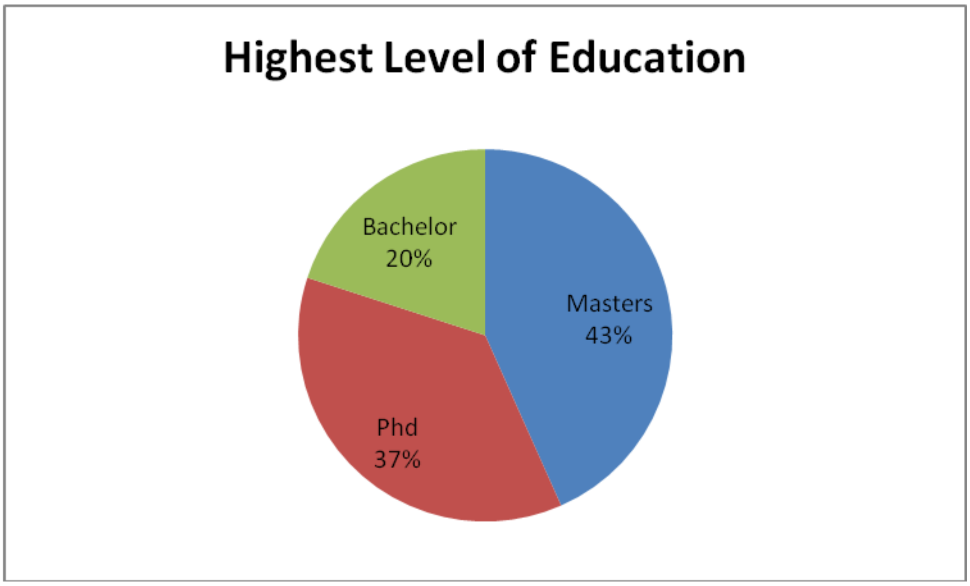
Below are the graphical illustrations and descriptions of the data above.

Figure 5.3 Gender of Participants



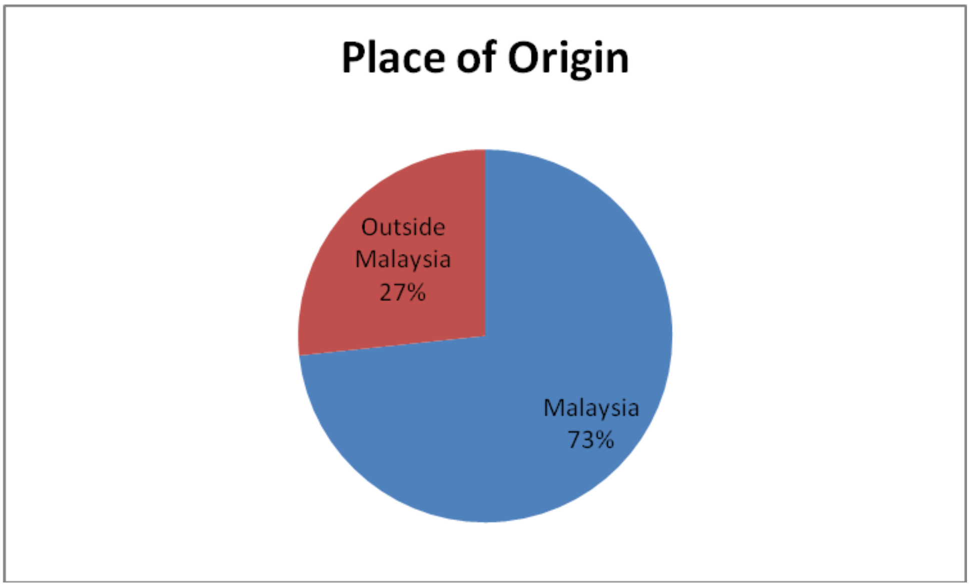
As can be seen from the pie chart on gender (figure 5.3) there were more male participants (77%) than female participants (23%). The reason for this is that there are more male experts in Islamic finance as compared to the number of females (KPMG International 2007). This is especially true for those who have approximately five years of experience in Islamic banking and finance. Further, generally those in the industry who practise Islamic finance are also predominantly of the male gender (ABQ Zawya Ltd 2005; IslamBank 2005; Parker, M 2008). The above representation of male to female ratio would seem to be a true reflection of the gender ratio in the field of Islamic finance.

Figure 5.4 Highest Level of Education



The level of education (figure 5.4) showed that a high proportion of participants (43% + 37%) had obtained Masters degrees and above. This could be due to three reasons, firstly the participants were chosen on the basis of approximately five years of experience in Islamic finance, and this means that many of the interviewees would have had the opportunity to go for higher education. Secondly, many of the courses offered on Islamic finance are offered at a higher level, that is, Postgraduate professional diploma[77], Masters and at a PhD level. Lastly, many of those interviewed were academicians and *Shariah* scholars who would have had a higher level of education due to the requirements of their profession.

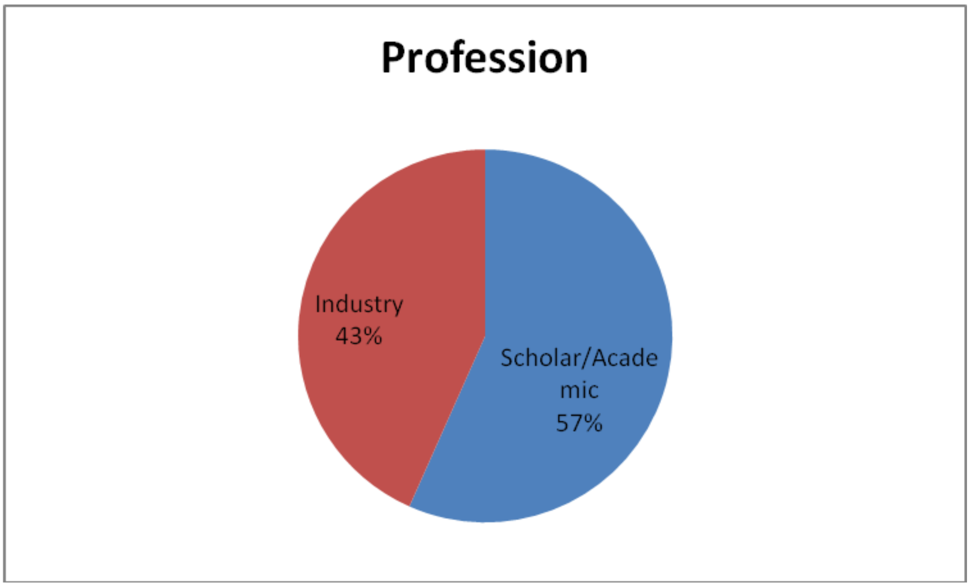
Figure 5.5 Place of Origin



The majority (73%) of the participants were from Malaysia, where the research was undertaken. This was mainly because of four reasons. Firstly, because of Malaysia's intention of becoming an international hub for Islamic finance, there are many qualified professionals who have the necessary qualifications and experience to participate in the interviews. Secondly, participants outside Malaysia were more difficult to obtain consent from; a few overseas participants agreed initially to be interviewed by phone or through emails but ultimately failed to respond despite a number of reminders. Thirdly, the contact addresses (especially email address) were not easily attainable for overseas respondents. Lastly, for overseas professionals "snowballing" did not work well as compared to those within Malaysia.

[77] Those who were interviewed for this research were predominately with Masters and PhD. Only one participant was pursuing his professional certificate in INCIEF (CIFP) uncompleted, and who already had a Masters degree.

Figure 5.6 Profession of Participants



The participants' professions were divided into two catergories - those who practiced or applied Islamic finance to everyday life, for example, bankers and lawyers, and those who researched and taught Islamic finance. *Shariah* advisors were placed into the latter category because they are required to research *Shariah* and *fiqh* to give legal opinions and also research as to whether to pass a product as *Shariah* compliant or not. Furthermore, all the *Shariah* advisors who were interviewed in this research came from academic institutions. The profession was divided into these two categories to enable easy description of the responses in Chapter 7 when data analysis was conducted. The number of participants for the two categories were roughly equal; there were 17 participants who were *Shariah* advisors and/or academicians and 13 from the industry. The reason why the number of *Shariah* advisors and academicians was larger was because of the relative flexibility of their time at work as compared to the industry participants. They had more free time to partipate in interview sessions. Industry participants however, had less flexibilty in time allocation for interviews and were often travelling. In one particular case it took three months to actually interview an industry participant due to a number of cancellations of the interview.

5.5 Ethical Considerations

Since data collection from the second stage of the methodology, that is, case study, involved interaction with human subjects, ethics approval was sought before contact with the subjects. This research involved low impact contact with the participants, therefore approval and ethics clearance was fairly straightforward. Ethics approval was obtained from the SCERH at Monash University. Date of approval was from the 27^{th} of February 2008 until 27^{th} February 2013, subject to annual approval. The project number was CF08/0510 - 2008000248 (See Appendix 1).

An explanatory statement about the nature of the study (See Appendix 2) was sent by email to potential participants. Where the participants replied positively to the request to be interviewed, the researcher confirmed a date and time to meet the interviewee. All face to face interviews took place at office hours and most at the place of work of the interviewee. Three interviews took place at a coffee outlet. For all the interview appointments the researcher took care not to be late and the researcher usually arrived 30 minutes before the appointed time of the interview to ensure the participants would not be waiting and there would not be any unanticipated delays. The researcher also accepted any place of meeting most convenient to the interviewee. At the date of the interview each interviewee was asked to read and sign a consent form before the interview began (see Appendix 3).

All participants voluntarily participated in the research and were free to withdraw at any time without penalty or comment. Participants were also informed about the withdrawal option and were informed that if they chose to withdraw there would be no adverse effect on them. No one refused to continue their participation in the study.

All participants in the study were reassured of their privacy and anonymity of any information provided by them.

5.6 Data Management and Analysis

A digital voice recorder was used to record the interviews with the permission of the participants. Only one participant refused to be digitally recorded, consequently the researcher wrote notes whilst interviewing this participant.

The digitally recorded interviews were duplicated on the same day of the interview for back-up purposes. Thereafter, the interviews were transcribed verbatim immediately after leaving the field on the same day or shortly thereafter by the researcher.

The transcribed interviews were then sent by email to the participants to check for accuracy of the transcriptions (see Appendix 6). The participants were also again thanked for their participation. Only three (3) participants wrote back with additions to their answers. These additions were incorporated into the original data.

The verbatim interview transcripts and field notes which were created in Microsoft Word documents were saved in Rich Text Format. These files were then imported into NVivo version 8 (a qualitative computer program) and stored in the 'sources' folder under 'cases'. Each case was actually the transcript of each participant in the research. The attributes, that is, the gender, profession, level of education and place of origin of each case were then detailed in a casebook which was created under 'classifications' under NVivo 8.

Thereafter, the responses of each case was coded firstly, into numerous free nodes and then transferred and added to form tree nodes. At this point some of the free nodes were merged and renamed because they were found to be very similar in nature and would have resulted in a replication. Coding in qualitative research is a way of classifying or indexing the verbatim transcriptions in order to facilitate later retrieval (Richards 2005; Bazeley 2007).

Three tree nodes were formed with a number of child nodes. The three tree nodes represented the three subsidiary research questions #4, #5 and #6 (figure 5.3 above). When analysis of the data was being carried out the tree nodes were reassessed as the researcher re-read the cases. Some of the coding were found to be placed at tree nodes which were not suitable. They were not suitable because they were placed under the wrong tree node or they were found to be more suitable under another tree node. These passages under the cases were then decoded and coded under different existing tree nodes or new tree nodes. The coding at the tree nodes were therefore continuously checked by the researcher for relevancy when data analysis was done and Chapter 7 was being written.

The tree nodes were also transformed into diagrammatic form through 'modelling' under NVivo 8 to enable a visual feel of the data. Once the tree nodes were made into models the relationships between parent, child and grandchildren nodes were easily identified[78].

The data was also analysed through the 'query' function of NVivo, where the 'word frequency', 'text search' 'coding query' and 'matrix coding' were used to analyse the data. The matrix coding was especially useful in this research to analyse the responses of each case (or participant) to each tree node to answer the subsidiary research questions. The results of the query for the matrix coding were depicted in table form in NVivo. These results were exported to Microsoft Excel and transformed into bar charts to enable the results to be viewed with greater clarity. The bar charts were then transferred to the thesis to be described and interpreted in Chapter 7. Finally a report of the research results was sent to the participants (see Appendix 8).

[78] For example to the tree node *are futures and options needed*, (which are represented in the colour blue in figure 7.1), children nodes were added titled *Are futures and options acceptable*, *Are futures and options useful or harmful,* and lastly *if all the objections could be overcome whether futures and options would be accepted in Islamic finance*. Under the child nodes *Are futures and options useful or harmful*, (coloured purple in figure 7.4), grandchildren nodes were added titled *futures or options useful,* and *futures or options harmful*. Under the child node *are futures and options acceptable* grandchildren nodes *futures and options not acceptable* and *futures and options acceptable* were added. Under the grandchild node of *futures and options not acceptable* the great-grandchild node of *options not acceptable* was added. Under the grandchild node of *futures and options acceptable* the great grandchild nodes *options more acceptable*, and *futures more acceptable* were added.

5.7 Criteria to Judge the Quality of Research Design

Variables employed to check the rigour of qualitative research concepts include trustworthiness, credibility, confirmability, and data dependability (Lincoln & Guba 1985; Yin 2003; Rolfe 2006). Yin (2003) who focuses on case studies uses four tests. These four tests are common to all social science methods and therefore can be used for the case study method and historical method used in this research (Yin 2003; Gerring 2007). The four tests which encompass, *inter alia*, the same requirements as trustworthiness, credibility, confirmability, and data dependability are: construct validity, internal validity, external validity, and reliability (Tellis 1997; Yin 2003).

5.7.1 Construct Validity

Construct validity refers to the usage of correct operational measures for the concepts being studied (Yin, 2003). In case study methodology three tactics were prescribed by Yin (1991, 2003) to ensure construct validity. The first one is the use of multiple sources of evidence. In this research for the case study method the source of data used was only semi-structured in-depth interviews. This being one source of evidence. However when conducting the interviews the researcher made sure that a wide variety of participants were interviewed. Participants were from the industry and also *Shariah* scholars from academics. Participants were from within Malaysia and also outside Malaysia.

Nevertheless the second and third tactics prescribed by Yin (2003) was followed thus ensuring there is construct validity for this research. The second tactic seeks to establish a chain of evidence (Yin, 2003). Chain of evidence means 'the obtained data should result from a sequential (measurement) that follows (or shows) a clear or compelling logic' (Lee, TW 1998, p.155). This principle is to ensure an external observer would be able to follow the path of any evidence and would also be able to trace the steps from initial findings to conclusion and vice versa (Yin, 2003). This is ensured in this research by the following steps: this research and in particular chapters 6 and 7 have made extensive citations of the historical laws and interviews through quotations and extracts of what the participants have stated. Secondly, a database was created in Microsoft Excel where the historical laws reviewed were listed down (found in section 5.4.1). Another database was created stating the time and place where the interviews took place (See Appendix 7). Thirdly, the third subsidiary research question was linked to the findings in Chapter 6 using the historical methodology and answered through comparative analysis. The fourth, fifth and sixth subsidiary research question were linked to the interview questions (figure 5.2 above) and then the responses of the respondents were analysed and interpreted to answer the subsidiary research questions (see Chapter 7).

The third tactic is to have the draft case study report, which in this case is the transcribed interviews, reviewed by the interviewees (Yin 2003). This was done by the researcher in this research as soon as the digitally recorded interviews were transcribed verbatim into Microsoft Word. The transcripts were emailed to the interviewees for their review (See Appendix 6), and any changes suggested by the interviewees were added.

Thus, although this research did not use multiple sources of data for the case study approach, it has shown a chain of evidence and review of the transcripts by the interviewees. Therefore it is submitted that the conditions for construct validity is satisfied.

5.7.2 Internal validity

Yin (2003) explains that the internal validity test is only a concern for explanatory or causal studies and not for descriptive or exploratory studies, because it requires establishing a causal relationship where certain conditions are shown to lead to others. ‘If the investigator incorrectly concludes that there is a causal relationship between x and y, the research design has failed to deal with some threat to internal validity’ (Yin, 2003, p.36). Yin (2003, p.36) proposes certain tactics such as ‘pattern matching’, ‘explanation building’, addressing ‘rival explanations’ and ‘using logic models’ to deal with problems of internal validity. As stated above, this case-study research is exploratory and descriptive in nature and therefore there are no conditions or causal relationships that are being investigated. Therefore this test is not applicable to this research.

5.7.3 External Validity

This test is conducted to determine whether a study's findings can be generalised beyond this research. This research can be generalised not only to the usage of derivatives and options in Malaysia but also to other parts of the world because the principles of *Shariah* are universal in the field of Islamic finance. Even though the majority of the participants (74%) were from Malaysia there were also participants from outside Malaysia (26%) who contributed their views and opinions to the interview questions posed. Therefore it is opined that this research findings can be generalised. Thus the test of external validity has been satisfied.

5.7.4 Reliability

This test is applied where, if a later investigator was to follow the same procedures as described by the researcher in this research and conducted the same study all over again, the later investigator should arrive at the same findings and conclusions (Yin 2003). Reliability is ensured in this research since the researcher has documented the procedures followed and the sources of information investigated. In the historical methodology the researcher listed down the databases from where the historical laws were found, the sources from which the laws were identified and also the laws themselves that were identified. In the case study method the criteria for selection of the interviewees were listed, that is, through personal contacts of the researcher, through conferences attended by the researcher, and through 'snowballing'. How the interview questions were formed and subsequently related back to the research questions was also detailed. Further, the details on data management and analysis, especially the use of NVivo 8 has been conscientiously described. Thus it is submitted that this test of reliability has also been satisfied.

5.8 Summary

In this chapter the research paradigm used was identified, namely qualitative research. Two research methods were deployed to answer the research questions. The historical method was used to identify relevant laws and the case study method to explore the applicability of these laws in Islamic finance in Malaysia. Data sources and data collection methods were described as well as the data management and analysis along with ethical considerations and the criteria to judge the quality of research design. The next chapter explains the findings from the first methodology used in this research – the historical method.

Chapter 6 Historical Method Applied to Review Laws

6.1 Introduction

This chapter presents a critical analysis of the laws that were created to overcome objections against derivatives in conventional finance. The laws that have been selected, presented and explained in this chapter are those that may possibly be applied to Islamic finance, to overcome the objections that exist in *Shariah* against derivative usage in Islamic finance. This chapter, thus, attempts to answer the third subsidiary research question of this thesis namely – **What laws in conventional finance can be used to overcome the objections to derivatives in Islamic finance?**

The sources of the laws reviewed are those statutes passed by the State in the UK and US from the 17th to 20th century. How these laws may match or overcome the objections in *Shariah* will also be explored.

In the previous chapters it was established that the objections in *Shariah* are similar to the objections that existed in conventional finance. The probable reasons why this similarity occurred in the two divergent and different fields were also explored in Chapter 4 and the methodology used for this study was described in Chapter 5.

6.2 Presentation of Historical Laws and Analysis in this Chapter

This chapter will be presented in the following manner. The laws in UK which regulated derivatives from the 17th century onwards will firstly be discussed. Thereafter US State laws will be explained from the 18th century, and then US Federal laws as they emerged in the 20th century will be reviewed. Discussion of the laws will include an analysis of the possible

Shariah objection that each law might overcome. The *Shariah* objections towards derivatives were identified in Chapter 3, and are as follows:

1. Both counter values in future sales are non-existent at the time of the contract, neither the money, nor the goods. It is therefore, not a genuine sale but merely a sale or exchange of promises. A sale can only be valid in *Shariah* if either the price or the delivery is postponed but not both.

2. For a sale to be valid there must be a transfer of ownership of the item sold. Therefore if the seller does not own the item he cannot transfer ownership. The rationale behind taking possession is to prevent *gharar.*

3. Futures and options trading involves speculation and verges on *maisir, qimar* and *gharar*.

4. Options sales is a mere right to buy or sell; charging of fees for this is not permissible.

5. Futures sales being the deferment of both counter values is a sale of one debt for another, that is, *bai al kali bi al kali,* which is forbidden in *Shariah*.

When analysing the provisions of the statutes to match them as possible solutions for each *Shariah* objection, for ease of reference the *Shariah* objections will be referred to in the numerical order as above. That is, where the *Shariah* objection - 'Both counter values in future sales are non-existent at the time of the contract, neither the money, nor the goods; it is therefore not a genuine sale but merely a sale or exchange of promises. A sale can only be valid in *Shariah* if either the price or the delivery is postponed but not both' - is referred to, this will be called *Shariah* objection #1 (referring to the numerical order above) and so on
After all the laws in the UK and US have been analysed and reviewed and matched with *Shariah* objections, the laws of the UK and US will be merged into categories of similar themes. This is done because there are a number of laws of the UK and the US which overlap, that is, which are the same or similar. Thus merging the laws into categories of similar themes will make the data of the laws from the 17^{th} century onwards more systematic, manageable and easier to present.

The next section will begin with a review of the UK laws.

6.3 UK Legislation

In the UK, compared to the US (discussed under section 6.4), there were relatively fewer attempts to regulate or restrict derivative trading. The following account of the statutes passed starts from the 17th century and goes on to the 20th century.

6.3.1 17th Century

Legislation limiting short selling in shares was enacted as early as in the late 17th century, where the UK government passed a law called William III, 1696-7: An Act to Restrain the Number and Ill Practice of Brokers and Stock-Jobbers[79]. This Act limited the number of days within which share sales could take place. Share sales were required to take place within **three days** and they were required to be recorded.[80]

By limiting the number of days for future delivery this may address *Shariah* objection #2 since the rationale behind the need to take possession is to eliminate or minimise *gharar*. By limiting the number of days allowed for transfer of ownership this may also minimise *gharar*.

Another Statute 'Charles II, An Act for Prevention of Frauds and Perjuryes 1677' made mere oral exchange of promises or executory promises unenforceable contracts. According to Part XVI of the Act:

---

79 Stock jobbers was the term used for speculators during that era (Swan 2000).

80 Part X states the following:

'And for the further preventing the Mischiefs and Inconveniences that doe daily arise to trade by the ill Practices of Brokers Stock Jobbers and others be it further enacted and declared by the Authority aforesaid That every Policy Contract Bargaine or Agreement made and entred into or to be made and entered into by any Person and Persons whatsoever and which by the Tenour thereof is to be performed after the said First Day of May One thousand six hundred ninety seven upon which any Premium already is or att any Time hereafter shall be given or paid for liberty to putt upon or to deliver receive accept or refuse any Share or Interest in any Joint Stock. Talleys Orders Exchequer Bills Exchequer Ticketts or Bank Bills whatsoever other than and except such Policies Contracts Bargaines or Agreements of the Nature aforesaid as are to performed within the space of Three Days (to be accounted from the Time of making the same) is and shall be utterly null and void to all intents and purposes as if the same had never been made and every such Premium and Premiums shall be paid back and restored to such Person or Persons who did give or pay the same his Executors Administrators or Assignes.

> No contract for the sale of any goods, wares and merchandises, for the price of ten pounds sterling upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain, or in part of the payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract, or their agents thereunto lawfully authorized.[81]

Therefore a sale of goods which was worth more than ten pounds (10 pounds) was not legally enforceable against a defaulting buyer or seller unless:

- there was part delivery of the goods or
- part payment or
- if it was evidenced by a written document which the defaulting party or his agent signed.

The Statute of Frauds and Perjuryes was repealed in 1954.

Making oral exchanges unenforceable and requiring part payment or part delivery of the underlying asset directly addresses *Shariah* objection #1. Since both counter values will not be non-existent at the time of the contract. Evidence in writing per se may not be sufficient to satisfy *Shariah* objection #1, but may address *Shariah* objection #3 which is to curb *maisir*, *qimar* and *gharar*.

6.3.2 18th Century

In the 18th century, Sir John Barnard's Act or Stock Jobbing Act 1733, Geo 2 c. 8, 1733, ('Sir John Barnard's Act') was passed. This Act was passed as a result of speculative trading in the

[81] The actual text of the Statute uses old English as follows:

> XVI. In what Cases only Contracts for Sales of Goods for £10 or more to be binding.
> And bee it further enacted by the authority aforesaid That from and after the said fower and twentyeth day of June noe Contract for the Sale of any Goods Wares or Merchandises for the price of ten pounds Sterling or upwards shall be allowed to be good except the Buyer shall accept part of the Goods soe sold and actually receive the same or give some thing in earnest to bind the bargaine or in part of payment, or that some Note or Memorandum in writeing of the said bargaine be made and signed by the partyes to be charged by such Contract or their Agents thereunto lawfully authorized.

shares of a company called the South Sea Company (see section 3.2.2.4). Sir John Barnard's Act provided the following measures for curtailing speculative activity:

> Whereas great inconveniences have arisen and do daily arise by the wicked, pernicious and destructive practice of stock jobbing … **all contracts and agreements whatsoever … in the nature of putts and refusals relating to the then present or future price or value of any such stock or securities as aforesaid, shall be null and void to all Intents and Purposes whatsoever** …
>
> IV. And be it further enacted … that all and every person or persons whatsoever, who shall enter into, make or execute such contract, bargain or agreement, upon which any premium or consideration in the nature of a premium, shall be paid for liberty to putt upon or to deliver, receive, accept or refuse any public or joint stock, or other public securities whatsoever, or any part share interest therein, or any contract or bargain in the nature of putts and refusals … **shall forfeit and pay the sum of 500 pounds; and also all and every broker, agent, scrivener or other person negotiating, transacting or writing any such contract, bargain or agreement as aforesaid, shall likewise forfeit and pay the sum of 500 pounds.** (Emphasis added).

Therefore, the Act applied to the sales of public or joint stock, or other public securities and rendered null and void both **option dealing**s, and speculative time bargains (future sales). Not only were these types of transaction rendered legally unenforceable, but civil and criminal penalties were stipulated for those who engaged in them. This law was limited to barring futures contracts in stocks and not commodity trade, as stated in part VII[82]. Sir John Barnard's Act was repealed in 1860.

Prohibiting option dealings could possibly address *Shariah* objection #4, since according to *Shariah* charging of fees for the mere right to buy or sell is not permissible. Further, where

[82] 'VII. And whereas it is frequent and mischievous practice for persons to sell dispose of stock or other securities, of which they are not possessed: Be it therefore further enacted by the authority aforesaid, that all contracts and agreements whatsoever, which shall, from and after the said first day of June 1734, be made or entered into for the buying, selling assigning or transferring of any publick or joint stock or stocks, or other publick securities whatsoever, or of any part, share or interest therein, whereof the person or persons contracting or agreeing, or on who's behalf the contract or agreement shall be made, to sell, assign and transfer the same, shall not at the time of making such contract or agreement, be actually possessed of, entitled unto, in his her or their own right or in his, her or their own name or names, or in the name or names of a trustee or trustees to their use, shall be null and void to all sum of 100 pounds …'

there is excessive speculation in any particular underlying asset, prohibiting futures and options sales in that underlying asset, whether it is a financial asset or a particular commodity, could address *Shariah* objection #3.

6.3.3 19th Century

In the 19th century two statutes were passed which affected derivative trading: the Gaming Act 1845, and the Banking Companies' (Shares) Act 1867.

According to s.18 of the Gaming Act 1845:

> 18. All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law and equity for recovering any sum of money or valuable thing alleged to be won upon any wager.

This section caused sales for future delivery where no intention to deliver was present but settled by payment of differences to be considered as void and unenforceable. Section 18 led to a great number of cases being tried in the courts[83], where courts sought to interpret whether there was 'intention' to deliver between the parties. If no such intention was found then the transaction was taken to be no more than a mere wager and was found to be void and unenforceable.

Section 18 of the Gaming Act 1845 was repealed in 2005 under the Gaming Act 2005, c. 19, s.334 (1)(c).

The Banking Companies' (Shares) Act (30 & 31 Vict c . 29) 1867, provided that:

> 1**.** That all Contracts, Agreements, and Tokens of Sale and Purchase which shall, from and after the First Day of *July* One thousand eight hundred and sixty-seven, be made or entered into for the Sale or Transfer, or purporting to be for the Sale or Transfer, of

83 Section 3.2.2.3 above

> any Share or Shares, or of any Stock or other Interest, in any Joint Stock Banking Company in the United Kingdom of *Great Britain* and *Ireland* constituted under or regulated by the Provisions of any Act of Parliament, Royal Charter, or Letters Patent, issuing Shares or Stock transferable by any Deed or written Instrument, shall be null and void to all Intents and Purposes whatsoever, unless such Contract, Agreement, or other Token shall set forth and designate in Writing such Shares, Stock, or Interest by the respective Numbers by which the same are distinguished at the making of such Contract, Agreement, or Token on the Register or Books of such Banking Company as aforesaid, or where there is no such Register of Shares or Stock by distinguishing Numbers, then unless such Contract, Agreement, or other Token shall set forth the Person or Persons in whose Name or Names such Shares, Stock, or Interest shall at the Time of making such Contract stand as the registered Proprietor thereof in the Books of such Banking Company; and every Person, whether Principal, Broker, or Agent, who shall wilfully.

Section 1 therefore required contracts of sale involving shares in banking companies to be in writing and to designate the identifying numbers of the shares. Contracts not complying with the Act were legally null, void and criminal. The object of the Act was to prevent speculative sales of bank shares not yet in the possession of the seller (Swan, 2000).

The Banking Companies' (Shares) Act was repealed in 1966 under the procedure for getting rid of 'obsolete, spent, unnecessary or superseded enactments' (Ferguson 1984, p.197)**.**

The requirement that the sale of the underlying asset be in writing, *per se* may not be sufficient to satisfy *Shariah* objection #1, but may address *Shariah* objection #3 which is to curb *maisir*, *qimar* and *gharar*. Also s.18 of the Gaming Act 1845 directly addresses *Shariah* objection #3, which is to prevent *maisir*, *qimar* and *gharar* related to wagers and gambling.

6.3.4 20th Century

In the 20th century three major pieces of legislation were passed - the Prevention of Frauds (Investment) Act 1939 (2 & 3 Geo. 6) Chapter 16, the Financial Services Act 1986 c.60, and Financial Services and Markets Act 2000 c.8.

The Prevention of Frauds (Investment) Act 1939 (2 & 3 Geo. 6) Chapter 16 provided the following provisions:

> 1. - (1) Subject to the provisions of the next following section, no person shall, on or after the appointed day, -
>
> > (*a*) carry on or purport to carry on the business of dealing in securities except under the authority of a principal's licence, that is to say, a licence under this Act authorising him to carry on the business of dealing in securities,…'
>
> 3. - (1) Subject to the following provisions of this Act, the Board of Trade:
>
> > (*a*) upon an application in that behalf made by any person in the prescribed manner, and on payment of the prescribed fee, shall grant to that person a principal's licence, and
> >
> > (*b*) upon an application made by any person in the prescribed manner, and on payment of the prescribed fee, shall grant to that person a representative's licence.
> >
> > (2) A licence shall, unless in the meantime it is revoked, be valid for the period of one year beginning with the day specified in the licence as the day on which it takes effect, and no longer.
> >
> > (3) A principal's licence shall specify the name of the person thereby authorised to carry on the business of dealing in securities, and shall not authorise him to carry on that business under any name other than that specified in the licence as his name:
> >
> > Provided that, if the Board of Trade think fit, such a licence may, at the request of the applicant for the licence, be framed so as to authorise the holder thereof to carry on the said business, either alone or jointly with any other person being the holder of a principal's licence, under such name or style as the applicant may specify in his application.

The above provisions give authority to a Board of Trade to issue licenses to those who want to deal in securities. These licences are renewable each year. This implicitly means that if the board of trade is dissatisfied with the way a person deals with securities the license can be refused the next year. For example, if there is evidence of gambling on the exchange on the prices of the securities this could be used as a reason to withhold the license from the person in the next year.

The scope of the Prevention of Frauds (Investment) Act 1939 was very narrow. Firstly, it only applied to those who dealt in securities, in effect excluding commodities transactions. Secondly, it did not seem to have any provisions that offered protection towards investors of commodities futures or even options (Gower 1988).

Due to the virtually non-existent statutory regulation of derivatives in the UK at that time, the Government of the UK decided that reforms were necessary and invited Gower[84] in 1981 to research and suggest recommendations and even propose laws to revise the existing financial services in the UK (Swan 2000).

In 1983 Gower delivered his recommendations, and proposed the introduction of a new act called the 'Investor Protection Act'. Gower, *inter alia*, suggested the following:

- repeal of the Prevention of Fraud (investment) Act 1939;
- regulation of the investment business by the governmental Department of Trade and Industry;
- a requirement that those engaged in the investment business be registered either by the Department of Trade and Industry or the appropriate self-regulatory organisation; and
- that it be made a criminal offence to carry out on investment business unless registered (Gower 1988).

Based on these recommendations new legislation was enacted by the UK government, that is, the Financial Services Act 1986. However, the fear that regulation would chase away investment and trading in the financial and commodity futures market led to a minimal introduction of new laws (Gower 1988).

[84] In 1981 Professor L C B Gower was at that time the part time advisor to the Department of Trade on company law matters (Gower 1988) P. 7

The relevant legal changes that the Financial Services Act 1986 introduced can be divided into two main categories,

- Firstly, only **authorised** people were to carry out all types of investment business in UK; and,
- Secondly, **investor protection** laws were imposed against misbehaviour in the investment business.

Following are the relevant provisions of the Financial Services Act 1986.

6.3.4.1 Authorised Persons

Under s.3 only authorised persons could carry on investment business in the UK:

> S. 3 – No person shall carry on, or purport to carry on, investment business in the United Kingdom unless he is an authorised person under Chapter III or an exempted person under Chapter IV of this Part of this Act.

If s.3 was contravened, then under s.4 any **unauthorised** person who carries on, or purports to carry on, investment business, would be guilty of an offence and liable to imprisonment for a term not exceeding two years or to a fine or to both. Also, s.6 provided rights to obtain an injunction restraining the contravention of s.3.

Further, s.5 provided that where an **agreement** is entered into by an unauthorised person then that agreement shall be unenforceable against the other party; and that party shall be entitled to recover any money paid or property transferred by him under the agreement, together with compensation for any loss sustained by him. In so doing this section protects investors who deal with unauthorised persons.

Those authorised are listed in detail in Chapter III of the Financial Services Act 1986; the most significant provision would be s.25 which provides:

A person holding an authorisation granted by the Secretary of State under the following provisions of this Chapter is an authorised person.

This provision is significant because the Secretary of State has the power to grant or refuse an application as seen under s.27.

Section 26 provides by whom and how an application to obtain authorisation[85] may be made. Section 27 provides reasons why the Secretary of State may grant or refuse an application:

> s.27(2) The Secretary of State shall grant the application if it appears to him from the information furnished by the applicant and having regard to any other information in his possession that the applicant is a **fit and proper person** to carry on the investment business and provide the services described in the application.

What exactly would be fit and proper is explained in the subsections under s.27[86]. Generally, it involves people suitably qualified.

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[85] Section 26 of the Financial Services Act 1986 -
s 26 Applications for authorisation.
(1) An application for authorisation by the Secretary of State may be made by--
(a) an individual;
(b) a body corporate;
(c) a partnership; or
(d) an unincorporated association.
(2) Any such application--
(a) shall be made in such manner as the Secretary of State may direct;
(b) shall contain or be accompanied by--
(i) information as to the investment business which the applicant proposes to carry on and the services which he will hold himself out as able to provide in the carrying on of that business; and
(ii) such other information as the Secretary of State may reasonably require for the purpose of determining the application; and
(c) shall contain the address of a place in the United Kingdom for the service on the applicant of any notice or other document required or authorized to be served on him under this Act.
(3) At any time after receiving an application and before determining it the Secretary of State may require the applicant to furnish additional information.
(4) The directions and requirements given or imposed under subsections (2) and (3) above may differ as between different applications.
(5) Any information to be furnished to the Secretary of State under this section shall, if he so requires, be in such form or verified in such manner as he may specify.

[86] Section 27(3) of the Financial Services Act 1986 -
(3) In determining whether to grant or refuse an application the Secretary of State may take into account any matter relating to any person who is or will be employed by or associated with the applicant for the purposes of the business in question, to any person who is or will be acting as an appointed representative in relation to that business and -
(a) if the applicant is a body corporate, to any director or controller of the body, to any other body corporate in the same group or to any director or controller of any such other body corporate;
(b) if the applicant is a partnership, to any of the partners;

Further s.28 provides that the Secretary of State may at any time withdraw or suspend any authorisation granted by him if it appears to him:

> (a) that the holder of the authorisation is not a fit and proper person to carry on the investment business which he is carrying on or proposing to carry on; or
> (b) without prejudice to paragraph (a) above, that the holder of the authorisation has contravened any provision of this Act or any rules or regulations made under it or, in purported compliance with any such provision, has furnished the Secretary of State with false, inaccurate or misleading information or has contravened any prohibition or requirement imposed under this Act.

Thus under s.28 the Secretary of State has the power to withdraw authorisation. This power is very useful to curb any abuse of rights in the financial markets.

Chapter IV provides a long list of those who are exempted persons, that is, those who do not need to obtain authorisation, such as the Bank of England (s.35), Investment Exchanges (s.36), Clearing Houses (s.38), Overseas Investment Exchanges and Clearing Houses (s.40).

The requirement that licences are needed for those who want to carry out derivative trading ensures that only qualified persons who are fit and proper carry out trading in derivatives. The yearly licensing requirement especially helps to weed out those who have been shown previously to have taken part in risky or speculative behaviour. In the case of Islamic finance such a provision could be used to remove those who are unsuitable or use derivatives as a gambling tool. The requirement of licences addresses *Shariah* objection #3 which is the need to prevent *maisir*, *qimar* and *gharar*.

(c) if the applicant is an unincorporated association, to any member of the governing body of the association or any officer or controller of the association.
(4) In determining whether to grant or refuse an application the Secretary of State may also have regard to any business which the applicant proposes to carry on in connection with his investment business.
(5) In the case of an applicant who is authorised to carry on investment business in a member State other than the United Kingdom the Secretary of State shall have regard to that authorisation.

6.3.4.2 Investor Protection

Chapter V of the Financial Services Act 1986 addressed the issue of investor protection.

According to s.47:

> any person who makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals any material facts; or recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made or from whom the facts are concealed) to enter or offer to enter into, or to refrain from entering or offering to enter into, an investment agreement or to exercise, or refrain from exercising, any rights conferred by an investment.

Therefore whether knowingly or innocently a person may not make false or reckless statements for the purposes of inducing or refraining a person from an investment business.

In the event a person is found guilty of such practices, then the same section provides that such a person would be liable to imprisonment for a term not exceeding seven years or to a fine or to both (s.47(6)).

Section 47A provides that the Secretary of State may issue statements of principle on the conduct and financial standing expected of persons authorised to carry on investment business. Section 47A further explains that the conduct expected may include ‘compliance with a code or standard issued by another person’. Contravention of the standard of principle will amount to disciplinary action being taken against them (s.47A (3)).

Section 48 on the other hand provides powers to the Secretary of State to make rules regulating the conduct of investment by authorised persons. Section 49 provides, the Secretary of State may make rules requiring authorised persons ‘to have and maintain in respect of that business such financial resources as are required by the rules.’

Section 52 allows the Secretary of State to make regulations requiring 'authorised persons to give him forthwith notice of the occurrence of such events as are specified in the regulations and such information in respect of those events as is so specified'.

Section 54 provides that the Secretary of State may,

> establish a scheme for compensating investors in cases where persons who are or have been authorised persons are unable, or likely to be unable, to satisfy claims in respect of any description of civil liability incurred by them in connection with their investment business.

To ensure compliance with the rules and regulations imposed by the Secretary of State s.61 provides wide powers to impose injunctions and restitution orders[87]. Section 62 on the other hand, provides the right to any person who has suffered losses as a result of the contravention of any rules or regulations imposed by the Secretary of State, to seek damages.

Further, s.65 provides general powers of restriction to the Secretary of State to restrict business – the Secretary of State may prohibit an authorised person from:

> (a) entering into transactions of any specified kind or entering into them except in specified circumstances or to a specified extent;
> (b) soliciting business from persons of a specified kind or otherwise than from such persons or in a specified country or territory outside the United Kingdom;
> (c) carrying on business in a specified manner or otherwise than in a specified manner.

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[87] s 61 Injunctions and restitution orders.
(1) If on the application of the Secretary of State the court is satisfied--
(a) that there is a reasonable likelihood that any person will contravene any provision of--
(i) rules or regulations made under this Chapter;
(ii) sections 47, 56, 57, or 59 above;
(iii) any requirements imposed by an order under section 58(3) above; or
(iv) the rules of a recognised self-regulating organisation, recognized professional body, recognized investment exchange or recognised clearing house to which that person is subject and which regulate the carrying on by him of investment business, or any condition imposed under section 50 above;
(b) that any person has contravened any such provision or condition and that there is a reasonable likelihood that the contravention will continue or be repeated; or
(c) that any person has contravened any such provision or condition and that there are steps that could be taken for remedying the contravention, the court may grant an injunction restraining the contravention or, in Scotland, an interdict prohibiting the contravention or, as the case may be, make an order requiring that person and any other person who appears to the court to have been knowingly concerned in the contravention to take such steps as the court may direct to remedy it.

(2) A prohibition under this section may relate to transactions entered into in connection with or for the purposes of investment business or to other business which is carried on in connection with or for the purposes of investment business.

In summation, the Financial Services Act 1986 included provisions requiring authorisation before investment business could be carried out, otherwise the contract would be unenforceable. Further, various provisions were included to assure protection of investors, and punishment of misbehaviour of those in the investment business.

These laws on investor protection protect those investing in derivatives by punishing any dishonest or deceitful behaviour, requiring a certain conduct and financial standing of investors. Also, these laws on investor protection ensure compensation where a counter party is unable to fulfil one's obligations, by providing contract enforceability, and providing powers to restrict business of investors. These laws protect *bona fide* investors, and ensure certainty and stability of the derivative markets. Hence these provisions would address *Shariah* objection #3.

The Financial Services Act 1986 was repealed on the 1st of December 2001 by S.I. 2001/3649, arts. 1, 3(1)(c) (with art. 292).

The Financial Services and Markets Act 2000 c.8. (FSMA) replaced the Financial Services Act 1986.

There are two main changes that the FSMA implemented:

- FSMA provided the framework for a single regulator to regulate the financial services industry[88], known as the Financial Services Authority[89] (formerly the Securities and

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[88] s. 1 FSMA

[89] The functions of the Financial Services Authority are laid down in s.2(4) The Authority's general functions are—
(a) its function of making rules under this Act (considered as a whole);
(b) its function of preparing and issuing codes under this Act (considered as a whole);
(c) its functions in relation to the giving of general guidance (considered as a whole); and
(d) its function of determining the general policy and principles by reference to which it performs particular functions.

Investment Board[90]). In so doing, it equipped the Financial Services Authority with a full range of statutory powers[91]; and,

- FSMA created the Financial Services and Markets Tribunal[92]. This tribunal is an independent tribunal to provide a forum for the independent review of certain decisions made by the Financial Services Authority (Financial Services Authority 2007)[93].

The FSMA did not, however, alter the requirement that only ‘authorised’ and ‘exempted’ persons (6.2.4.1 above) could carry on regulated activities (ss.19 & 31 - 54 FMSA). However, FMSA did include a definition of what ‘regulated activities’ are under s.22 FMSA:

> **Regulated activities**
>
> 22.—(1) An activity is a regulated activity for the purposes of this Act if it is an activity of a specified kind which is carried on by way of business and —
>
> (a) relates to an investment of a specified kind; or
>
> (b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind.
>
> (2) Schedule 2 makes provision supplementing this section.
>
> (3) Nothing in Schedule 2 limits the powers conferred by subsection (1).

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90 Historically the financial services industry was, regulated by a wide range of different bodies - The Securities and Investment Board, Self-Regulating Organisations, the Personal Investment Authority, the Investment Management Regulatory Organisation and the Securities and Futures Authority, the former Supervision and Surveillance Branch of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Treasury, the Friendly Societies Commission; and the Registry of Friendly Societies. (*Explanatory Notes to Financial Services And Markets Chapter 8* 2000)

91 An example of the Financial Services Authorities’ statutory powers can be found in its rule making power under Part X ss.138-156 FMSA.

92 S.132 FMSA

Hearings and Appeals

132.—(1) For the purposes of this Act, there is to be a tribunal known Services and as the Financial Services and Markets Tribunal (but referred to in this Act Markets Tribunal. as “the Tribunal”).

(2) The Tribunal is to have the functions conferred on it by or under this Act.

(3) The Lord Chancellor may by rules make such provision as appears to him to be necessary or expedient in respect of the conduct of proceedings before the Tribunal.

(4) Schedule 13 is to have effect as respects the Tribunal and its proceedings (but does not limit the Lord chancellor’s powers under this section).

93 ‘Examples of the kinds of decisions which may be referred to the Tribunal include:

- decisions to discipline authorised firms and approved persons;
- decisions to vary a firm’s permission to conduct certain or all regulated activities;
- decisions relating to market abuse;
- decisions to withdraw individual approval; and
- decisions to make prohibition orders banning people from employment relating to certain or all regulated activities.’ (Financial Services Authority 2007)

(4) "Investment" includes any asset, right or interest.

(5) "Specified" means specified in an order made by the Treasury.

Schedule 2, referred to in s.22 above, widely defines the general range of activities and investments that may be included within the order defining the scope of regulation, but it does not exhaustively list them (*Explanatory Notes to Financial Services And Markets Chapter 8* 2000).

As for 'investor protection' under the Financial Services Act 1986 (6.2.4.2 above), the FMSA instead altered this to 'market abuse' (s.118 FMSA[94]). Market abuse closely resembled the investor protection sections in the Financial Services Act 1986, except that the definition of 'market abuse' is wider.

Section 118 sets out the behaviour which constitutes market abuse. According to subsections (1) and (2), in order to be abuse, the behaviour must:

- take place in relation to investments traded on a market to which the section applies (this includes derivative trading under 'regulated activity' according to s.22 and schedule 2 of the FMSA[95]);
- be behaviour of a particular kind, as set out in subsection (2) (discussed below); and

[94] **Market abuse**
118.—(1) For the purposes of this Act, market abuse is behaviour (whether by one person alone or by two or more persons jointly or in concert)—
(a) which occurs in relation to qualifying investments traded on a market to which this section applies;
(b) which satisfies any one or more of the conditions set out in subsection (2); and
(c) which is likely to be regarded by a regular user of that market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market.
(2) The conditions are that—
(a) the behaviour is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would or would be likely to be
regarded by him as relevant when deciding the terms on which transactions in investments of the kind in question should be effected;
(b) the behaviour is likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question;
(c) a regular user of the market would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question.

[95] Schedule 2 FMSA –
Regulated Activities
General
1. The matters with respect to which provision may be made under section
22(1) in respect of activities include, in particular, those described in general
terms in this Part of this Schedule.
Dealing in investments
2. (1) Buying, selling, subscribing for or underwriting investments or offering
or agreeing to do so, either as a principal or as an agent.

- be behaviour which is likely to be regarded by a regular user of the market as a failure on the part of the person (A) engaged in the behaviour to observe the standards which the regular user would reasonably expect of a person in A's position. The regular user of the market is defined in subsection (10) to be a reasonable person who regularly deals on the market. He is intended to represent the distillation of the standards expected by those who regularly use the market (*Explanatory Notes to Financial Services And Markets Chapter 8* 2000).

There are three types of behaviour set out in subsection (2). Generally, these refer to behaviour based on information not generally available to the rest of the market; that the behaviour is likely to give the regular market user a false or misleading impression; or that the regular user would be likely to regard the behaviour as behaviour which would distort the market[96].

The Financial Services Authority also has wide powers to impose **any** penalty for market abuse which it considers appropriate under s.123 FMSA[97].

In summary, the FMSA introduced the Financial Services Authority as a single regulator of the financial services sector in UK. It also bestowed upon the Financial Services Authority a wide range of statutory powers. These statutory powers, though, are not absolute as they are subject to review by an independent tribunal, also brought to life by the FMSA. As for the provisions of the Financial Services Act 1986 (discussed elsewhere in this chapter), they have been left largely intact by the FMSA, especially the requirement that only authorised persons be allowed to carry out regulated activities. However, the FMSA has defined regulated

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[96] '*Subsection (6)(a)* brings behaviour which takes place in relation to the subject matter of investments within the definition of behaviour which can be caught by these provisions. This means that, for example, behaviour in relation to a precious metal which affects the price of a futures contract in the metal can potentially be caught by these provisions if it is behaviour which falls within all of the tests set out above. *Subsection (6)(b)* also brings investments within the regime which are not themselves qualifying investments for the purposes of this section, but which are derivatives of a qualifying investment (for example options on options); or whose price or value is expressed by reference to the price or value of qualifying investments, for example spread bets. *Subsection (8)* allows the Authority to provide that behaviour conforming with a particular rule or rules does not amount to market abuse'*Explanatory Notes to Financial Services and Markets Chapter 8*(2000).

[97] **Power to impose penalties**
123. (1) If the Authority is satisfied that a person ("A")—
(a) is or has engaged in market abuse, or
(b) by taking or refraining from taking any action has required or encouraged another person or persons to engage in behaviour which, if engaged in by A, would amount to market abuse, it may impose on him a penalty of such amount as it considers appropriate.

activities, which is sufficiently wide and includes derivative contracts. As for investor protection, market abuse has been defined and explained in its place by the FMSA.

The FMSA, by designating a single regulating body to oversee derivative trading and ensure adherence to laws, rules and regulation of the regulating body and also rules and regulations of the boards of trade and exchanges, by investors and others, ensures constant control and monitoring of the overall activities of derivatives trading. This generally prevents *gharar* and therefore would indirectly address *Shariah* objections #2 and #3.

The FMSA however does not address issues such as excessive speculation, gaming and contracts for differences or selling of what one does not own. What can be seen however is that while the earlier laws seem to address issues of betting, gaming and chances of luck such as Sir John Barnard's Act 1733, the 20th century laws have dealt with providing a conducive environment to regulate speculation rather then actually seeking to prevent it.

The next discussion turns to the laws which were passed in the US.

6.4 US Legislation

Under this section selected US State and Federal laws will be reviewed.

6.4.1 State Law

Nearly all the States in the US passed statutes that addressed derivative trading[98] (Parker, C 1911; Patterson 1931; Markham 1991). Examples of such provisions can be seen in the **present** State statutes of Michigan, New York and Washington. Here the provision of the Michigan Penal Code is cited as an example:

98 See note 45 above.

Chapter 750 Michigan Penal Code (2007),

§ 750.126 **Bucket Shops**[99]-

Sec. 126. Intent of chapter - It is the intention of this chapter to prevent, punish and prohibit within this state, the business now engaged in and conducted in places commonly known and designated as **bucket shops,** and also to include the practice now commonly known as bucket shopping by any person or persons, agents, corporations, associations or co-partnerships who or which ostensibly carry on the business or occupation of commission merchants or brokers in grain, provisions, cotton, coffee, petroleum, stocks, bonds or other commodities whatsoever.

§ 750.128. **Maintenance of bucket shop; punishment**.

Sec. 128. Punishment - Any corporation, association, co-partnership, person or persons, or agent, who shall keep or cause to be kept within this state, any **bucket shop,** and any corporation, person or persons, or agents whether acting individually or as a member or as an officer, agent or employee or any corporation, association or co partnership, who shall keep, maintain or assist in the keeping and maintaining, of any such **bucket shop** within this state, shall be guilty of a felony, punishable by imprisonment in the state prison not more than 2 years or by a fine of not less than 500 dollars or more than 1,000 dollars. The

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[99] CHAPTER 750 MICHIGAN PENAL CODE **Bucket shop;** definition.
'Sec. 127. **Bucket shops** defined-A **bucket shop,** within the meaning of this chapter, is defined to be an office, store or other place wherein the proprietor or keeper thereof, or other person or agent, either in his or its own behalf, or as the agent or correspondent of any other person, corporation, association or copartnership within or without the state conducts the business of making or offering to make contracts, agreements, trades or transactions respecting the purchase or sale, or purchase and sale of any stocks, grains, provisions or other commodity or personal property wherein both parties thereto, or said proprietor or keeper contemplated or intended that the contracts, agreements, trades or transactions shall be, or may be closed, adjusted or settled according to or upon the basis of the market quotations or price made on any board of trade or exchange, upon which the commodities or securities referred to in such contracts, agreements, trades or transactions are dealt in, and without a bona fide transaction on such board of trade or exchange, or wherein both parties or such keeper or proprietor shall contemplate or intend that such contracts, agreements, trades or transactions shall be or may be deemed closed or terminated, when the market quotations of prices made on such board of trade or exchange for the articles or securities named in such contracts, agreements, trades or transactions shall reach a certain figure, and also any office, store or other place where the keeper, person or agent or proprietor thereof, either in his or its own behalf, or as an agent as aforesaid therein, makes or offers to make, with others, contracts, trades or transactions for the purchase or sale of any such commodity, wherein the parties thereto do not contemplate the actual or bona fide receipt or delivery of such property, but do contemplate a settlement thereof based upon differences in the price at which said property is or is claimed to be bought and sold. The said crime shall be complete against any proprietor, person, agent or keeper thus offering to make any such contracts, trades or transactions, whether such offer is accepted or not.'

continuance of such establishment after the first conviction shall be deemed a second offense and if the offender be a corporation, it shall be liable to forfeiture of all its rights and privileges as such.

§ 750.311. **Gambling in stocks, bonds, grain or produce.**

Sec. 311. Gambling in stocks, bonds, grain, etc.--**It shall be unlawful** for any corporation, association, firm, copartnership or person to keep or cause to be kept by any agent or employee within this state, any office, store or other place, wherein is conducted or permitted **the pretended buying or selling** of the shares of stocks or bonds of any corporation, or petroleum, cotton, grain, provisions or other produce, either on margins or otherwise, without any intention of receiving and paying for the property so bought or of delivering the property so sold; or wherein is conducted or permitted the pretended buying or selling of such property on margins, **when the party selling the same or offering to sell the same does not have the property on hand to deliver upon such sale**; or when the party buying any of such property, or offering to buy the same, **does not intend actually to receive the same** if purchased or to deliver the same if sold; all such acts and all purchases and sales, or contracts and agreements for the purchase and sale of any of the property aforesaid in manner aforesaid, and all offers to sell the same or to purchase the same in manner aforesaid, as well as all transactions in stocks, bonds, petroleum, cotton, grains or provisions in the manner as aforesaid, on margins for future or optional delivery, **are hereby declared gambling and criminal acts**, whether the person buying or selling or offering to buy or sell acts for himself or as an agent, employee or broker for any firm, co-partnership, company, corporation, association or broker's office. (Emphasis added).

From the Michigan Penal code it is seen that State statutes on derivatives dealt primarily with the prevention of transactions where there was no intention to deliver the underlying asset[100],

[100] In New York in 1812 a law was enacted declaring all contracts for the sale of stocks or bonds void, unless the seller at the time, was **the actual owner or assignee thereof**, or authorized by such owner or assignee to sell the same. This law was similar to a one passed in England in 1733 John Barnard’s Act. The New York statute was repealed in 1858 the repealing statute provided that no contract should be void because the property sold was not at the time in possession of the seller.
In Massachusetts an act was passed in 1836 **forbidding short sales of stocks or bonds**. In Pennsylvania in 1841 an act was passed **making short selling a misdemeanour**, with a fine from $100 to $1000. Money paid was recoverable. This law was repealed in 1862. Mississippi passed a law in 1882 which required the **mutual agreement of the parties not to deliver to make the contract void.** Tennessee in 1883, Arkansas in 1883, Texas in 1885, South Carolina in 1883, Michigan in 1887, Iowa in 1886 and Missouri in 1889 all passed laws

prevention of wagering arrangements[101], illegalisation of bucket shops, and illegalisation of options and futures in certain commodities[102].

The US State statutes that prohibited option dealings possibly addresses *Shariah* objection #4, since, according to *Shariah,* charging of fees for the mere right to buy or sell is not permissible. Also by making wagers unenforceable this directly addresses *Shariah* objection #3. Preventing sales of contracts where there is no intention to deliver the underlying asset addresses *Shariah* objections #2 and #3, by ensuring that delivery of the asset actually takes place.

The approach, taken by nearly all States in US, was nothing more than a codification of case law judgments made during that period[103]. In other words, State law in US sought to prevent rather than to regulate derivative trading (Patterson 1931).

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the substance of which was that **futures and options were illegal where there was no intent to actually receive or deliver the article sold**. (Parker, C 1911).
In Massachusetts in 1890 an act was passed which stated "Whoever contracts to buy or sell upon margins, **without intent to actually receive or deliver**, may sue for any payment made". In 1901 this law was amended prohibiting wagering contracts in stocks or commodities where no purchase is intended. 'Lack of seller's ownership is evidence of a wagering contract.' (Parker, C 1911), p.465

[101] In Illinois, the following statute was passed at an early date: "Whoever contracts to have or give himself or another the option to sell of buy at a future time any grain or other commodity. Stock of any railroad or other company, or gold, or forestalls the market by spreading false rumours to influence the price of commodities therein, or corners the market, or attempts to do so in relation to any of such commodities, shall be fined not less than $10 nor more than $1000, or confined in the county jail not exceeding one year, or both; **and all contracts made in violation of this section shall be considered gambling** and shall be void."' (Parker, C 1911), p.464.
In Ohio in 1882 a similar Act as the one of Illinois was passed.
In 1890 North Dakota restrained public officers from speculating while in office.
(Parker, C 1911)

[102] The constitution of California in 1879 contained a provision that "all contracts for sale of shares of capital stock of any corporation or association on margin, or to **be delivered at a future day, shall be void**, and any money paid on such contracts may be recovered." 'This section of the constitution was amended in 1908.' (Parker, C 1911), p.464 .
In Louisiana's new constitution in 1898 it was provided that legislature should pass laws to **suppress dealings in options or futures** on agricultural products or articles of necessity. In 1906 Georgia passed law **enforcing a penalty for dealing in futures**, bona fide trade though was not prohibited.
In 1907 Alabama **prohibited dealings in futures**. Arkansas prohibited bucket shops, and dealing in futures. Florida made it unlawful to deal in cotton futures; Montana prohibited gambling and dealing in futures; Nebraska suppressed bucket shopping and gambling in stocks; and Vermont passed an act to restrain stock gambling.
In 1909, Kansas, New Hampshire, Arizona, Iowa and Tennessee passed laws **declaring the maintaining aiding in maintaining a bucket shop as a felony**. It was even a felony if telegraph and telephone companies allowed such sales over their lines. (Parker, C 1911).
In 1910 'various acts of a similar nature to those above were passed in Myoming, Kentucky, South Carolina, New Jersey, Virginia, Louisiana, Rhode Island and Mississippi.' (Parker, C 1911), p.465.

[103] See section 3.2.2.3 above.

Some States, recognising the inadequacy of this rule, amended their statutes to render valid all futures trades executed on organised exchanges[104].

An example of such a provision is found in the present Texas Civil Statutes Title 132:

Texas Civil Statutes Title 132
Occupational and Business Regulation Chapter Five.
Commodity Exchanges, Tex. Rev. Civ. Stat. art. 8652

Art 8652. Future contracts valid

All contracts of sale for future delivery of cotton, grain, stocks, or other commodities, (1) made in accordance with the rules of any board of trade, exchange, or similar institution, and (2) actually executed on the floor of such board of trade, exchange, or similar institution, and performed or discharged according to the rules thereof, and (3) when such contracts of sale are placed with or through a regular member in good standing of a cotton exchange, grain exchange, board of trade, or similar institution, organized under the laws of the State of Texas or any other State, shall be and they hereby are declared to be valid and enforceable in the courts of this State, according to their terms; provided, that contracts of sale for future delivery of cotton in order to be valid and enforceable as provided herein, must not only conform to the requirements of clauses 1 and 2 of this section, but must also be made subject to the provisions of the United States Cotton Futures Act, approved August 11, 1916, and any amendments thereto; provided, further, that if this clause should for any reason be held inoperative, then contracts for the future delivery of cotton shall be valid and enforceable if they conform to the requirements of clauses 1 and 2 of this section; provided further, that all contracts as defined in Section 1 hereof where it is not contemplated by the parties thereto that there shall be an actual delivery of the commodities sold or bought shall be unlawful.

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[104] The following statutes were enacted declaring that contracts for future delivery of grain and other commodities were valid and enforceable if made according to the rules of an exchange, actually executed on the exchange and performed or discharged according to its rules, and made with or through a member in good standing: Ark. Acts 1929, No.208, Ark. Dig. Stat. (1931 Supp.) ss. 2661a-2661k; Ga. Acts 1929, p.245, Ga. Code (1930 Supp.) ss. 4264(1) – 4264(8); Miss. Acts 1928, c. 304, Miss. Code (1930) ss. 1827-1837; Ola. Laws 1917, c. 97, Okla Stat. (1931), c. 15 art,21; S.Car. Acts 1928. No. 711, S. Car Code (1932), ss. 6313-6321; Tex. Acts 1925, c. 15, Tex. Rev. Pen. Code (1925), arts. 656-646.

Regulation rather than prevention of derivative trading was largely dealt with not under State laws in US but rather Federal legislation; this is discussed next.

6.4.2 Federal Regulation

According to Parker (1911), in the US many attempts were made to introduce Federal regulation on derivative trading from the year 1890 until 1911. However none of the bills introduced made it to become law.

Finally in 1914 the Cotton Futures Act 38 STAT. 693 was passed. This Act was re-enacted, 39, STAT, 476 in 1916 ('Cotton Futures Act').

Apart from the following provisions, the Cotton Futures Act dealt mainly with the grading of cotton deliverable on futures contracts[105].

According to s.3 of the Cotton Futures Act:

> Sec. 3. That upon each contract of sale of any cotton for future delivery made at, on, or in any exchange, board of trade, or similar institution or place of business, there is hereby levied a tax in the nature of an excise of 2 cents for each pound of the cotton involved in any such contract.

This tax of two cents per pound on futures contracts was imposed unless stipulated regulatory conditions were met.

The conditions are found under sections 4, 5 and 10 of the Cotton Futures Act:

- Under s.4 each contract of sale of cotton had to be in writing;
- Under s.5 the basis grade of the cotton had to be specified and was to be one of the grades and standards established by the Secretary of Agriculture;

[105] Two other statutes, the Grain Standards Act 39 STAT. 482 (1916), 7 U.S.C. s 71 (1946) and the Warehouse Act 39 STAT. 486 (1916), 7 U.S.C s. 241 also served merely to raise and standardise conditions of delivery on futures contracts.

- Under s.5 where the basis grade was above or below the standards specified by the Secretary of Agriculture then the difference in the contract price above or below should be paid;
- Under s.5 delivery of prohibited cotton was not allowed;
- Under s.5 full weight of cotton, notice of date of delivery and certificate of identity was to be tendered;
- Under s.5 in case of dispute between persons as to the classification of any cotton tendered either person was allowed to refer the question of true classification of cotton to the Secretary of Agriculture;
- Under s.10 the grade, type, sample or description of the cotton, price, dates, and time of shipment involved was to be specified;
- Under s.10 providing for the delivery of cotton contracted for; and shall not be affected by "set-off" or "ring settlement', but only by the actual transfer of the specified cotton mentioned in the contract.

Two of these conditions are significant. Firstly, the requirement under s.4 above each contract of sale of cotton for future delivery had to be in writing. Requiring the transaction to be in writing *per se* may not be sufficient to satisfy *Shariah* objection #1, but may address *Shariah* objection #3 which is to curb *maisir, qimar* and *gharar*. Secondly, under s.10 the contract must provide that delivery of the cotton shall not be affected by 'set-off' or 'ring' settlement[106], but only by the actual transfer of the specified cotton mentioned in the contract. Prohibiting a set-off or ring settlement addresses *Shariah* objections #2 and #1 since disallowing a set-off will ensure transfer of ownership and ensure a genuine sale takes place, respectively.

The first comprehensive federal effort to regulate exchange trading was the Grain Futures Act, 42 STAT. 998 (1922) ('Grain Futures Act'). This statute was preceded in 1921 by the Futures Trading Act, 42 STAT.187 ('Futures Trading Act') [most of which was promptly declared unconstitutional by the US Supreme Court as an invalid exercise of the taxing power in *Hill v Wallace* 259 U.S. 44 (1922)].

Sections 3 and 4 of the Futures Trading Act are as follows:

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[106] 'Set-off' and 'ring'- settlement was aptly defined in Board of the *City of Chicago v Christie Grain Stock Company*, see section 3.2.2.3 above.

Sec. 3. That in addition to the taxes now imposed by law there is **hereby levied a tax amounting to 20 cents per bushel on each bushel involved** therein, whether the actual commodity is intended to be delivered or only nominally referred to, **upon each and every privilege or option** for a contract either of purchase or sale of grain, intending hereby to tax only the transaction known to the trade as “privileges”, “bids,” “offers,” “puts and calls,” “indemnities,” or “ups and downs”.

Sec. 4. That in addition to the taxes now imposed by law there is **hereby levied a tax of 20 cents a bushel on every bushel involved herein, upon each contract of sale of grain for future delivery except –**

(a) **Where the seller is at the time of making such contract the owner of the actual physical property covered thereby**, or is the grower thereof, or in case either party to the contract is the owner or renter of land which the same is to be grown, or is an association of such owners, or growers of grain, or of such owners or renters of land; or

(b) **Where such contracts are made by or through a member of a board of trade which has been designated by the Secretary of Agriculture as a “contract market,”** as hereinafter provided, and if such contract is evidenced by a memorandum in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery, and provided that each board member shall keep such memorandum for a period of three years from the date thereof, or for a longer period if the Secretary of Agriculture shall so direct, which record shall at all times be open to the inspection of any representative of the United States Department of Agriculture or the United States Department of Justice (Emphasis added).

These provisions of the Futures Trading Act were attempts by the US government to legislate privileges (options) out of existence by imposing a prohibitive tax (Lower 1978). The Futures Trading Act indicated (in s.4 Futures Trading Act) an attempt to prevent speculation by requiring the seller to be the owner or grower of the physical commodity or that future contracts are made through a member of a board of trade, which has been designated as a ‘contract market’. Under s.5 of the Futures Trading Act, the Secretary of Agriculture is authorised to designate boards of trades as ‘contract markets’ based on conditions stipulated within it, and s.6 Futures Trading Act allows any board of trade desiring to be designated a 'contract market' to make an application to the Secretary of Agriculture. There was a further requirement that the contract or memorandum in writing be established to evidence the transaction where the future contract is traded in a 'contract market'. Section 4 of the Futures Trading Act is therefore a very useful provision which can be used to curtail excessive speculation or gambling on the exchange. Further, imposing taxes on each future or option traded in cases of speculators only would address *Shariah* objections #2 and #3, since by inserting a tax requirement this might curb speculation by discouraging those who have no genuine need to hedge, and also discouraging the buying and selling of futures by those who do not possess or own the underlying asset.

Section 10 of the Futures Trading Act imposes additional taxes for violations of sections 3 and 4 as follows:

> Sec. 10. That any person who shall fail to evidence any such contract by a memorandum in writing, or keep the record, or make a report, or who fail to pay the tax, as provided in sections 4 and 5 hereof, or who shall fail to pay the tax required in section 3 hereof, shall pay in addition to the tax a penalty equal to 50 per centum of the tax levied against him under the Act, and shall be guilty of a misdemeanor, and upon conviction thereof fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

Imposing and enforcing penalties in cases of breach of the laws, rules and regulations ensure compliance with the laws, rules and regulation. The $10,000 sum charged in the event of a breach has a deterring effect on participants of the market. Therefore penalties in general address *Shariah* objections #1, #2, and #3 by ensuring compliance with the laws.

The Grain Futures Act contained substantially the same provisions as the Futures Trading Act, but was not based on taxing power[107]. Instead s.3 of the Grain Futures Act reiterated the advantages of the futures market, that is, price dissemination, but also highlighted the disadvantages of futures transactions carried out in such a large volume, that is, speculation, manipulations and controls. Section 3 concluded that due to these disadvantages there could

[107] The constitutionality of the Grain Futures Act's provisions dealing with regulation of exchanges was sustained in *Board of Trade v Olsen*.

be sharp fluctuations in the price of those commodities traded by futures. Regulation is thus required:

> Sec. 3. Transactions in grain involving the sale thereof for future delivery as commonly conducted on boards of trade and known as “futures” are affected with a national public interest; that such transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling grain and the products and by-products thereof in interstate commerce; that the prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of grain and the products and by-products thereof and to facilitate the movements thereof in interstate commerce; that such transactions are utilized by shippers, dealers, millers, and others engaged in handling grain and the products and by-products thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price; that **the transactions and prices of grain on such boards of trade are susceptible to speculation, manipulations, and control, and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling grain and products and byproducts thereof in interstate commerce, and that such fluctuations in prices are an obstruction to and a burden upon interstate commerce in grain and the products and by-products thereof and render regulation imperative** for the protection of such commerce and the national public interest therein. (Emphasis added).

Section 4 of the Grain Futures Act mirrored closely s.4 of the Futures Trading Act. Section 4 of the Grain Futures Act is as follows:

> Sec. 4. It shall be unlawful for any person to deliver for transmission through the mails or in interstate commerce by telegraph, telephone, wireless, or other means of communication any offer to make or execute, or any confirmation of the execution of, or any quotation or report of the price of, any contract of sale of grain for future delivery on or subject to the rules of any board of trade in the United States, or for any person to make or execute such contract of sale, which is or may be used for (a) hedging any transaction in interstate commerce in grain or the products or by-products

thereof, or (b) determining the price basis of any such transaction in interstate commerce, or (c) delivering grain sold, shipped, or received in interstate commerce for the fulfillment thereof, except –

> (a) **Where the seller is at the time of making such contract the owner of the actual physical property covered thereby, or is the grower thereof**, or in case either party to the contract is the owner or renter of land on which the same is to be grown, or is an association of such owners, or growers of grain, or of such owners or renters of land; or

Where such contract is made by or through a member of a board of trade which has been designated by the Secretary of Agriculture as a "contract market," as hereinafter provided, and if such contract, is evidenced by a record in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery: Provided, That each board member shall keep such record for a period of three years from the date thereof, or for longer period if the Secretary of Agriculture shall so direct, which record shall at all times be open to the inspection of any representative of the United States Department of Agriculture or the United States Department of Justice. (Emphasis added).

The Grain Futures Act made trading in futures unlawful unless conducted on exchanges designated by the commission (the Grain Futures Commission comprising of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General) as a 'contract market'. To be so designated, exchanges were required to prevent manipulation of prices, dissemination of false or misleading market information, and cornering of commodities as well (ss.5 and 6 Grain Futures Act). Failure to comply with these requirements resulted in suspension or revocation of the contract market designation (s.7 of the Grain Futures Act), which, in effect, would close the exchange. The only direct control over individual traders was a provision imposing criminal penalties for certain actions (s.9 of the Grain Futures Act was similar to s.10 of the Futures Trading Act).

Requiring that trading in futures be conducted on designated exchanges ensures that only qualified persons are allowed to provide the venue and facilities for trading. Further the requirement under the Grain Futures Act that contract markets were required to prevent manipulation of prices, dissemination of false or misleading market information, and cornering of commodities as well, ensures speculative activity is curbed. Therefore these requirements address *Shariah* objection #3 which is the need to prevent *maisir*, *qimar* and *gharar*.

The Grain Futures Act also required exchanges and their members to keep records and file reports, and authorised the Secretary of Agriculture to conduct investigations of exchange operation (s.8 Grain Futures Act). Thus the records could be scrutinised by the Secretary of Agriculture and any abnormalities in trading could be identified. This law prevents uncertainty by ensuring transparency and thereby prevents *gharar* and would address *Shariah* objection #3.

However a limitation of the Grain Futures Act was that it was limited to transactions in grain futures only, and not to other commodities.

In 1936, the passage of a more comprehensive Commodity Exchange Act Ch. 545, 49 Stat. 1419[108] ('Commodities Exchange Act') was introduced. The Commodities Exchange Act replaced and amended the inadequacies of the Grain Futures Act.

For example, s.2 of the Commodities Exchange Act provided that wherever the word 'grain' appeared this was to be struck out and replaced by the terms 'commodity', 'any commodities' or 'commodities'. Also under s.2 of the Commodities Exchange Act, the Grain Futures Commission became the Commodity Exchange Commission and continued to consist of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General.

A significant addition by the Commodities Exchange Act was under s.4a which imposed limits on futures trading to stem excessive speculation in commodities:

> Sec. 4a (1) Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contracts markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such

[108] This Commodities Exchange Act is now found in the UNITED STATES CODE SERVICE TITLE 7. AGRICULTURE CHAPTER 1. COMMODITY EXCHANGES. The following account of legislations passed after the Commodities Exchange Act, are actually legislation which amended, altered and added provisions to the Commodities Exchange Act. Only the relevant and significant legislations amending the Commodities Exchange Act are discussed in this thesis.

> commodity. For the purpose of diminishing, eliminating, or preventing such burden, **the commission shall**, from time to time, after due notice and opportunity for hearing, by order, **proclaim and fix such limits on the amount of trading under contracts of sale of such commodity for future delivery** on or subject to the rules of any contract market which may be done by any person as the commission finds is necessary to diminish, eliminate, or prevent such burden. Nothing in this section shall be construed to prohibit **the commission from fixing different trading limits for different commodities, markets, futures, or delivery months, or different trading limits for buying and selling operations,** or different limits for the purposes of subparagraphs (A) and (B) of this section, or from exempting transactions commonly known to the trade as 'spreads' or 'straddles' or from fixing trading limits applying to such transactions different from trading limits fixed for other transactions. (Emphasis added).

As can be seen from s.4a Commodities Exchange Act, this right to impose trading limits was a wide power that prevented the buying or selling of commodity futures beyond a limit fixed by the commission. This power given to the commission was in addition to the requirement that exchanges, through self-regulation were to ensure prevention of price manipulation, dissemination of false or misleading market information, and cornering of commodities, to retain their designation as a contract market (s.5b Commodities Exchange Act).

Setting trading limits would address *Shariah* objection #3 since excessive speculation on a certain asset or position may be minimised. Further, self-regulation ensures better monitoring over daily trading activity. With the existence of numerous boards of trade and exchanges it would be very difficult for a regulating body to oversee every aspect of derivative trading on a daily basis. It is therefore important to legislate appropriate laws that ensure autonomy and the ability of self-regulation by boards of trade/exchanges. Indirectly these laws that enable boards of trades and exchanges to self-regulate ensure *Shariah* objection #3 is addressed.

The Commodities Exchange Act also prohibited fictitious and fraudulent transactions under s.4b and s.4c:

> Sec 4b. It shall be unlawful for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of (1) any contract of sale of any commodity in interstate

commerce, or (2) any contract of sale, of any commodity for future delivery made, or to be made, on or subject to the rules of any contract market for or on behalf of any person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity for the products or by the products thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity or the products or by products thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof –

(A) **to cheat or defraud or attempt to cheat or defraud** such person;

(B) willfully to make or cause to be made to such person any **false report** or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;

(C) **willfully to deceive or attempt to deceive such person** by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract for such person; or

(D) **to bucket such order, or to fill such order by offset against the order or orders of any other person**, or willfully and knowingly and without the prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person.

Sec. 4c. It shall be unlawful for any person to offer to enter into, enter into, or confirm the execution of, any transaction involving any commodity, which is or may be used for (1) hedging any transaction interstate commerce in such commodity or the products or byproducts thereof, or (2) determining the price basis of any such transaction in interstate commerce in such commodity, or (3) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment, thereof –

(A) if such transaction is, is of the character of, or is commonly known to the trade as, a ‘wash sale’, ‘cross trade’, or ‘accommodation trade’, or is a **fictitious sale**;

(B) if such transaction is, is of the character of , or is commonly known to the trade as, **a 'privilege', 'indemnity', 'bid'. 'offer', 'put', 'call' 'advance guaranty', or 'decline guaranty'**, or

if such transaction is used to cause any price to be reported, registered, or recorded which **is not a true and bona fide price**,' (Emphasis added).

These laws protect those investing in derivatives by punishing any dishonest or deceitful behaviour. Further through s.4c (B) above, the Commodities Exchange Act banned the trading in options[109], in commodities regulated under the Commodities Exchange Act. This ban was lifted in 1982[110]. Prohibiting options dealings could possibly address *Shariah* objection #4, since according to *Shariah* charging of fees for the mere right to buy or sell is not permissible.

Under s.4d it was necessary for any person who wanted to engage as a futures commission merchant to be registered under the Commodities Exchange Act with the Secretary of Agriculture. Section 4e laid down that it would be illegal for any person who has not registered, to act as floor broker, and s.4f required application for registration. Section 4g laid down the circumstances when revocation or suspension of registration would take place, that is, on violations of the provisions of the Commodities Exchange Act or the rules and regulations set by the Secretary of Agriculture.

The requirement that registration is needed for those who want to carry out derivative trading ensures that only qualified persons who are fit and proper carry out trading in derivatives. The fact that revocation or suspension of registration could take place when there are violations of the provisions of the Commodities Exchange Act helps exclude those who had previously taken part in risky or speculative behaviour. Thus the requirement of registration may address *Shariah* objection #3, which is the need to prevent *maisir*, *qimar* and *gharar*.

Further under s.6b of the Commodities Exchange Act any board of trade, director, officer agent or employee of any board of trade who is violating or has violated any of the provisions

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[109] Options were banned under the Commodities Exchange Act as a result of an incident in 1933, where an attempt was made to manipulate the wheat futures market using options. This resulted in an opportunity for farmers (who opposed options) to force the U.S. government to ban trading in these options in the Commodities Exchange Act (Freeman 1993).

[110] When President Ronald Reagan signed the 1982 Futures Trading Act (Freeman 1993)

of the Commodities Exchange Act or any of the rules and regulations of the Secretary of Agriculture would be guilty of a misdemeanor and fined not less than $500 or more than $10,000 or imprisoned for not less than six months or more than one year, or both. Imposing and enforcing penalties in cases of breach of laws and rules ensures compliance with the laws and rules.

In 1968 the Commodities Exchange Act Amendment, 49 Stat. 1491 ('Commodities Exchange Amendment Act') was passed.

Under this statute the significant changes made to the Commodities Exchange Act are as follows:

- Section 4a (1) of the Commodities Exchanges Act was amended to give wider powers to the Commodities Exchange Commission to prevent excessive speculation. Under the new amendment, the former power of proclaiming and fixing limits on the amount of trading under contracts of sale of such commodity for future delivery was retained intact and further reinforced in the following way:

> … proclaim and fix such limits on the amounts of trading **which may be done or positions which may be held by any person under** contracts of sale of such commodity for future delivery on or subject to the rules of any contract market as the commission finds are necessary to diminish, eliminate **such limits, the position held and trading done by any persons directly or indirectly controlled by such person shall be included with the positions held and trading done by such person; and further, such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading were done by, a single person**. (Emphasis added to show the changes added to s.4a (1) of the Commodities Exchange Act).

Under the above provision the Commission was given greater power to even check positions held by a person or a person controlled by such person. Setting trading limits would address *Shariah* objection #3 since excessive speculation on a certain asset or position may be minimised.

- Section 6(a) of the Commodities Exchange Act was amended to provide the Commodities Exchange Commission authorisation to suspend for a period of six months or to revoke the designation as a contract market any board of trade which is found to have not enforced its rules.

- Sections 6(b) and (c) of the Commodities Exchange Act were amended to include provisions to order any person to cease and desist from manipulating or attempting to manipulate the market price of any commodity, in interstate commerce, or for future delivery or who has violated any of the provisions of the Commodities Exchange Act or the rules or regulations or orders of the Commodities Exchange Commission. Failure to comply with such an order would cause such person(s) to be guilty of misdemeanor and liable on conviction to a fine of not less than $500 or more than $10,000 or imprisonment of not less than six months or more than one year, or both.

These powers given to the Commodities Exchange Commission ensured that the Commission could monitor individuals as well as boards of trade in the commodity markets. Imposing and enforcing penalties in cases of breach of the laws, rules and regulations ensures compliance with the laws, rules and regulation by the commodity markets and also participants. Penalties in general address *Shariah* objections #1, #2, and #3 by ensuring compliance with the laws.

The next statute to be passed was in 1974, the Commodities Futures Trading Commission Act 88 Stat. 1389 (‘Commodity Futures Trading Commission Act’).

The Commodity Futures Trading Commission Act inserted a number of new sections to the Commodities Exchange Act. One of the most significant additions of the Commodity Futures Trading Commission Act was the creation of the Commodity Futures Trading Commission (s.101 Commodity Futures Trading Commission Act, inserted in s.2(a) of the Commodities Exchange Act), an independent agency with powers greater than those of its predecessor agency, the Commodity Exchange Authority. For example, while the Commodity Exchange Authority only regulated agricultural commodities enumerated in the Commodity Exchange Act, the 1974 Act granted the Commodity Futures Trading Commission exclusive jurisdiction over futures trading in all commodities [s.101(3) Commodity Futures Trading Commission Act, inserted in s.2(a)(2) of the Commodities Exchange Act].

Designating a regulating body to oversee derivative trading ensures adherence to laws, rules and regulation by the boards of exchange, and also the rules and regulation of the boards of trade and exchanges, by investors and others. Further, constant control and monitoring on the overall activities of derivative trading will also be ensured by the designation of a regulating body. This minimises *gharar* and therefore, indirectly addresses *Shariah* objections #2 and #3.

The Commodities Futures Trading Commission Act took up regulating those who were termed as ‘commodity trading advisor’ and ‘commodity pool operator’. Under s.202 of the Commodities Futures Trading Commission Act, s.2 of the Commodities Exchange Act was amended to provide the following definition of ‘commodity trading advisor’ and ‘commodity pool operator’:

> SEC 202. Section 2 (a) of the Commodity Exchange Act, as amended (7 U.S.C. 2, 4), is amended by adding at the end of paragraph (1) the following new sentences: “The term ‘commodity trading advisor’ shall mean any person who, for compensation or profit, engages in the business of advising others either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities; … The term ‘commodity pool operator’ shall mean any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order.

These ‘commodity trading advisors’ and ‘commodity pool operators’ were recognised under s.205 of the Commodities Futures Trading Commission Act, which inserted s.4l in the

Commodities Exchange Act, as affecting national public interest[111]. They were therefore required to be registered under s.4n of the Commodities Exchange Act as inserted by s.205 of the Commodities Futures Trading Commission Act.

These ‘commodity trading advisors’ and ‘commodity pool operators’ were also required to maintain books and records, for a period of three years, or longer if the Commodity Futures Trading Commission so required, and these records were open to inspection by any representative of the Commission or the Department of Justice (s.4n(4)(A) Commodities Exchange Act as inserted by s.205 of the Commodity Futures Trading Commission Act).

Under s.4o of the Commodities Exchange Act (as inserted by s.205 of the Commodity Futures Trading Commission Act), further regulations were subscribed to the commodity trading advisor and commodity pool operator.

> SEC4o(1) It shall be unlawful for any commodity trading advisor or commodity pool operator registered under this Act, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly-
> (A) to employ any device, scheme, or artifice to defraud any client or participant or prospective client or participant; or
> (B) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant.

In providing these provisions the Commodities Futures Trading Commission Act tried to prevent false reporting, market manipulations, and negligent or reckless advice being given. Strict controls were also laid in respect of allowing people to register as commodity trading

[111] SEC41. It is hereby found that the activities of commodity trading advisors and commodity pool operators are affected with a national public interest in that, among other things-
" (1) their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, solicitations, subscriptions, agreements, and other arrangements with clients take place and are negotiated and performed by the use of the mails and other means and instrumentalities of interstate commerce ;
"(2) their advice, counsel, publications, writings, analyses, and reports customarily relate to and their operations are directed toward and cause the purchase and sale of commodities for future delivery on or subject to the rules of contract markets; and
"(3) the foregoing transactions occur in such volume as to affect substantially transactions on contract markets.

advisors and commodity pool operators (s.4n(6) of the Commodities Exchange Act as inserted by s.205 of the Commodities Futures Trading Commission Act[112]).

Another provision which ensured strict standards and proficiency of floor brokers, future commission merchants and others associated with them, was the introduction of training and written examinations - s.4p of the Commodity Exchange Act (inserted by s.206 of the Commodity Futures Trading Commission Act):

> SEC. 4p. The Commission may specify by rules and regulations appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable to insure the fitness of futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers. In connection therewith, the Commission may prescribe by rules and regulations the adoption of written proficiency examinations to be given to applicants for registration as futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers, and the establishment

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112 S.4n(6) The Commission is authorized, without hearing, to deny registration to any person as a commodity trading advisor or commodity pool operator if such person is subject to an outstanding order under this Act denying to such person trading privileges on any contract market, or suspending or revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or suspending or expelling such person from membership on any contract market.
(7) The Commission after hearing may by order deny registration, revoke or suspend the registration of any commodity trading advisor or commodity pool operator if the Commission finds that such denial, revocation, or suspension is in the public interest and that-
(A) the operations of such person disrupt or tend to disrupt orderly marketing conditions, or cause or tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities;
(B) such commodity trading advisor or commodity pool operator, or any partner, officer, director, person performing similar function or controlling person thereof-
(i) has within ten years of the issuance of such order been convicted of any felony or misdemeanor involving the purchase or sale of any commodity or security, or arising out of any conduct or practice of such commodity trading advisor or commodity pool operator or affiliated person as a commodity trading advisor or commodity pool operator; or
(ii) at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from acting as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or as an affiliated person or employee of any of the foregoing, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of commodities or securities; or
(C) any partner, officer, or director of such commodity trading advisor or commodity pool operator, or any person performing a similar function or any controlling person thereof is subject to an outstanding order of the Commission denying trading privileges on any contract market to such person, or suspending or
revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or suspending or expelling such person from membership on any contract market.

> of reasonable fees to be charged to such applicants to cover the administration of such examinations.

This regulation ensured that no improper practices would be carried out by those who advise or invest on behalf of the investors. Fraud, false reporting, market manipulations, and negligent or reckless advice are prevented. The requirement to undergo training on ethical issues, and training on rules and regulations of the regulating body and the boards of trade /exchanges is a very useful tool which may include, in the case of Islamic finance training, issues on *gharar, maisir, qimar* and how to avoid them. These laws address *Shariah* objection #3.

The Commodities Futures Trading Commission was also given power to conduct regular investigations of the market and submit these reports to the public. This ensured transparency and minimised information asymmetry:

> Sec. 412. The Commodity Exchange Act, as amended, is amended by adding the following new section at the end thereof:
>
> SEC 16 . (a) The Commission may conduct regular investigations of the markets for goods, articles, services, rights, and interests which are the subject of futures contracts, and furnish reports of the findings of these investigations to the public on a regular basis. These market reports shall, where appropriate, include information on the supply, demand, prices, and other conditions in the United States and other countries with respect to such goods, articles, services, rights, interests, and information respecting the futures markets.

Daily trading records were also introduced by the Commodities Futures Trading Commission Act:

> SEC. 415. Section 4g of the Commodity Exchange Act, as amended, is amended by inserting “(1)” after the section designation and by adding the following new subsections:
>
> (2) Every clearinghouse and contract market shall maintain daily trading records. The daily trading records shall include such information as the Commission shall prescribe by rule.

(3) Brokers and futures commission merchants shall maintain daily trading records for each customer in such manner and form as to be identifiable with the trades referred to in subsection (2).

(4) Daily trading records shall be maintained in a form suitable to the Commission for such period as may be required by the Commission. Reports shall be made from the records maintained at such times and at such places and in such form as the Commission may prescribe by rule, order, or regulation in order to protect the public interest and the interest of persons trading in commodity futures.

(5) Before the beginning of trading each day, the exchange shall, insofar as is practicable and under terms and conditions specified by the Commission, make public the volume of trading on each type of contract for the previous day and such other information as the Commission deems necessary in the public interest and prescribes by rule, order, or regulation.

The effect of such a provision was to establish transparency in the trading of derivatives and also ensure tracking of positions held by individuals, thus enabling the exchanges and the commission to track market manipulations, excessive speculation or any other undesirable activity that could affect derivative trade.

Boards of trade/exchanges, brokers and future commission merchants were to maintain records. These records are subject to scrutiny by a higher authority (the regulating authority). The volume of derivative contracts traded is also available to the public to view. Through these records the regulating body is able to identify any abnormalities in derivative trade. These laws prevent uncertainty by ensuring transparency and symmetric distribution of information within the whole system, thereby preventing *gharar. Shariah* objection #3 is thus addressed.

Thereafter, the next Federal legislation affecting derivative trading to be passed was the Futures Trading Act 92 Stat 865 (‘Futures Trading Act 1978’).

The Futures Trading Act 1978 amended the Commodities Exchange in three ways; firstly, it required the Commodities Futures Trading Commission to maintain communication with the Securities and Exchange Commission, the Department of the Treasury, and the Federal

Reserve Board[113] (s.2 of the Futures Trading Act 1978 amending s.2 of the Commodities Exchange Act).

Secondly, it replaced s.8 of the Commodities Exchange Act with a new s.8 as follows:

> SEC. 8. (a) For the efficient; execution of the provisions of this Act, and in order to provide information for the use of Congress, the Commission may make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to the provisions of this Act. The Commission may publish from time to time the results of any such investigation and such general statistical information gathered there from as it deems of interest to the public: *Provided***,** That except as otherwise specifically authorized in this Act, the Commission may not publish data and information that would separately disclose the business transactions or market positions of any person and trade secrets or names of customers.

This new provision now gave the Commodities Futures Trading Commission the right to investigate boards of trade, and other persons, subject to the Commodities Exchange Act. The Commission also had the power to disclose publicly any information from the results of the investigation. Also, through the investigative powers given to the regulating bodies any market manipulations, speculative buying and selling or other activities prohibited in *Shariah* can be monitored and stopped, if necessary. This would address *Shariah* objection #3.

The third relevant change made by the Futures Trading Act 1978 was to increase the criminal penalties in the event of breaching the provisions of the Commodity Exchange Act. The penalty was increased from a sum of $100,000 to $500,000 (inserted by s.19 of the Futures Trading Act 1978 into s.9 of the Commodities Exchange Act). This hefty sum imposed in the event of a breach would have a deterring effect on erring participants in the market. Therefore penalties in general address *Shariah* objections #1, #2, and #3, by ensuring compliance with the laws.

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[113] 'The Commission shall maintain communications with the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission for the purpose of keeping such agencies fully informed of Commission activities that relate to the responsibilities of those agencies, for the purpose of seeking the views of those agencies on such activities, and for considering the relationships between the volume and nature of investment and trading in contracts of sale of a commodity for future delivery and in securities and financial instruments under the jurisdiction of such agencies.'

The next statute that was passed that amended the Commodities Exchange Act was the Futures Trading Act, 96 Stat. 2294 ('Futures Trading Act 1982'). This new amending Act made a number of significant changes to the Commodities Exchange Act; the relevant ones are as follows:

- **Speculative Limits**

  Section 4a of the Commodities Exchange Act was amended; the existing authority (discussed above) of the Commodities Futures Trading Commission to adopt daily speculative positions or daily trading limits by rule, regulation or order was confirmed. However, a new provision allowed the contract markets to adopt speculative limits in an amount not more than that fixed by the Commodities Futures Trading Commission, and made exceeding such exchange fixed limits a violation under the Commodities Exchange Act. Further, knowingly violating exchange-fixed limits or Commission speculative limits was made a criminal violation[114]. The result of this provision was to allow the Commission to enforce exchange enforced speculative limits in administrative disciplinary proceedings or under civil court injunction actions under s.6 (b) and s.6(c) of the Commodities Exchange Act, respectively.

- **Commodities Futures Trading Commission's Emergency Powers**

  Section 8a(9) of the Commodity Exchange Act was amended -

> (9) to direct the contract market, whenever it has reason to believe that an emergency exists, to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not

[114] Commodities Exchange Act s.4a - '(5)Nothing in this section shall prohibit or impair the adoption by any contract market or by any other board of trade licensed or designated by the Commission of any bylaw, rule, regulation, or resolution fixing limits on the amount of trading which may be done or positions which may be held by any person under contracts of sale of any commodity for future delivery traded on or subject to the rules of such contract market, or under options on such contracts or commodities traded on or subject to the rules of such contract
market or such board of trade: *Provided*, That if the Commission shall have fixed limits under this section for any contract or under section 4c of this Act for any commodity option, then the limits fixed by the bylaws, rules, regulations, and resolutions adopted by such contract market or such board of trade shall not be higher than the limits fined by the Commission. It shall be a violation of this Act for any person to violate any bylaw, rule, regulation, or resolution of any contract market or other board of trade licensed or designated by the Commission fixing limits on the amount of trading which may be done or positions which may be held by any person under contracts of sale of any commodity for future delivery or under options on such contracts or commodities, if such bylaw, rule, regulation, or resolution has been approved by the Commission: *Provided*, That the provisions of section 9(c) of this Act shall apply only to those who knowingly violate such limits.'

> limited to, **the setting of temporary emergency margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith** prior to the effective date of the Commission's action. The term 'emergency' as used herein shall mean, in addition to threatened or actual market manipulations and corners, any act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity. **Any action taken by the Commission under this paragraph shall be subject to review** only in the United States Court of Appeals for the circuit in which the party seeking review resides or has its principal place of business, or in the United States Court of Appeals for the District of Columbia Circuit. Such review shall be based upon an examination of all the information before the Commission at the time the determination was made. The court reviewing the Commission's action shall not enter a stay or order of mandamus unless it has determined, after notice and hearing before a panel of the court, that the agency action complained of was arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law (Emphasis added).

Section 8a(9) clarifies that the powers of the Commodities Futures Trading Commission include the setting of temporary emergency margin levels on any futures contract, and the retroactive fixing of position limits that may apply to a position acquired in good faith prior to the effective date of the emergency powers over contract markets. By providing such a provision, margin setting powers of an exchange were now to be shared with the Commodities Futures Trading Commission in emergencies. Further, the Commodities Futures Trading Commission’s emergency powers were subject to judicial review.

These emergency powers given to the regulating body allow immediate action to be taken by the regulating body to promptly rectify and provide immediate remedies to any unforseen circumstances. The emergency powers could immediately stop any speculative activity or market manipulations from happening. This would address *Shariah* objection #3.

- **Confidentiality Provisions**

Section 8 of the Commodities Exchange Act was amended and a new paragraph added whereby the Commodities Futures Trading Commission was given the right to withhold from public disclosure, data or information obtained in an ongoing investigation.

- **Enforcement**

Provision was made in s.9[115] of the Commodity Exchange Act whereby persons convicted of knowingly violating the Commodities Futures Trading Commission or exchange speculation limits would suffer a registration suspension and market bar for two years or such longer period as the Commission may determine.

- **Option Transactions**

Since 1936 and with the passing of the Commodities Exchange Act 1936 the granting and sale of options on agricultural commodities had been prohibited. In 1982 the Futures Trading Act 1982 repealed the ban[116]. In 1981 the Commodities Futures Trading Commission adopted a pilot program where a comprehensive set of regulations to govern exchange-trading of options on futures contracts was established (US Commodity Futures Trading Commission 2007). This pilot status of option transactions finally came to an end with the passing of the next statute.

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115 Futures Trading Act 1982–
SEC. 227. Section 9 of the Commodity Exchange Act (7 U.S.C. 13) is amended by- (2) amending subsection (b) by adding at the end thereof the following: "A person convicted of a felony under this subsection shall be suspended from any registration under this Act, denied registration or re-registration for five years or such longer period **as** the Commission shall determine, and barred from using or participating in any manner in any market regulated by the Commission for five years or such longer period **as** the Commission shall determine on such terms and conditions **as** the Commission may prescribe, unless the Commission determines that the imposition of such suspension, denial of registration or re-registration, or market bar is not required to protect the public interest. The Commission may upon petition later review such disqualification and market bar and for good cause shown reduce the period thereof.

116 SEC. 101. (a) Section 2(a) of the Commodity Exchange Act **(7** U.S.C. 2**)** is amended by- **(**3) adding a new subparagraph (B) to read as follows:
'(ii) This Act shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'options, 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty') and transactions involving, and may designate a board of trade as a contract market in, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereon: Provided however, That no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery unless the board of trade making such application demonstrates and the Commission expressly finds that the specific contract (or option on such contract) with respect to which the application has been made meets the following minimum requirements:

The Futures Trading Act 1982 1986 100 Stat. 3556 (‘Futures Trading Act 1982 1986‘) ended the pilot status of its program for commodity option transactions under s.4c Commodities Exchange Act:

> Subsection *(c)* of section 4c of the Commodity Exchange Act (7 U.S.C. 6c(c)) is amended to read as follows: “(c) Not later than 90 days after the date of the enactment of the Futures Trading Act 1982 of 1986**,** the Commission shall issue regulations-
>
> (1) to eliminate the pilot status of its program for commodity option transactions involving the trading of options on contract markets, including any numerical restrictions on the number of commodities or option contracts for which a contract market may be designated; and
>
> (2) otherwise to continue to permit the trading of such commodity options under such terms and conditions that the Commission from time to time may prescribe.”

The Futures Trading Act 1986 also added provision s.6(b)(3) to the Commodities Exchange Act which allowed the service of subpoenas upon any person who is not found within the territorial jurisdiction of any court of the US subject to the prior approval of the Commodities Futures Trading Commission. This provision recognised the growing number of cross jurisdiction transactions and the possibility of market manipulations being created by those across borders.

The next legislation to be passed was the Futures Trading Practices Act 1992 106 Stat.3590 (‘Futures Trading Practices Act’).

Under this statute a few significant additions regulating futures and option commodity markets were made.

A new provision requiring mandatory ethics training for registrants was added to section 4p of the Commodities Exchange Act:

> SEC. 210. Ethics Training for Registrants.
> (a) Mandatory Training for Registrants S4p (7U.S.C. 6p) is amended by-

(1) inserting “(a)” after “SEC. 4p.”; and

(2) adding at the end the following:

(b) The Commission shall issue regulations to require new registrants, within six months after receiving such registration, to attend a training session, and all other registrants to attend periodic training sessions, to ensure that registrants understand their responsibilities to the public under this Act, including responsibilities to observe just and equitable principles of trade, any rule or regulation of the Commission, any rule of an appropriate contract market, registered futures association, or other self-regulatory organization, or any other applicable Federal or state law, rule or regulation.

This provision makes training on ethical issues, and training on rules and regulations of the Commission and the exchanges compulsory for new registrants and also makes it compulsory for all other registrants to attend such training sessions periodically. This training is a very useful tool and can actually be included in the case of Islamic finance training on issues of *gharar, maisir* and how to avoid them thus addressing *Shariah* objection #3. The issue of training of participants in the derivative markets was first raised by Parker (1911). He proposed training those who speculate with better knowledge and skills to curb ignorance which in turn resulted in excessive speculation, taking on games of chance and gambling in futures markets.

Another amendment made by the Futures Trading Practices Act to s.9 of the commodities Exchange Act was to increase penalties from $500,000 to $1,000,000 (or $500,000 where the person is an individual) for:

- stealing, embezzling, purloining, money, securities or property having a value in excess of $100,
- Manipulating or attempting to manipulate the price of any commodity,
- Knowingly making or causing to be made any false or misleading statement in any application, report, or document required to be filed under this Act,
- Wilfully falsifying, concealing, or covering up by any trick, scheme, or artifice a material fact, or for making any false, fictitious, or fraudulent statements or representations,

- Wilfully violating any other provision of the Commodities Exchange Act, or any rule or regulation made under the Commodities Exchange Act[117].

The next statute to amend the Commodities Exchange Act was the Commodity Futures Modernization Act of 2000, 114 Stat. 2763, 2763A-365 ('Commodity Futures Modernization Act').

The Commodity Futures Modernization Act made 26 new amendments to the Commodities Exchange Act. The need to modernise and also deal with electronic transactions can be seen in the latest amendments. Many of the amendments were not totally new sections discussing new issues but rather added details and clarity to existent issues. For example the Commodity Exchange Act was amended to strike out the old s.5 of the Commodities Exchange Act, on

[117] (a) It shall be a felony punishable by a fine of not more than $1,000,000 (or $500,000 in the case of a person who is an individual) or imprisonment for not more than five years, or both, together with the costs of prosecution, for:
(1) An person registered or required to be registered under this Act, or any employee or agent thereof, to embezzle, steal, purloin, or with criminal intent convert to such person's use or to the use of another, any money, securities, or property having a value in excess of $100, which was received by such person or any employee or agent thereof to margin, guarantee, or secure the trades or contracts of any customer or accruing to such customer as a result of such trades or contracts or which otherwise was received from any customer, client, or pool participant in connection with the business of such person. The word 'value' as used in this paragraph means face, par, or market value, or cost price, either wholesale or retail, whichever is greater.
(2) Any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any contract market, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered for transmission through the mails or interstate commerce by telegraph, telephone, wireless, or other means of communication false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce, or knowingly to violate the provisions of section 4, section 4b, subsections (a) through (e) of subsection 4c, section 4h, section 40(1), or section 19.
(3) Any person knowingly to make, or cause to be made, any statement in any application, report, or document required to be filed under this Act or any rule or regulation thereunder or any undertaking contained in a registration statement required under this Act, or by any contract market or registered futures association in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact, or knowingly to omit any material fact required to be stated therein or necessary to make the statements therein not misleading.
(4) Any person willfully to falsify, conceal, or cover up by any trick, scheme, or artifice a material fact, make any false, fictitious, or fraudulent statements or representations, or make or use any false writing or document knowing the same to contain any false, fictitious, or fraudulent statement or entry to a contract market, board of trade, or futures association designated or registered under this Act acting in furtherance of its official duties under this Act.
(5) Any person willfully to violate any other provision of this Act, or an rule or regulation thereunder, the violation of which is made unlawful or the observance of which is required under the terms of this Act, but no person shall be subject to imprisonment under this paragraph **4** or the violation of any rule or regulation if such person proves that he had no knowledge of such rule or regulation."

designation of boards of trade as contract markets, and to add a totally new and exhaustive section[118].

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[118] Sec 5 **Designation of boards of trade as contract markets**

(a) Applications. A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act.

(b) Criteria for designation.

(1) In general. To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this subsection.

(2) Prevention of market manipulation. The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.

(3) Fair and equitable trading. The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize—

(A) transfer trades or office trades;

(B) an exchange of--

(i) futures in connection with a cash commodity transaction;

(ii) futures for cash commodities; or

(iii) futures for swaps; or

(C) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.

(4) Trade execution facility. The board of trade shall—

(A) establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and

(B) demonstrate that the trade execution facility operates in accordance with the rules Or specifications.

(5) Financial integrity of transactions. The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.

(6) Disciplinary procedures. The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.

(7) Public access. The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.

(8) Ability to obtain information. The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this subsection, including the capacity to carry out such international information-sharing agreements as the Commission may require.

(c) Existing contract markets. A board of trade that is designated as a contract market on the date of the enactment of the Commodity Futures Modernization Act of shall be considered to be a designated contract market under this section.

(d) Core principles for contract markets.

(1) In general. To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.

(2) Compliance with rules. The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

(3) Contracts not readily subject to manipulation. The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.

(4) Monitoring of trading. The board of trade shall monitor trading to prevent manipulation, price

distortion, and disruptions of the delivery or cash-settlement process.

(5) Position limitations or accountability. To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.

(6) Emergency authority. The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to--

(A) liquidate or transfer open positions in any contract;

(B) suspend or curtail trading in any contract; and

(C) require market participants in any contract to meet special margin requirements.

(7) Availability of general information. The board of trade shall make available to market authorities, market participants, and the public information concerning--

(A) the terms and conditions of the contracts of the contract market; and

(B) the mechanisms for executing transactions on or through the facilities of the contract market.

(8) Daily publication of trading information. The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.

(9) Execution of transactions. The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.

(10) Trade information. The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

(11) Financial integrity of contracts. The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

(12) Protection of market participants. The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.

(13) Dispute resolution. The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.

(14) Governance fitness standards. The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this paragraph).

(15) Conflicts of interest. The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest.

(16) Composition of boards of mutually owned contract markets. In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.

(17) Recordkeeping. The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.

(18) Antitrust considerations. Unless necessary or appropriate to achieve the purposes of this, the board of trade shall endeavor to avoid--

(A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or

(B) imposing any material anticompetitive burden on trading on the contract market.

(e) Current agricultural commodities.

(1) Subject to paragraph (2) of this subsection, a contract for purchase or sale for future delivery of an agricultural commodity enumerated in section 1a(4) that is available for trade on a contract market, as of the date of the enactment of this subsection [enacted Dec. 21, 2000], may be traded only on a contract market designated under this section.

(2) In order to promote responsible economic or financial innovation and fair competition, the Commission, on application by any person, after notice and public comment and opportunity for hearing, may prescribe rules and regulations to provide for the offer and sale of contracts for future delivery or options on such contracts to be conducted on a derivatives transaction execution facility.

The new section (s.5) required that for a board of trade to be designated as a contract market, it shall ensure the following:

- Prevention of market manipulation through market surveillance, compliance and enforcement.
- Ensure fair and equitable trading by detection and enforcement of rules.
- Establish and enforce rules specifying the manner of operation of the trade execution facility maintained by the board of trade.
- Establish and enforce rules and procedures ensuring financial integrity of transactions.
- Establish and enforce disciplinary procedures that authorise the board of trade to discipline violations of the board rules.
- Provide public access to the rules and regulations and contract specifications of the board of trade.
- Establish and enforce rules that will allow the board of trade to obtain necessary information.
- Monitor and enforce compliance with the rules of the contract market.
- Monitor trading to prevent manipulations, price distortions and disruptions of the delivery or cash-settlement process.
- Adopt position limitations or position accountability for speculators where necessary and appropriate.
- Adopt rules to provide for the exercise of emergency authority.
- Make available information concerning terms and conditions of the contracts of the contract market and the mechanism for executing transactions on or through the facilities of the contract market.
- Make public daily information on settlement prices, volume, open interest, and open and closing ranges for actively traded contracts on the contract market.
- Maintain rules for the recording and safe storage of all identifying trade information to assist in the prevention of customer and market abuses.
- Establish and enforce rules providing for the financial integrity of any contracts traded on the contract market and to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.

- Establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.
- Establish and provide facilities for alternative dispute resolution.
- Establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility.
- Establish and enforce rules to minimise conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts.
- In the case of mutually owned contract market the board of trade shall ensure that the composition of the governing board reflects market participants.
- Unless necessary to achieve the purposes of the Act avoid adopting any rules or taking any actions that result in any unreasonable restraints of trade or imposing material anticompetitive burden on trading on the contract market.

This new s.5 provides for in detail all the necessary functions of a contract market to ensure transparency, freedom from fraud, market manipulations, proper resolution of conflicts, and other concerns in derivative trading. In other words all the necessary tools for self-regulation by a contract market.

The Commodity Futures Modernization Act also provided a new s.5a[119] to the Commodities Exchange Act, where a more flexible designation category for a board of trade, called the

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119 **Sec 5a Derivatives transaction execution facilities**
(a) In general. In lieu of compliance with the contract market designation requirements of sections 4(a) and 5, a board of trade may elect to operate as a registered derivatives transaction execution facility if the facility is--
(1) designated as a contract market and meets the requirements of this section; or
(2) registered as a derivatives transaction execution facility under subsection (c) of this section.
(b) Requirements for trading.
(1) In general. A registered derivatives transaction execution facility under subsection (a) may trade any contract of sale of a commodity for future delivery (or option on such a contract) on or through the facility only by satisfying the requirements of this section.
(2) Requirements for underlying commodities. A registered derivatives transaction execution facility may trade any contract of sale of a commodity for future delivery (or option on such a contract) only if--
(A) the underlying commodity has a nearly inexhaustible deliverable supply;
(B) the underlying commodity has a deliverable supply that is sufficiently large that the contract is highly unlikely to be susceptible to the threat of manipulation;
(C) the underlying commodity has no cash market;
(D) (i) the contract is a security futures product, and (ii) the registered derivatives transaction execution facility is a national securities exchange registered under the Securities Exchange Act of 1934;
(E) the Commission determines, based on the market characteristics, surveillance history, self-regulatory record, and capacity of the facility that trading in the contract (or option) is highly unlikely to be susceptible to the threat of manipulation; or

derivatives transaction execution facilities, was created. Here a board of trade may elect to operate as a derivatives transaction execution facility rather than a contract market if it met designation requirements which included:

(a) establishing and enforcing trading rules that would deter abuses, provide market participants with impartial access to the markets and capture information that may be used in rule enforcement; and,

(b) defining trading procedures to be used;

The derivatives transaction execution facility could trade futures and options on any commodity which was in nearly inexhaustible supply, was not susceptible to manipulation, or which did not have a cash market in commercial practice, (s.5a Commodities Exchange Act).

Another provision added by the Commodity Futures Modernization Act was s. 22(a) of the Commodity Exchange Act, which provided for contract enforcement between eligible counter parties. A transaction between eligible contract persons was unenforceable under Federal or state laws based solely on the failure of an agreement to comply with the terms or conditions of an exclusion from any of the provisions of the Commodities Exchange Act or regulation of the Commission. As such this provision ensured legal certainty for transactions traded on the exchanges.

In summary, it can be seen that the Federal laws in the US try to regulate, in detail, trading in futures and options. In comparison to the UK, the laws in US are more detailed and address problems of speculation and gambling on the exchange. Although the laws in the UK and the US have been explored separately, for their use in this thesis they will be discussed together

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(F) except as provided in section 5(e)(2), the underlying commodity is a commodity other than an agricultural commodity enumerated in section 1a(4), and trading access to the facility is limited to eligible commercial entities trading for their own account.

(3) Eligible traders. To trade on a registered derivatives transaction execution facility, a person shall--

(A) be an eligible contract participant; or

(B) be a person trading through a futures commission merchant that--

(i) is registered with the Commission;

(ii) is a member of a futures self-regulatory organization or, if the person trades only security futures products on the facility, a national securities association registered under section 15A(a) of the Securities Exchange Act of 1934;

(iii) is a clearing member of a derivatives clearing organization; and

(iv) has net capital of at least $ 20,000,000.’

in the next section by merging laws which are similar from the two jurisdictions under common headings.

6.5 Merging UK laws with US laws and Matching Laws with *Shariah* Objections - Third Research Question Answered

In Chapter 3 a comparison of *Shariah* objections with conventional law objections showed that all three conventional law objections were similar to the first three *Shariah* objections. Therefore the laws which were passed in conventional finance to regulate derivative trading may be attempted to be used to overcome the objections in *Shariah*. This was attempted when reviewing the laws under sections 6.3 and 6.4 and in table 6.1 in Appendix 9.

The laws in UK and US were merged and grouped into eight main categories and further subdivided into specific laws represented by the States of the UK and US; they are as follows:

1. **Laws regulating derivative trading activity**
    a. Limiting number of days for future delivery
    b. Oral exchanges of promises/executory promises unenforceable
    c. Taxes levied on each future/ option sale
    d. Trading limits imposed
2. **Laws on licensing**
    a. Licensing requirement subject to prerequisites
3. **Laws that govern the regulating body**
    a. Designation of regulating body to oversee functions of the boards of trade/exchanges, enforce laws etc
    b. Regulating body’s emergency powers
    c. Regulating body’s power to conduct regular investigations
    d. Decisions made by regulating body subject to review
4. **Laws regulating boards of trade/ exchanges**
    a. Boards of trade/exchanges required to regulate derivative trade
    b. Boards of trade /exchanges required to maintain records

5. **Laws regulating those who facilitate derivative trading**
    a. Regulation of those who advise/invest on behalf of others
    b. Training of those involved in derivative trading
6. **Laws on investor protection**
    a. Punishing dishonest behaviour
    b. Statements issued on the conduct and financial standing expected of persons
    c. Ensuring investor protection
    d. Powers to restrict business
7. **Prohibitions**
    a. Prohibiting options dealings and/or future contracts
    b. Wagers not recoverable at law
    c. Set-off/ ring settlement prohibited
8. **Penalties for violations**
    a. Penalty imposed for violation of laws/ rules/ regulations
    b. Penalty imposed on boards of trade/ exchanges.

Table 6.1 in Appendix 9 provides an overview of the eight categories of laws, the specific laws from the UK and US and finally the *Shariah* objections that may be overcome by these laws.

To answer the subsidiary research question number three - **What laws passed in conventional finance can be used to overcome the objections to derivatives in Islamic finance?**

The following findings are made:

Table 6.1, in Appendix 9, lists the laws from the historical derivative legislation in the UK and US, which may be used in Islamic finance to overcome objections therein.

The first category of laws, that is laws regulating derivative activity, included laws from the UK and US limiting the number of days for future delivery, making oral exchanges of promises unenforceable, requiring part payment or delivery of underlying asset, levying taxes and imposing trading limits. These laws can address *Shariah* objections in the following ways:

By limiting the number of days for future delivery this may address *Shariah* objection #2 since the rationale behind the need to take possession is to eliminate or minimise *gharar*. By limiting the number of days allowed for transfer of ownership this will also minimise *gharar*. Making oral exchanges unenforceable and requiring part payment or part delivery of the underlying asset directly addresses *Shariah* objection #1 since both counter values will no longer be non-existent at the time of the contract. Further, prohibiting oral exchanges ensures that uncertainty will be eliminated and thus *gharar* avoided. This addresses *Shariah* objection #3.

Imposing taxes on each future or option traded may address *Shariah* objections #2 and #3, since inserting a tax requirement may prevent those who do not have a genuine need to hedge from speculating on an exchange because they would want to avoid the payment of taxes. This tool might be used to curb speculation and also the buying and selling of futures by those who do not possess or own the underlying asset.

Setting trading limits in exchanges would address *Shariah* objection #3 since excessive speculation on a certain asset or position may be prevented and controlled, especially at times when the price of a commodity is volatile.

The second category of laws, that is, laws on licensing required the boards of trades/exchanges and those who want to carry out derivative trading to fulfil licensing requirements. These laws act as a filter where only qualified persons are allowed to provide the venue and facilities for trading and only qualified persons who are fit and proper carry out trading in derivatives. Further, the yearly licensing requirement ensures that only worthy persons are allowed to trade and those who have previously taken part in risky or speculative behaviour can be evicted. Further, the requirement under the US law that contract markets have to comply with the enforcement of rules and regulations further ensures speculative activity is curbed. Therefore the requirement of licences which are in turn subject to certain prerequisites definitely addresses *Shariah* objection #3 which is the need to prevent *maisir*, *qimar* and *gharar*.

The third category of laws, that is, laws that govern a regulating body, includes laws that designate a regulating body to oversee functions of the boards of trade/exchanges, enforce laws etc. Laws that provide emergency powers to a regulating authority, laws that provide power to conduct regular investigations by a regulating body and judicial review of the decisions made by the regulating body.

Designating a regulating body to oversee derivative trading ensures adherence to laws, rules and regulation by the boards of trade and exchange, and also the rules and regulation of the boards of trade and exchanges, by investors and others. Further, constant control and monitoring of the overall activities of derivative trading will also be ensured by the designation of a regulating body. This minimises *gharar* and therefore indirectly addresses *Shariah* objections #2 and #3.

The emergency powers given to the regulating body allows immediate action to be taken by the regulating body to promptly rectify and provide immediate remedies to any unforseen circumstances. The emergency powers could immediately stop any speculative activity or market manipulations from happening. This would address *Shariah* objection #3.

Also, through the investigative powers given to the regulating bodies any market manipulations, speculative buying and selling or other activities prohibited in *Shariah* can be monitored and stopped, if necessary. This would address *Shariah* objection #3. The powers of the regulating body are at the same time subject to review and therefore are not absolute, ensuring a check and balance to the system. Ensuring certainty, this would address *Shariah* objection #3.

The fourth category of laws, that is, laws regulating boards of trade/exchanges includes laws that require boards of trade/exchanges to regulate derivative trade, and boards of trade /exchanges to maintain records.

Under these laws, boards of trade/exchanges are required to self-regulate derivative trade. Self-regulation ensures better monitoring over daily trading activity. With the existence of numerous boards of trade and exchanges, it would be very difficult for a regulating body to oversee every aspect of derivative trading on a daily basis. It is therefore important to legislate appropriate laws that ensure autonomy and the ability of self-regulation by boards of trade/exchanges. Indirectly, these laws that enable boards of trades and exchanges to self-regulate ensure *Shariah* objection #3 is addressed.

Boards of trade/exchanges, brokers and future commission merchants are to maintain records; these records are subject to scrutiny by a higher authority such as the regulating body. Volume of derivative contracts traded is also available to the public to view. Through these records the regulating body is able to identify any abnormalities in derivative trade. These laws ensure transparency within the boards of trade/exchanges. Thus while boards of trade/exchanges are given autonomy they are required to reveal the transactions that occur within, thereby avoiding secrecy. This also prevents uncertainty and asymmetrical distribution of information within the whole system, thereby preventing *gharar*. *Shariah* objection #3 is thus addressed.

The fifth category of laws, that is, laws regulating those who facilitate derivative trading, includes laws that regulate those who advise or invest on behalf of others and training those involved in derivative trading. The regulation imposed on those who advise or invest on behalf of the investors ensures no improper practices occur. Fraud, false reporting, market manipulations, and negligent or reckless advice are prevented. The requirement to undergo training on ethical issues, and training on rules and regulations of the regulating body and the boards of trade/exchanges is a very useful tool which may include, in the case of Islamic finance training, issues of *gharar, maisir, qimar* and how to avoid them. These laws addresses *Shariah* objection #3.

The sixth category of laws, that is, laws on investor protection, includes laws punishing dishonest behaviour, statements issued on the conduct and financial standing expected of persons, laws ensuring investor protection and powers to restrict business.

These laws protect those investing in derivatives by punishing any dishonest or deceitful behaviour. By requiring a certain conduct and financial standing of investors, by ensuring compensation where a counter party is unable to fulfil his/her obligations, by providing contract enforceability, and by providing powers to restrict business of investors, these laws protect *bona fide* investors, and ensure certainty and stability of the derivative markets. This would address *Shariah* objection #3.

The seventh category of laws includes laws prohibiting options dealings and/or future contracts, wagers and set-off/ring settlements. Prohibiting option dealings could possibly address *Shariah* objection #4, since according to *Shariah* charging of fees for the mere right to buy or sell is not permissible. Also by making wagers unenforceable this directly addresses *Shariah* objection #3. Prohibiting a set-off or ring settlement addresses *Shariah* objections #2 and #1 since disallowing a set-off will ensure transfer of ownership and ensure a genuine sale takes place, respectively.

The eighth category of laws, that is, penalties for violations, includes penalties imposed for violation of laws, rules or regulations and penalties imposed on boards of trade/exchanges. Imposing and enforcing penalties in cases of breach of the laws, rules and regulations ensure compliance with the laws, rules and regulation. The hefty sum imposed in the event of a breach has a deterring effect on participants of the market. Therefore penalties in general address *Shariah* objections #1, #2, and #3 by ensuring compliance with the provisions of statute and also internal rules and regulations of the regulating body and also boards of trade/exchange.

6.6 Summary

This chapter has attempted to answer the third subsidiary research question by listing down and explaining the laws in the States of the UK and the US on derivative trading from the 17th century to the present time, and these laws have been matched with the objections in *Shariah* in order to overcome them.

In the next chapter the subsidiary research questions #4, #5 and #6 will be answered through the analysis and interpretation of the results from the second stage of the case study methodology.

Chapter 7 Data Analysis and Interpretation of the Case Study Interviews

7.1 Introduction

This chapter presents the findings and interpretation of responses from the second methodology, that is, the case study method, through semi-structured interviews. The first methodology was the historical method, discussed in the previous chapter.

The historical method presented a review of conventional laws that were created to overcome objections against derivatives in conventional finance. These laws were thereafter matched with the objections that exist in *Shariah* against derivative usage in Islamic finance.

The findings and analysis of the responses of the respondents will be used to answer the fourth, fifth and sixth subsidiary research questions. The first, second and third subsidiary research questions were answered in chapters 3, 4 and 6 respectively.

The fourth, fifth and sixth subsidiary research questions are:

4#: Are derivatives needed in Islamic finance?

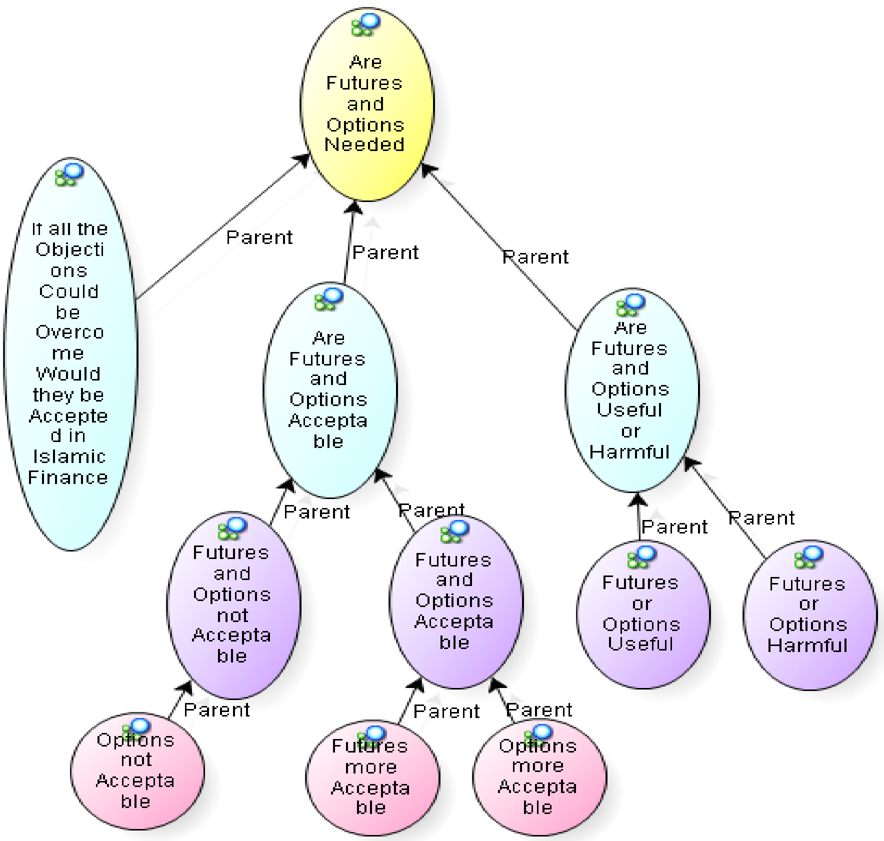
5#: Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?

6#: Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?

7.2 Analysing the Findings to Answer the Fourth Subsidiary Research Question

The fourth subsidiary research question - **Are derivatives needed in Islamic finance? -** was answered through four interview questions. The responses from the four interview questions were coded, classified and eventually transferred to a tree node (figure 7.1). Below is a model of the tree node for the fourth subsidiary research question. The tree nodes were created through coding of the interview transcripts. Coding enabled classification of the responses (Richards 2005; Bazeley 2007), so that the results could be analysed to answer the subsidiary research questions.

Figure 7.1 Model of the Tree Node – Are Derivatives Needed in Islamic Finance?



Thus to answer subsidiary research question #4 - **Are derivatives needed in Islamic finance? -** the participants were queried firstly whether in their opinion futures and options are acceptable in Islamic finance? Secondly, in their opinion how acceptable futures are compared to options in Islamic finance? Thirdly, whether in their opinion futures and options are useful or harmful and lastly whether in their opinion if all the objections against futures and options could be overcome, whether they would be accepted in Islamic finance? (See figure 5.2).

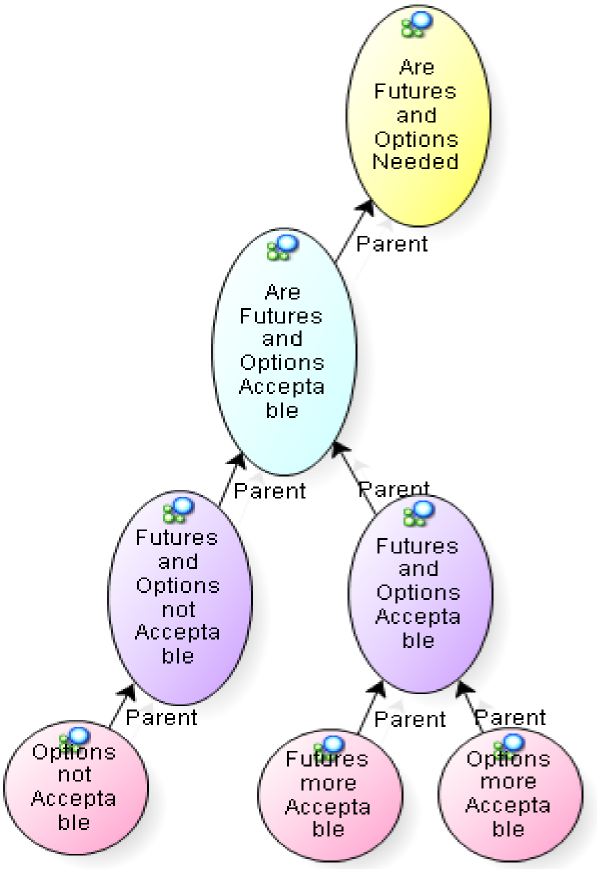
The responses for the first and second interview questions were merged. This is because the first interview question, which asks whether the participants opine futures and options are permissible, is directly linked to the responses to the second interview question, which is whether in comparison futures or options are more acceptable in Islamic finance? Since the answers from these two interview questions are linked, when classifying the tree nodes the responses for the second interview question were placed as a grandchild node under the responses from the first interview question (see figure 7.1). This was done so that the interview responses could be analysed and explained in a coherent manner.

The following is the analysis for each tree node and description of the interview answers. Each participant is represented as P1, P2, P3 etc.

7.2.1 Are Futures and Options Acceptable in Islamic Finance Today?

The model of the tree and child nodes for – 'Are futures and options acceptable?' can be represented as follows:

Figure 7.2 Model of the Child Node - Are Futures and Options Acceptable?

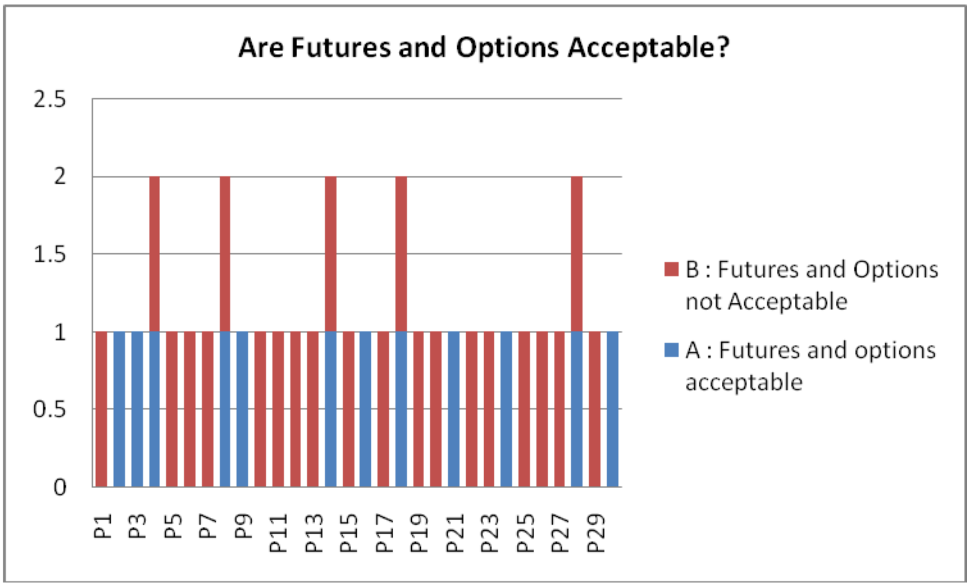


For a clearer projection of whether the majority of participants opined that futures and options are acceptable or unacceptable in Islamic finance, the responses were converted into a table and bar chart, as shown below.

Table 7.1 Are Futures and Options Acceptable?

Responses	**Percentage of participants**
Futures and options not acceptable	60%
Futures and options acceptable	23%
Undecided	17%

Figure 7.3 Bar Chart on Respondents' Opinion on Whether Futures and Options are Acceptable



The above table and bar chart represents the participants' opinion on whether they agree futures and options are acceptable in Islamic finance as they exist today. Eighteen or 60% of the participants believed that futures and options are not acceptable in Islamic finance, 7 or 23% of the participants believed that futures and options are acceptable in Islamic finance and 5 or 17% of the participants were undecided, that is, they said that futures and options may be both acceptable and unacceptable.

Therefore, the majority of participants believed that futures and options are not acceptable in Islamic finance. The reasons given by these participants were because they felt that the contracts were not real, there were no exchange of the counter values, just movements of cash, both counter values were being deferred which was not allowed in Islamic finance, and no consideration passed at the time of the contract, only mere promises. They also believed that in the case of futures, *gharar* and *maisir* were present and futures involved the exchange of a debt for a debt or *bi al kali bai al kali* which made futures impermissible. These objections of the participants were similar to the objections of Mahmassani (1983), Khan, A. (1988), Usmani (1996), Obaidullah (1998, 2001, 2002), El-Gamal (1999), Khan F. (2000) Kahf (2002), Suwailem and Wilson (2007) as discussed in the literature review presented in Chapter 3.

P20, an academic, had this to say:

> I don’t think it will be permissible … not having an underlying asset and again it will lead to speculation, a form of *maisir,* in my view it cannot be permissible.

One participant, (P13), a *Shariah* advisor and academic, believed that derivatives made money a commodity by trading it in the conventional market, especially the financial market and in Islam this is prohibited because money is not considered a commodity, just a means of exchange. When asked about trading derivatives which have commodities as their underlying asset, P13 believed that because 95% of the derivative trading is settled or positions reversed before delivery was made, there was no trading in the commodity per se, thus making the transaction a *hiyal* (legal stratagem) and not a genuine trade.

Participants also believed that while futures and options intended purpose and possible use was to hedge risk, which is permitted in Islam, this was not possible in the current exchange markets because of the unavoidable speculators. P29, a financial analyst and industry participant stated:

> … if you want to hedge your risk, for example [by using] futures and options, it is not possible for you to avoid speculators. So this is a need, for example in [the] LME, London Metal Exchange, or the IPE, International Petroleum Exchange, in London, about 95% of the transactions are on paper, [that means] speculators. So no, I don’t think it can be used in Islam.

There were also participants who believed that since futures and options were clearly impermissible, one should turn to Islamic alternatives and turn to *Shariah* instead of trying to find ways to make conventional instruments permissible. P23, managing director of a consulting firm and industry participant stated:

> The answer is no, and therefore alternative[ly] we have the *Shariah* compliance or *Shariah* model of futures and options, and that is, on the basis of the principle of *khiyar* and the various types of *khiyar,* and also *milkiya,* ownership, and also we have the principles of *Joala* and *ujr,* service charge.

The minority or seven (7) or 23% of the participants believed futures and options are acceptable. They believed that futures and options should be permissible because of the economic value, the risk management and hedging benefits that they provided. As P21, an Islamic banker and industry participant stated:

> It should be allowed because the Islamic finance environment has changed, we won't be able to secure Islamic deals in future.

The minority opined that futures and options should not be simply objected to, but reasons to justify their use should be found. As stated by P24, a partner in a law firm and industry participant:

> I think that it should be allowed, so long as whatever we do [is] from a *Shariah* point of view we can justify [it]. You shouldn't just say 'no' just because somebody says futures cannot [be used]. We go back to the *hadith* which says why you cannot have derivatives, it says 'you cannot buy the fish in the sea' but then again we have to look at the technology at that time. If you can actually be sure that you have basis of some technology to confirm that there is [a particular number of] fish in the sea then it is Okay.

When participants were asked whether in comparison futures or options are more acceptable in Islamic finance, ten (10) or 33% of the participants felt that they were equally objected to and impermissible, for example P27, *Shariah* advisor and academic stated:

> I don't think one is more acceptable then the other. Why do we want to justify one is more acceptable then the other? Both are equally objected to.

However the majority 15 or 50% of the participants felt that options were more impermissible compared to futures. The reason for this opinion was because, options it was opined had problems within *fiqh* literature (see section 3.2.1.3), as participant P1, a director of a consulting firm and industry participant opined:

> … options appear to have a series of deeper problems which go back to apparent lack of clarity, in *fiqh* itself, as to whether 'rights' to buy and sell things is a traditional sale [acceptable in *Shariah*].

Options were objected to in *fiqh* because of its status as a mere 'right'. The requirement that a premium be paid for a mere 'right' to buy or sell was considered to be impermissible because of the intangible nature of the ‘right’, especially when options are traded in the secondary market,

> … but the problem is paying a premium for it and trading on the secondary market. That is for options. Of course the commodities must be *halal*, but the issue is not about the underlying commodities but more on the mechanism of the options itself. (P7, *Shariah* advisor and academic).

This opinion held by the participants interviewed is in line with the objections to options described in the literature review, in particular the opinions of Delorenzo (n.d), El Gari (1993), Usmani (1996), Obaidullah (1998) and OIC Fiqh Academy (2000).

Lastly, options were objected to because they were viewed as being nothing more than pure gambling, which is prohibited in *Shariah*. P16, an industry participant, had this to say:

> Options leads to pure gambling, whereas futures do not lead to that “much” gambling.

This objection is again similar to the objection found against options in the literature review; see Obaidullah (1998, 2001, and 2002) and El-Gamal (1999) for instance.

On the flip side, participants opined futures were comparatively more acceptable than options; because in *Shariah* there already exists a more basic and similar contract, that is, the *salam* contract. As participant P9, an academic, stated:

> Largely because of the *bai-salam* contract [which] is very much like a forward, so *Shariah* scholars may look at the *salam*, forwards, and futures as looking similar … But keep in mind these are very different things. It is like saying that they are both for risk management and managing very different kinds of risk. It is like the difference between a car and an airplane. There are many things that a car cannot do. It can get you from point A to point B, but it can’t get you across oceans and all that, so these [*salam*, forwards and futures] are different things.

A much smaller number of participants - 5 or 17% - believed that options comparatively were more acceptable because in options the losses would be much less and only sustained when the option is not exercised, that is, the losses would only be the premium paid. In the case of futures the losses are not known and could be huge amounts. As participant P14, an academic, opined:

> If you ask me options should be better than futures because if you lose you will only lose your premium, but in futures if you book the price and it goes the other way around you have no choice, you have already booked and you have to pay the price, options should be accepted more than futures.

There were also some participants who were undecided. As seen from the bar chart in figure 7.3, five (5) participants, P4, P8, P14, P18 and P28, opined that futures and options are acceptable as well as unacceptable in Islamic finance today. The reason for this contradiction or anomaly is because these participants opined that futures and options are not acceptable, but also came to the conclusion that options and futures are needed and therefore may be acceptable. For example P4, an Islamic banker, had this to say on the acceptability of futures and options in Islamic finance today:

> … a true derivative that mirrors the conventional derivative I don't think it is in existence, and I think it [Islamic finance industry] has matured to a point where it needs derivatives to move forward … How acceptable are they? I think they are very acceptable, it's just that no one has seen a product we can use time and again, so that remains a challenge …

Also participants P8, a partner in a legal firm, P18, an academic, and P28, also an academic, believed that futures and options were impermissible but when it came to a legitimate hedge then they should be acceptable. P18 said:

> I think both are equally suspected of being impermissible, I don't think one is considered less so than the other, my understanding is that both of them are considered bad because of the products … one can't make a categorical rule, I think one really has to take a case by case approach, but in principle I believe derivative contracts when one of the counterparties is hedging in a legitimate position, a legitimate commodities position, that should be without doubt permissible …

This stand was also shared by P8:

> My answer is Yes, not from the *Shariah* element but more from the pragmatic element. I believe that for us to compete to be a real alternative to conventional finance one has to ensure, hedging financing tools should be considered and rationalised.

In other words, if financial tools are for risk management then they are acceptable for Islamic finance. Thus the participants who contradicted themselves believed that futures and options while needed for hedging purposes may not be acceptable in the form that they exist at the moment.

Therefore summarising the findings for the question - Are futures and options acceptable? The majority of participants opined that they were not acceptable, for various reasons such as:

- the contracts are not real;
- there are no exchange of the counter values, just movements of cash;
- both counter values are being deferred which is not allowed in Islamic finance;
- no consideration passes at the time of the contract, only mere promises;
- in the case of futures *gharar* and *maisir* were present; and,
- futures involves the exchange of a debt for a debt or *bi al kali bai al kali*, which is prohibited.

These views reflected the opinions of the scholars cited in the literature review (Chapter 3).

Participants felt that since futures and options were unacceptable, alternative contracts in *Shariah* should be researched and used.

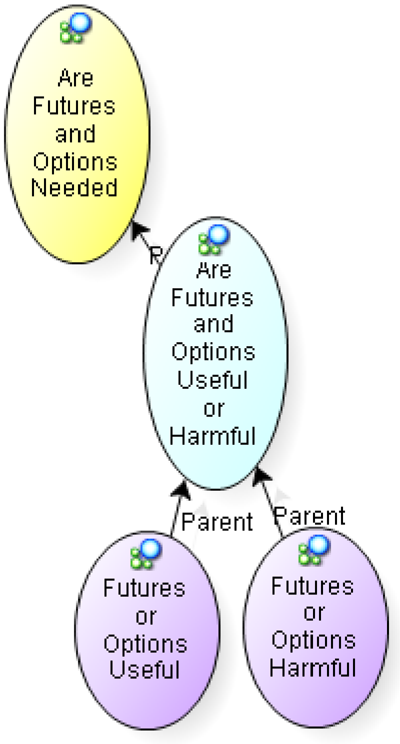
In the minority, some participants believed that futures and options should be acceptable because of the economic benefit they provide; they opined that justification for their need and acceptability should be sought. Lastly, some participants believed that futures and options if used for a legitimate hedge should be acceptable, but in today's financial environment they are not accepted because of the speculators and the gambling nature of futures and options.

The next section will discuss the responses to the third interview question, to answer the fourth subsidiary research question.

7.2.2 Are Futures and Options Useful or Harmful for Islamic Banking and Finance?

The next question asked the interviewees – Are futures and options useful or harmful for Islamic finance? The model of the responses from the participants is shown in figure 7.4.

Figure 7.4 Model of Child Node - Are Futures and Options Useful or Harmful?

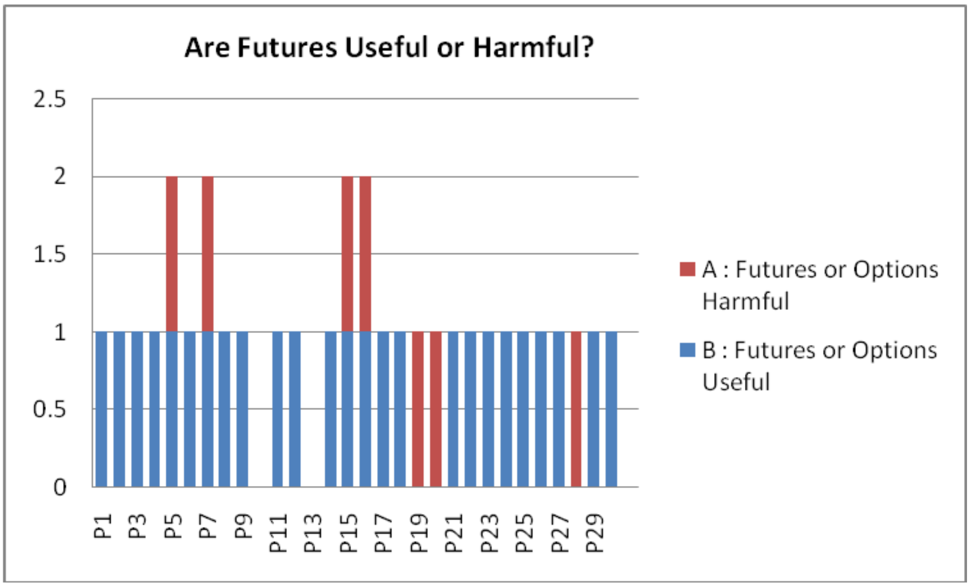


The responses of the participants are presented in table 7.2 and bar chart figure 7.5.

Table 7.2 Are Futures and Options Useful or Harmful?

Responses	Percentage of participants
Futures or options useful	70%
Futures or options harmful	10%
Undecided	13%
No comment	7%

Figure 7.5 Bar Chart of Respondents' Opinion on whether Futures and Options are Useful or Harmful



As can be seen from the bar chart (figure 7.5) and table (7.2) the majority, twenty-one (21) or 70% of the participants, believe that futures and options are useful; only three (3) or 10% of the participants believed futures and options were harmful and another four (4) or 13% believed they were harmful as well as useful. There were two (2) or 7% of the participants who did not comment on this question.

The majority of participants believed futures were useful because of the risk management benefits they provided. The participants opined that futures and options when used for hedging purposes were useful because they would enable Islamic finance to expand further, and increase economic activity in Islamic finance. Also the participants pointed out that the current market needed these types of risk management tools. The participants believed that if the *maslaha* (public benefit) outweighed the harm of speculation and gambling then futures and options could be within the *maqasid-al-Shariah* (the objectives of *Shariah*). As participant P22, an academic and *Shariah* advisor, stated:

> I look at it from a different perspective, but of course we base it on *Al-Maqasid Shariah* and the objective of *Shariah* is if you want to introduce something you have to show that it is very useful, that the good is more than the bad. That's why you have to agree that it is more useful than harmful for the contracting parties and society. So for me it is useful because we can argue that from the business point of view.

Those who believed futures and options were harmful believed they were harmful because of the speculators, and the inability of these instruments to exist without the presence of speculators which would lead to gambling. For example participant P20, an academic. said:

> Not useful. Again the reason would be because they are not complying with *Shariah* principles. [They would be] leading to speculation and all, and then again this will lead to people holding money or the goods for some speculative purpose.

Those participants who believed futures and options were both useful and harmful came to this double conclusion because they opined these instruments did provide risk management benefits, but however, because of their nature they could not be used without the speculative disadvantage which was not tolerated in *Shariah*. Participant P28, an academic, had this to say:

> It has both the pros and cons but when you look at yesterday's newspaper Badawi was saying about futures in oil. It is both. (Interviewer: But do you think it is more useful or more harmful?) Looking at the way everybody is using it for speculation, I will go for the second term [of being] more harmful.

Another reason why participants sat on the fence was because they agreed that futures were useful but felt that options were harmful, and therefore, they could not give a blanket answer as to whether futures and options were useful or harmful. Participant P5, a CEO of an Islamic bank and industry participant, concluded:

> Option is harmful, futures is useful.

Thus summarising the findings for the question - Are futures and options useful or harmful? The majority of participants believed that futures and options were actually useful because of the risk management benefit and positive economic benefits they provided, while the minority believed that the speculative nature of futures and options make them harmful. A few participants could not commit themselves to one answer and instead answered that futures and options are both useful and harmful, because they felt that while futures and options did provide risk management benefits they could not be divorced from the speculation that also took place.

The next section discusses the responses to the fourth interview question to answer the fourth subsidiary research question

7.2.3 If All the Objections Against Derivatives Could be Overcome Would They be Accepted in Islamic Finance?

Finally the participants were asked - If all the objections against derivatives could be overcome would they be accepted in Islamic finance? The model and table of the responses are shown below.

Figure 7.6 Model of Child - Node if all the Objections Could be Overcome Would They be Accepted in Islamic Finance?

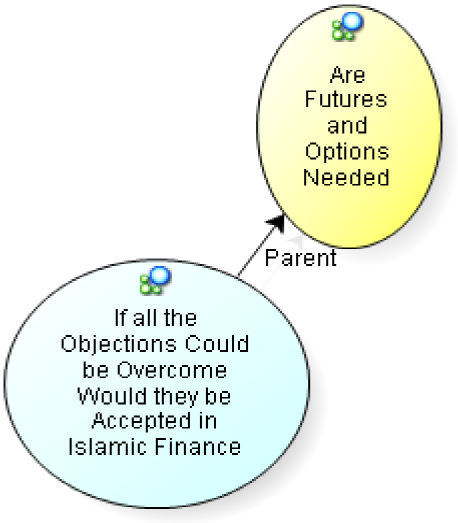


Table 7.3 If all the Objections Could be Overcome Would They be Accepted in Islamic Finance?

Responses	Percentage of participants
If all the objections against derivatives could be overcome they would be accepted in Islamic finance	90%
If all the objections against derivatives could be overcome they would still not be accepted in Islamic finance	10%

Twenty-seven (27) participants or 90% of the total participants believed that if all the objections against derivatives could be overcome they would be accepted in Islamic finance. The overwhelming majority believed that if *gharar*, *maisir* and *riba* could be overcome then there should be no problem in accepting these instruments. The minority three (3) or 10% of the participants did not believe that if all the objections against derivatives could be overcome they would be accepted in Islamic finance.

Of the three participants in the minority, P1 believed that the situation in Islamic finance would be the same as it is in the West today. The majority of the public would not understand the financial instruments. They would be anxious about them while only a smaller group would accept and use them. P1, a director of a consulting firm and industry participant, opined that this would be exactly what would happen in Islamic finance:

> I think the same thing would happen in the Islamic space, the vast majority of people wouldn't know or would be anxious, and the next group of people would be anxious no matter what you told them, but you'll still have a small group of people who would be active users.

P15, an Islamic banker and industry participant, believed that futures and options would be objected to no matter what, even if the objections could be overcome:

> There will still be objections. (Interviewer: So you think there is no way to go around this?) No, it just goes on [objections to futures and options].

P17, a consultant in Islamic banking and industry participant, took a more cautionary path by stating that there are current Islamic alternatives that are being used such as *wa'ad* (promise), however P17 cautioned against using legal trickery in trying to make futures and options acceptable to Islamic finance:

> The current message is it is prohibited but we can use legal tricks to circumvent it. This will destroy the remaining credibility the industry has. May Allah protect us and let us become more serious in what we do!

Therefore apart from the three participants, the majority of the participants believed that if the objections against derivatives could be overcome they would be accepted in Islamic finance.

The fourth subsidiary research question - **Are derivatives needed in Islamic finance? -** can now be answered. The following inferences may be made from the findings:

Participants believed that futures and options were useful because of their hedging and risk management qualities, however they also recognised the harmful side of derivatives, that is, the speculative and possible gambling nature. Although a majority of participants believed that futures and options were not acceptable in Islamic finance they also answered that if the harmful effects of derivatives could be overcome futures and options could be accepted and used in Islamic finance. Thus it may be inferred that if the objections towards futures and options could be overcome in Islamic finance they would be accepted in Islamic finance.

Participants also believed that futures and options are needed in Islamic finance today to hedge risk and also to allow businesses to cope with the uncertainties and the differing demands of modern day life.

When comparing futures and options participants generally believed that futures were more in line with *Shariah*, whereas a number of fundamental objections towards options made options more unacceptable. But at the same time when the participants were asked 'If all the objections against derivatives could be overcome would they be accepted?', the vast majority of the participants believed that they would be accepted and those who objected to this did not state that options would not be accepted as compared to futures. Therefore if the objections against derivatives could be overcome they would be accepted.

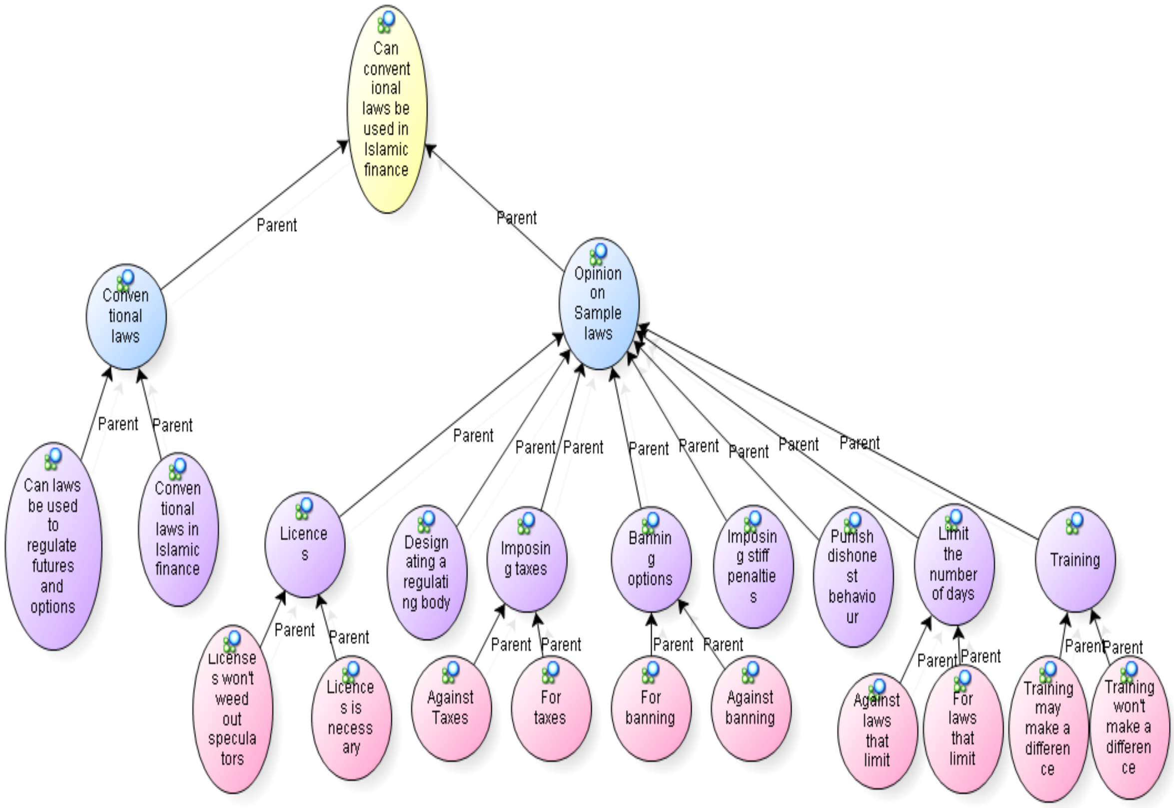
Thus the answer to the subsidiary research question - **Are derivatives needed in Islamic finance? -** showed that the majority of participants believed that derivatives are needed subject to overcoming the objections in *Shariah*.

7.3 Analysing the Findings to Answer the Fifth Subsidiary Research Question

The fifth subsidiary research question is, **Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?** This question was answered through two types of interview questions.

The first type of interview question sought to obtain the interviewees' perceptions of whether firstly laws can regulate futures and options and whether conventional laws in particular can be used in Islamic finance to regulate futures and options. The second type of interview question asked the interviewees' opinion on specific laws that were taken from the first methodology (historical method). Below is a model of the interview questions for the fifth subsidiary research question.

Figure 7.7 Tree Node on Can Conventional Laws be Used in Islamic Finance to Overcome the Objections to Derivatives?



The next section discusses in detail the participants' responses to the first type of interview question on the interviewees' perceptions of enacting laws.

7.3.1 Can Laws be Used in Islamic Finance to Overcome the Objections in *Shariah*?

The responses of the participants are presented in table 7.4 as follows:

Table 7.4 Can Laws be Used in Islamic Finance to Overcome the Objections towards Derivatives in *Shariah*?

Responses	Percentage of participants
Laws can be used to regulate futures and options	77%
Laws cannot prevent speculation	17%
No comment	6%

On the first type of question - Whether laws can be used to regulate futures and options and overcome the objections in *Shariah*? - twenty-three (23) or 77%, of the participants believed that laws can be used to regulate futures and options. As P24, a managing partner of a legal firm specialing in Islamic banking and finance, stated:

> Yes [laws can be used to regulate futures and options]. (Interviewer: in a positive way?). Yes in a positive way.

However, when it came to speculation, five (5) or 17% of the participants believed that laws would not be able to weed speculators out because speculation may not be discovered. As participant P5, a CEO of an Islamic bank and industry participant, stated:

> You can regulate but you cannot police speculation because it [seems to be] a clear transaction but it's actually speculation, you can't actually police up to that stage. Legally the documents are all there but you wouldn't know the underlying intention.

A *Shariah* scholar and academic, P6, believed that whether the laws would be effective in regulating futures and options would depend on the types of laws. If the laws or rules could abide by the *Shariah* requirements and ensure certainty of delivery of the underlying asset then laws may actually be used.

Another participant, P9, an academic, believed that while laws would definitely help in regulating futures and options there was a price to be paid by incorporating all these regulations and that was loss of efficiency to the capital markets:

> … so basically all regulation has costed benefits and all regulation leads to some kind of loss, loss of efficiency, and therefore one has to be careful, not to over-regulate and to use some clever types of regulation.

When answering the second part of the interview question – How? (could laws regulate futures and options) - an academic, P19, believed that the regulators must be independent from those being regulated. They must not be insiders because that would compromise and bias the quality of the type of regulation being passed:

> … while regulation can minimise problems, one fundamental problem in many countries with advanced financial market is that regulators are often insiders; in other words, they are not independent and also they have mindset similar to those they are supposed to regulate.

Another participant, a *Shariah* advisor and academic, P27, believed that laws could definitely regulate futures and options but the problem was enforcement and how effective the law would be in regulating futures and options.

Thus the findings showed that the majority of participants believed that laws could definitely be used to regulate futures and options, and are actually needed to do so. However, whether the laws could weed out speculators was doubted by some participants. Further, the questions of whether laws would cause over-regulation and affect market efficiency were also raised. Participants believed that regulators had to be independent from the regulated and enforcement of the laws would determine how effective the laws ultimately are.

For the second question - Whether **conventional laws** could be used in Islamic finance to regulate futures and options - the responses were as follows:

Table 7.5 Can Conventional Laws be Used in Islamic Finance to Overcome the Objections towards Derivatives in *Shariah*?

Responses	**Percentage of participants**
Conventional Laws can be used to regulate futures and options	63%
Conventional Laws cannot prevent speculation	30%
No comment	7%

Nineteen (19) or 63% of the participants believed that in the financial world today Islamic finance has to work within the regulatory framework of conventional finance as well as conventional law. Consequently, conventional laws can be used as a starting point in Islamic finance to regulate futures and options. Participants opined that in conventional finance as well as Islamic finance there was a need to regulate and also manage excessive speculation. So as long as the conventional laws were within the principles of *Shariah* there was nothing wrong in their usage. P11, an academic, stated:

> I think somehow operation of Islamic derivatives and conventional derivatives is not very different. That's why the conventional laws can be used, because the purpose is the same. The purpose of derivatives is not speculation since for conventional finance you need regulation to limit speculation, the same thing you need for the Islamic finance [industry]. They also need that type of regulation. So as long as it [conventional laws] is not against *Shariah*, the conventional law, I think can be used to regulate Islamic derivatives.

Nine (9) participants or 30% of the total participants believed that conventional laws should not be used in Islamic finance to regulate futures and options. The reason being because the sources of the laws, that is, conventional and Islamic, were different, and since the sources were different the general intention and outcome would be different. P29, a financial analyst and industry participant, believed that:

> It's not possible [to use conventional laws], Islamic finance needs Islamic laws according to *Quran*, [and] *sunnah.*, [In] *Shariah* it is not possible to use conventional laws.

And another participant, P22, a *Shariah* advisor and academic, opined:

> The basis [of Islamic finance] is from the *Al-Quran*, *sunnah*, *ijma* and *qiyas* these are the sources of law, so if you use the conventional law to regulate Islamic finance I don't think it is appropriate enough.

Generally, therefore, the findings showed that participants believed that laws could be used to regulate futures and options. Additionally conventional law could be used to regulate futures and options, but the conventional laws would have to abide by the principles and requirements of *Shariah*.

7.3.2 Participants' Views of Sample Laws Proposed

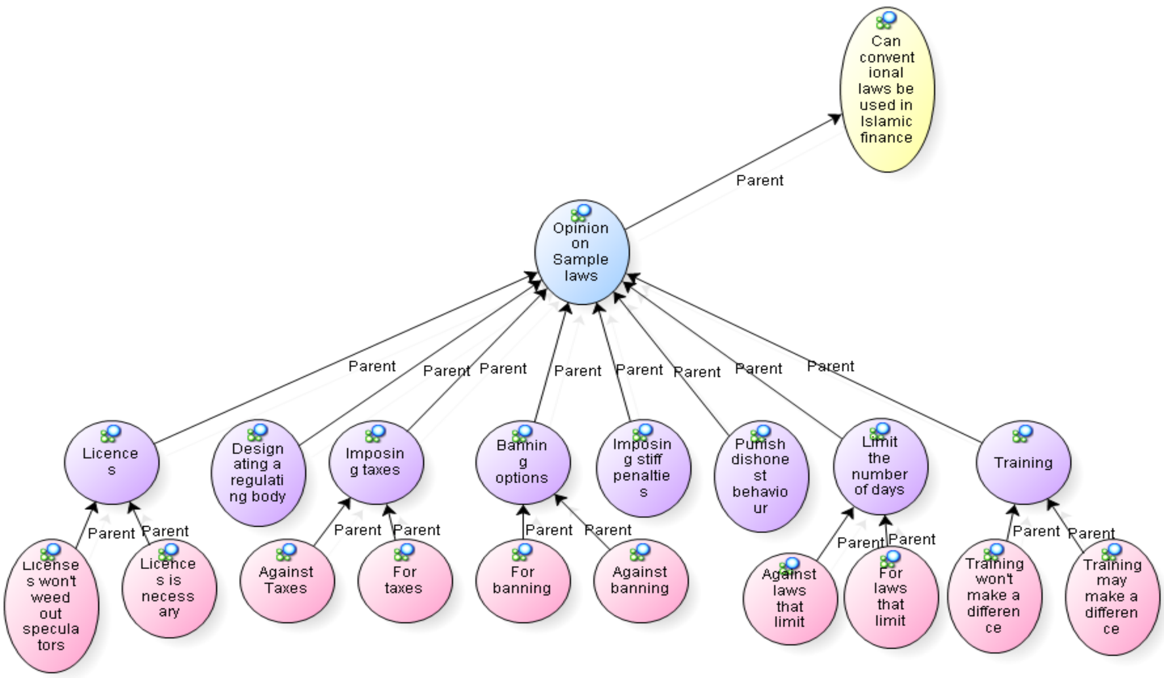
Eight sample laws (discussed in Chapter 5) were proposed to the participants. The participants were asked whether these sample laws would help overcome the objections in Islamic finance towards derivatives.

The sample laws that were proposed are as follows:

1. Laws that limit the number of days for future delivery.
2. Imposing taxes or fees to use futures or options.
3. Enacting laws that require licenses to be issued to boards of trade and those who carry out investment business.
4. Designating a regulating body to oversee functions of boards of trade, exchanges and others who engage in derivative trading.
5. Training those who provide services to users of derivative trading on ethical and Islamic law principles.
6. Imposing laws that punish dishonest behaviour on an exchange.
7. Banning or illegalising options totally or on certain commodities.
8. Imposing stiff penalties for violations of laws relating to derivative trading.

The responses of the participants to the sample laws are shown in the model below.

Figure 7.8 Tree Node on Opinion on Sample Laws



The responses of the participants were analysed and presented in bar charts to identify what the majority of participants thought of the laws proposed. The findings and results of the responses are presented below.

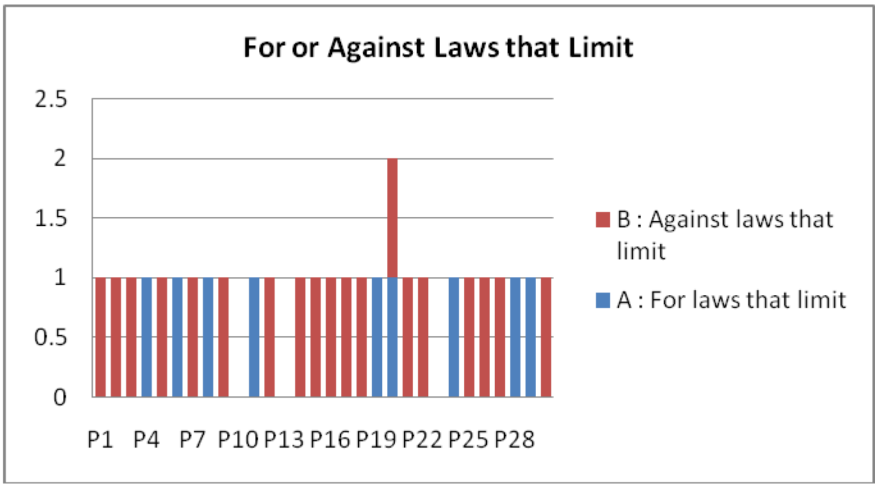
First Sample Law – Limiting the Number of Days for Future Delivery

The first sample law that the participants were asked to give their view on was - Whether limiting the number of days for future delivery would help overcome speculation?

Table 7.6 Sample law – For or Against Laws that Limit the Number of Days for Future Delivery

Responses	Percentage of participants
Against laws that limit number of days for future delivery	63%
For laws that limit the number of days for future delivery	26%
Undecided	3%
No comment	8%

Figure 7.9 Bar Chart on Respondents' Opinion on Sample Law for or Against Laws that Limit the Number of Days for Future Delivery



The above bar chart, figure 7.9, and table 7.6 show that a majority of participants, nineteen (19) or 63% of the participants, opined against laws that limit the number of days for future delivery. Eight (8) or 26% of the participants opined for limiting the number of days for future delivery. One participant answered for and against laws that limit days for delivery.

The majority of participants believed that laws that limit the number of days for future delivery would not in any way prevent speculation. The participants opined in this manner because they felt that even in *bai-salam* there is no restriction on the time period for future delivery. Further, the needs of individual companies and the nature of the underlying asset would make limiting the number of days for future delivery unconducive and/or counter-productive. As participant P5, a CEO of an Islamic bank and industry participant, stated:

> It cannot reduce speculation. See if I have an oil well, my oil well is going to recede 2 years from now, so how can I hedge it in a shorter period of time? Or if I am a cattle farmer how am I going to do it? Cattle doesn't grow in 30 days, so that's it, it's the same thing if you look back at the date crop. The date crop is from one year to another year. So all you do to hedge is you have to set, as long as you define the item and the quantity of the item and the price of the item that derives the quantity that's all you need for hedging. You have to specify the time but it depends upon what grows where. Tomato can grow in 60 days but dates don't grow in 60 days. I don't think reducing the time will reduce the speculation.

Those in the minority felt that limiting the number of days for future delivery would limit speculation because it would limit *gharar* and would also be closer to *Shariah*. Some participants also believed that limiting the days in future delivery to three days would be similar to the rules of *khiyar* in *Shariah* and therefore should be followed. As participant P11, an academic, stated:

> Even in Islam when we refer back to why the *fuqaha* say this [futures and options] is not permissible [it is] because if you consider this is the *khiyar*, option for the buyer to choose, there is also a certain limit of days. So up to 3 days, somehow I agree if there is a limitation in the number of days its closer to the *Shariah* compliance, less *gharar*, the number of speculators would also decrease because the time is very short.

One participant, P20, an academic, remained undecided by opining for and against limiting the number of days for future delivery. The reason being because this participant while agreeing that limiting the number of days for future delivery may ensure certainty in the contracts, felt that at the same time the needs of the industry may not be met because different underlying assets have different dates of maturity.

From the responses of the majority of participants the findings do not support the notion of recommending laws that limit the number of days for future delivery to overcome or minimise speculation.

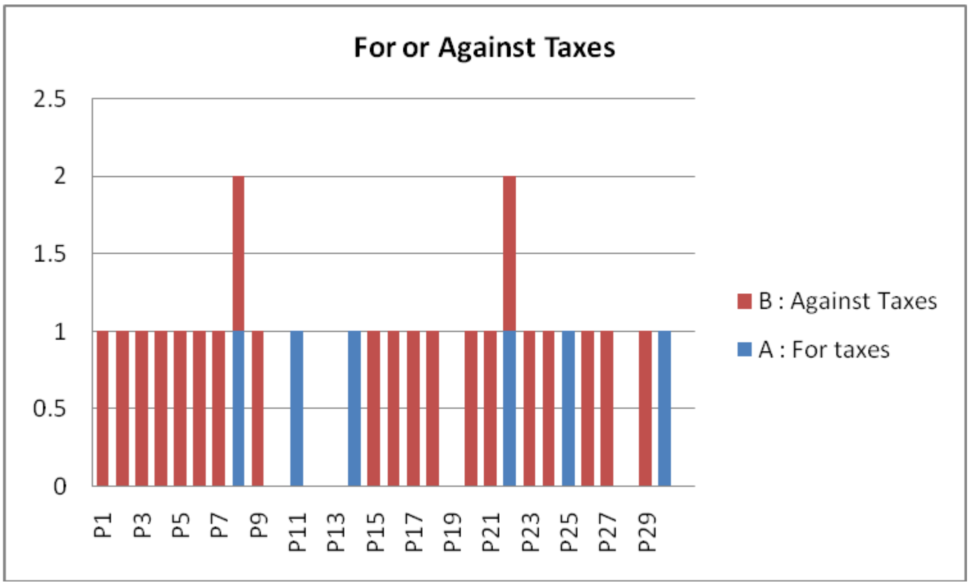
Second Sample Law – Imposing Taxes or Fees

The second sample law that the participants were asked to give their views on was - Whether taxes or a fee should be imposed for the usage of futures and options. Participants were asked whether if a fee or tax was imposed this would discourage speculators.

Table 7.7 Sample law – For or Against Taxes

Responses	Percentage of participants
Against laws that impose taxes	63%
For laws that impose taxes	13%
Undecided	7%
No comment	17%

Figure 7.10 Bar Chart on Respondents' Opinion on Sample Law For or Against Imposing Taxes



The above table 7.7 and bar chart figure 7.10 show that the majority of respondents, nineteen (19) or 63%, did not agree with imposing taxes on the usage of options and futures, while the minority, four (4) or 13%, agreed on imposing taxes. Two (2) or 7% of the total participants opined both for and against taxes.

The majority of proponents who believed that taxes would not impede speculators felt that these taxes would instead become a burden on those who actually needed futures and options to hedge their risks. The participants felt that speculators who were faced with taxes could actually work it in with the profits that they expected to gain and therefore the taxes would not have much effect on them. Participants also believed that taxes would hinder economic activity and the usage of derivatives in general.

Participants felt that while taxes on speculators may be justified, the fact was that if taxes were to apply generally then it would not be good because genuine hedgers would be affected. As participant P30, an academic, stated:

> So you think we [should] put some special tax for speculators? (Interviewer: No generally if you want to use futures and options you have to pay tax) I know that but how can you determine who is a speculator or not (Interviewer: Everybody has to pay) so by imposing a tax you may avoid some risk hedgers (Interviewer: Is it good or bad?) it's not good.

The minority of participants who agreed with imposing taxes felt that imposing taxes would prevent speculators trading in futures and options because of the added costs, as participant P11, an academic, stated:

> To discourage those who speculate so that only those who want to hedge use the instruments, yes I agree definitely. This would discourage speculation, since the price of derivatives [will] already [be] increased; maybe only people who need the derivative for the purpose of hedging will use it.

The two participants who decided for and against imposition of taxes opined that while taxes would definitely curb speculators and should therefore be good, at the same time taxes would also hurt true hedgers and this would not be good. As participant P8, a partner in a legal firm and industry participant, stated:

> I have an issue with taxes in general, again I am looking at it as a player in the market. Unfortunately in the Middle East, for example, they don't have a tax regime. So we have been trying to get rid of the tax requirement to attract them … Ok fair enough possibly, you wouldn't call it that [taxes], administrative fee that would basically discourage speculation generally. Ok fine on that basis take away the pragmatic real tax economics issue on a pseudo basis you look at the end to avoid speculation you charge administrative fee to make sure people are really serious about it. Ok, put aside

> the economics as a concept, reduce *Shariah*, and make it more regulated, that's Ok and you try to deter speculation, Ok fine.

Therefore, the findings showed that a majority of participants believed that imposing taxes on futures and options would not curb speculators and would instead hurt those who actually need the instruments to hedge their risks. While the minority opined that speculation may be hindered by imposing a tax. The minority did not take into account the effect the taxes would have on true hedgers.

Consequently, from the findings it may be inferred that imposing taxes would actually be a detriment to true hedgers and although it may be a stumbling block for speculators it will not necessarily deter them from using futures and options for speculative activity. Thus this sample law may not be practically useful for those using futures and options.

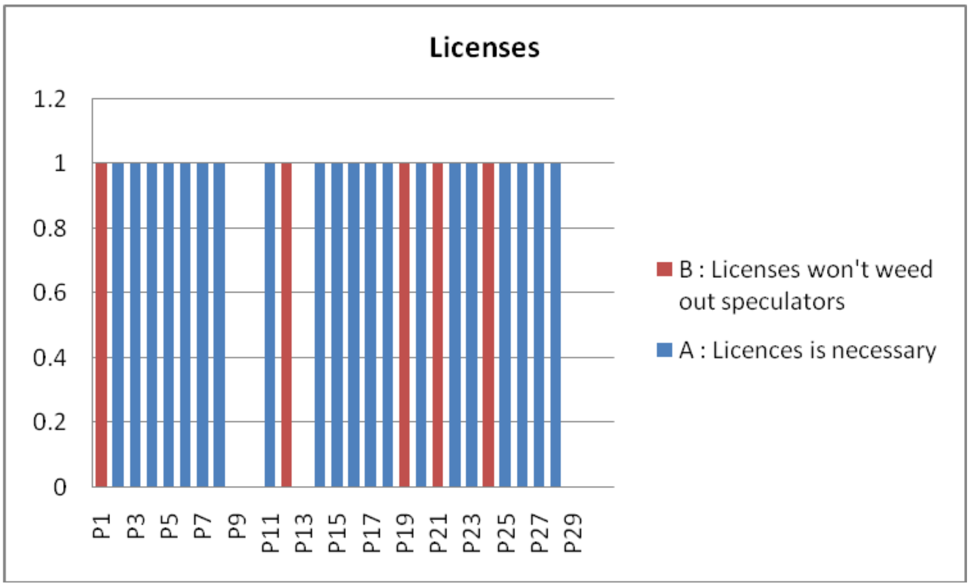
Third Sample Law – Licensing Requirements

The third sample law that the participants were asked to give their opinion on was - Whether laws that require licences to be issued to boards of trade and those who carry out derivative trading would help in minimising speculation at an exchange?

Table 7.8 Sample law – For or Against Licensing Requirements

Responses	Percentage of participants
Licensing necessary	67%
Licences won't weed out speculators	17%
No comment	16%

Figure 7.11 Bar Chart on Respondents' Opinion on Sample Law on Licensing



The above bar chart and table shows that twenty (20) or 67% of the total participants opined that licensing is necessary. Five (5) or 17% of the participants opined that licensing would not be able to weed out speculators.

The proponents believed that imposing a licensing requirement would mean a criteria would be imposed as to who could actually qualify to obtain the licences. The criteria might help in checking who actually uses the exchanges and could possibly be used to weed out and minimise speculators and others who abuse the usage of futures and options.

As stated by particpant P17, a consultant and industry participant:

> Also, this [licensing laws] will be a usual requirement, but not only alone to regulate and scale down the speculation but to add credibility to the traders and basically promote them with a sort of stability and security enhanced by the law maker. Such regulation will fuel the markets and make them viable.

And participant P23, managing director of a consulting firm and industry participant, stated:

> Yes, I agree with this prerequisite of license[ing], for traders, participants, clearing house and the fund manager and so on. I agree with the idea to impose a license, otherwise there could be some misuse or abuse in the market. Misuse of public fund or the deceiving, and so to control these malpractices in the financial industry and financial derivatives it is [of] utmost importance to control the license[ing].

Therefore the findings show that the majority of participants opined that licences were necessary and could help in controlling who entered the market and thus possibly weed out speculators, and others who misuse or abuse the market. Misuse and abuse of the market includes fraudulent practices, using information which is not publicly available (insider dealing), breach of exchange rules, distorting the price-setting mechanisms of financial instruments, and disseminating false or misleading information (Europa 2007).

The minority believed that licensing although needed would not weed out speculators. As one participant, P1, director of a consulting firm, an industry participant, explained why, when asked whether licensing would weed out speculators:

> No. You have to remember the two problems of speculators are that they are either incredibly clever or they're very rich, so if they're clever they can pass the test [of licensing requirements] if they're rich they can hire somebody to pass the test [of licensing requirements].

And another participant, P19, an academic, stated:

> A necessary matter, but does not guarantee reduction of abuse, as evident from these developed markets

The minority of participants opined that licensing though needed would not necessarily weed out speculators because speculators would find a way around the licensing requirements. Further, they opined that this is evidenced by what is happening in the developed markets.

However, if the majority (80%) of the participants felt that licensing requirements could weed out speculators and also those who misuse the market, then it is recommended that licensing be a requirement for the Islamic exchange markets. In addition the licensing requirements for Islamic exchange markets could use a different set of criteria than what is being used by current developed markets. Currently in developed markets, speculation is tolerated and deemed necessary for market liquidity although abuses are not tolerated; this is not the same for *Shariah* where speculation which is akin to gambling is not permitted. Therefore in the case of Islamic financial exchanges and capital markets a different and/or an additional set of criteria may ensure that speculators and those who abuse the market would be weeded out.

Thus, it is inferred that this sample law would seem to be able to address the issue of speculation with regards to those who provide the facilities to use futures and options such as boards of exchanges, and also those who use futures and options such as banks, companies, hedge funds, and individuals.

Fourth Sample Law – Designating a Regulating Body

The fourth sample law that was presented to the participants for their opinion was - Whether designating a regulating body to oversee functions of boards of trade, exchanges and others who engage in derivative trading would help in overcoming the *Shariah* objections towards derivatives?

All the participants (100%) who answered this question opined that a regulating body was necessary for regulating the futures and options market.

The participants also believed that one regulating body was sufficient so there would not be conflicting rules and regulations and there would be no regulations which were repeated and thus counter productive. Participants opined that the Securities Commission in Malaysia would be able to handle that role and that a division within the Securities Commission would suffice. As P4, an Islamic banker and industry participant, opined:

> But assuming the SC is already there they should be overseeing this (Interviewer: You think the SC is sufficient?) Yes, because this is just one financial instrument along the whole supply chain of Islamic finance. Which are the accounts if you use a standard board only regulating one proportion? So I think there should be one central body that oversees the whole thing, right from the seller [to] the buyer and [to] the guy who is giving you the commodity.

The participants also believed that the regulators could not be the same parties as those who were regulated, there had to be a separation of ‘roles’, ‘purposes’ and ‘powers’, otherwise there may be situations of conflict of interest and creating rules and regulations favourable to those who were being regulated. As participant P19, an academic, stated:

> However, while regulation can minimise problems, one fundamental problem in many countries with advanced financial market is that regulators are often insiders; in other words, they are not independent. They have [a] mindset similar to those they are supposed to regulate.

Therefore, the findings show that the participants opined that this sample law on the designation of a regulating body as being appropriate in the usage of derivative trading in Islamic financial markets. As long as there was one regulator which was independent from those regulated, the participants opined that this was sufficient. Thus it can be inferred that this sample law may be appropriate in regulating derivative markets in Islamic finance.

Fifth Sample Law – Training

The fifth sample law that was presented to the participants for their opinion was - Whether training those who facilitate derivative trading on ethical and *Shariah* principles could curb excessive speculation, uncertainty and other abuses[120] on the exchange?

Table 7.9 Sample law – Training

Responses	Percentage of participants
Training may make a difference	63%
Training won't make a difference	30%
No comment	7%

Figure 7.12 Bar Chart on Respondents' Opinion on Sample Law on Training

[120] Such as fraudulent practices, using information which is not publicly available (insider dealing), breach of exchange rules, distorting the price-setting mechanisms of financial instruments, and disseminating false or misleading information (Europa 2007).

Nineteen (19) or 63% of the total participants as shown in table 7.9 and figure 7.12 opined that training is necessary for those who facilitate derivative trading on ethical and Islamic principles. This may make a positive difference in reducing speculation, uncertainty and other abuses on the exchange.

The participants in the majority believed that training would make a difference because firstly, by training those who facilitate derivative trading on ethical and Islamic principles it would give them the knowledge of proper and improper behaviours. The participants opined that there may be many who do not know what is correct in light of *Shariah*, therefore training them would ensure that they are aware of the Islamic principles and they may avoid things which are prohibited, Islamically and ethically. As participant P20, an academic, stated:

> Yes, if they are more aware of the issues of *gharar, maisir,* and all that, [and that] it is not accepted in *Shariah* they [would] be going into less unscrupulous activities. They will be investing in only good investments which would not be having any side effects … all this thing [training]will make them aware of the social issues of Islamic finance where you talk about the mutuality and development of the *Ummah* and so at least they will learn something.

Further, participants opined that although currently, training was provided by regulators such as the SC in Malaysia, there was a lack or total absence of any training on Islamic principles, and this should be incorporated. Participants also believed that there should be more education centres that teach Islamic principles so there would be dissemination of knowledge and Islamically permitted trading.

Nine (9) or 30% of the participants, on the other hand, believed that training those who facilitate derivative trading on ethical and Islamic principles would not make a difference to speculation, uncertainty and other abuses on the exchange.

Those in the minority believed that training is a good thing; however they doubted whether it could actually minimise speculation. As participant P1, a director of a consulting firm and industry participant, remarked:

> Training is always a good thing in ethical principles and in Islamic [finance] it is fantastic, and why not? But will that translate into a change of behaviour?

Another participant in the minority also opined that the reason participants enter into the futures and options market is to make money and therefore training facilitators would not hinder them from this objective. Participant P16, an industry participant, stated:

> What I'm trying to say is that even if you train people, according to me it doesn't help that much. According to the way I look at it, because the people who are getting into futures or into options, the fellow's mindset is that he wants to make money, nobody wants to lose money. So what type of training are you going to give?

Therefore the findings on this sample law can be summarised in this manner - the majority of participants opined that training is necessary and may be able to regulate a person's behaviour by teaching them what is the correct and permissible way to trade according to *Shariah*. As for the minority of participants who answered this question, they also believed that training was necessary but opined that this may not necessarily translate to reformed behaviour on the exchange.

Thus for this sample law, based on the opinion of the majority of the participants, it can be inferred that training on Islamic and ethical principles is necessary and might make a positive impact on reducing the speculative activities on an exchange.

Sixth Sample Law - Punishing Dishonest Behaviour

The sixth sample law was - Could laws that punish dishonest behaviour overcome excessive speculation and uncertainty?

All the participants who answered this question opined that laws which punish dishonest behaviour are needed. One participant, P23, managing director of a consulting firm and industry participant, gave proposals as to how this should be accomplished:

> … for the Islamic financial industries we don't have punishment yet, and that's why those who are the wrongdoers they are charged under the Civil law, only under the civil courts. Therefore my strong suggestion is that there should be an Islamic division, *Shariah* guidelines and regulatory framework to be incorporated into the existing legislation to facilitate this particular component to punish … participants or players according to *Shariah* principles.

In other words punishment of the participants should be done according to *Shariah* principles for non-observance of guidelines, which includes *Shariah* guidelines.

However, some of the participants raised concerns about the application of such laws. P1, director of a consulting firm and industry participant, agreed that laws that punish dishonest behaviour is needed but believed that it would be difficult to establish when speculation would be excessive and at what stage to punish excessive speculation:

> Every exchange has to do that [punish dishonest behavior on the exchange] and should do that, but I don't know, will that change your fundamental problem? And the problem is at what stage do you say its excessive speculation? And at what stage do you say its excessive speculation and that it has to be punished? That's the problem, and that's different from dishonest behavior.

Another participant, P30, an academician, held the same opinion that it was necessary to identify dishonest behavior and if there were mechanisms to identify it then it would work:

> … but how do you identify dishonest behaviour? If you can really measure and really identify dishonest behaviour then you can impose this, until then it will be difficult. There must be a benchmark.

Another participant believed that while dishonest behaviour deserved to be punished and criminalised (especially intentional fraud), there had to be a balance so as not to over-penalise transactions that might discourage investors from entering the market, especially for developing countries. P18, an academician, stated:

> You need to have laws that criminalise fraud especially intentional fraud. I would be careful about over criminalising market transactions especially in the developing countries, where you still want to get a certain momentum going on in the market, and if you have a too strict criminalisation then it might deter the development of the market.

Thus, for this sample law of punishing dishonest behaviour it can be inferred that it is a necessary feature to prevent dishonest behaviour, excessive speculation and other abuses on the exchange. However concerns were raised by a few participants on how the dishonest behaviour could be measured and identified and how speculative activity could be identified and measured. Also raised was the need not to over-criminalise market transactions as this would deter development of markets.

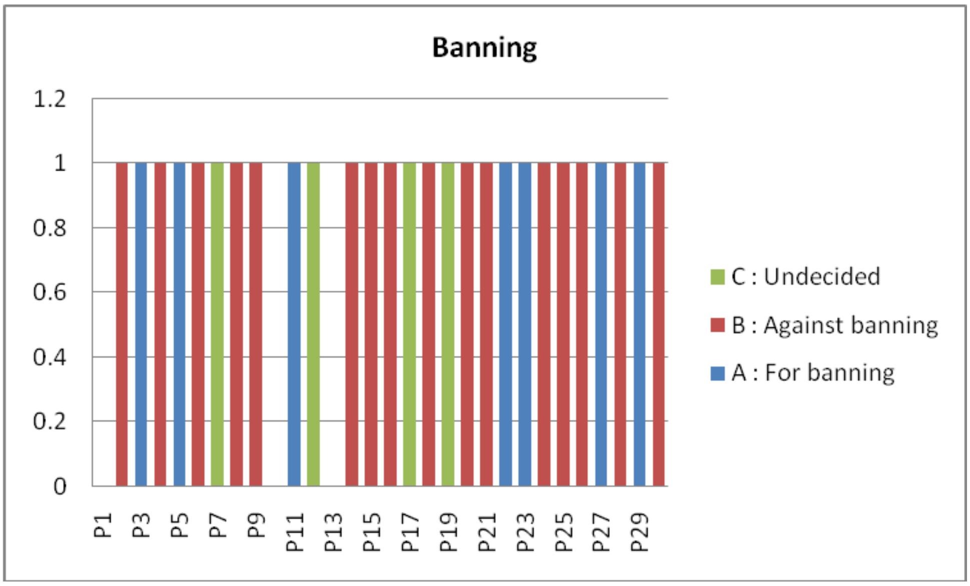
Seventh Sample Law - Banning Options

The seventh sample law asked the respondents' opinion on - Whether banning or illegalising options completely or on certain commodities would ensure genuine sales take place and excessive speculation is curbed?

Table 7.10 Sample law – Banning Options

Responses	Percentage of participants
Against banning	53%
For banning	27%
Undecided	13%
No comment	7%

Figure 7.13 Bar Chart on Respondents' Opinion on Sample Law on Banning Options



As can be seen from bar chart figure 7.13 and table 7.10, the majority of participants, sixteen (16) or 53%, opined against banning options, whereas seven (7) or 27% of the participants opined in favour of banning options or banning options in certain commodities. There were also four (4) or 13% of the participants who were undecided.

The majority opined against banning options firstly because of the need to mitigate risk. Options, the participants believed, are tools of risk management and therefore are needed to mitigate risk, as one participant, P2, an academic, opined:

> I don’t believe in this, because if we accept the issue of risk we have to accept applying the risk mitigation tools in any of the commodities.

Secondly, participants believed that banning or illegalising options would not do away with them, because if parties to a transaction needed to use these sorts of contracts they would go ahead and use them or find other means of getting what they wanted, regardless of the ban; therefore there was no purpose in banning options. As participant P16, an industry participant, stated:

> I think, whatever it is, you cannot stem excessive speculation they will [always] find ways. You may ban them, you may illegalise them, but I think they will come around [find a way to speculate] with some other ways or means.

Another participant opined that options should not be banned if they were created in such a way as to comply with the principles of *Shariah.* The participant opined that if options comply with principles of *Shariah* then actual and genuine hedging would be taking place with real underlying assets; if this were the case, options should not be banned. As P21, an industry participant, stated:

> Possible that this might happen in Islamic banking [banning of options]. But the purpose of trading in Islamic banking is different; it’s for genuine sales and not for speculative purposes. So it shouldn’t be banned. In going forward, this will be a very important element in helping the development of Islamic finance in the area of manufacturing, contract financing, [and] even retail sales.

Participants also argued that instead of banning or illegalising options, proper regulatory devices were necessary to regulate them. One participant, P30, an academician, opined that banning options in Islamic finance would just make those who want to use them move to conventional finance where they were legal and readily available. In other words the participant opined that banning options in Islamic finance would not have any effect.

The minority of participants on the other hand opined that banning options in certain commodities was necessary, such as items which are *haram* and items which are *ribawi* in nature. As participant P22, a *Shariah* advisor and academic, stated:

> Yes, for certain products, for the 6 *ribawi* products.

However *riba* may not apply in the case of futures and options since the trade made on an exchange is not barter trading, but is a commodity or financial asset in exchange of money.

Another participant opined that by banning options there would be a reduction of speculation and the principles of *Shariah* would be adhered to. As participant P11, an academic, stated:

> … banning or illegalising options on certain commodities, definitely, will reduce speculation; I do not accept options as a *Shariah* compliant product.

Another participant, P23, managing director of a consulting firm and industry participant, opined that if options had harmful effects on the public then they should be banned:

> It depends on the situation, if any commodities in which the options or futures is being imposed causes harm to the public at large or even personal[ly to an individual] then those types of commodities futures and options should not be allowed.

There were also a few participants who were undecided on whether a ban on options would ensure genuine sales take place and speculation curbed, for example P7, *Shariah* scholar and academic, stated:

> It depends on the situation, the state of the economy. It depends on the situation.

Another undecided participant opined that further research was required for this question to be answered. P17, a consultant and industry participant, stated:

> There is a lack of research and/or discussion. Think about food stuff and its regulations in classical Islamic law, and the price hikes caused example by index funds which are using futures to hedge the exposure.

And another participant believed that a case to case evaluation was necessary to decide whether banning options was necessary. Participant P19, an academician, stated:

> Case by case evaluation might be helpful.

Thus it can be inferred from the findings that the majority of participants believed that options should not be banned because of the possible benefit it would provide when it is used for hedging purposes. However options should be banned in situations where the underlying assets are *haram*.

Eighth Sample Law – Imposing Stiff Penalties

The eighth sample law that the participants were asked for their opinion on was - Whether imposing stiff penalties for violations of laws relating to derivative trading would ensure compliance with *Shariah* principles?

All the participants who answered this question opined that imposing stiff penalties for violations was necessary. Many believed that it would act as a deterrent, preventing people from committing the violations in the first place. For example, participant P4, an Islamic banker and industry participant, stated:

> I suppose it will deter people. It hasn't been done in this part of the world, they don't understand the concepts [futures and options] they won't be able to violate. I suppose it will have [deterrent effect], it's just like share trading you get slapped by a big fine taken to court and all, so yes I think it's needed.

Some participants also believed that while stiff penalties were important, they also had to be commensurate with the violation committed. In other words, the penalties should not be onerous. For example, P5, CEO of an Islamic bank an industry participant, stated:

> Of course, but the stiff penalties must commensurate with what losses or harm was done, you cannot say that 'Ah you went out and entered into pork belly contract therefore we're going to hang you'. (interviewer: In US they have penalties going up to USD1 million) Yes, but do you know what is the trading volume? What is USD1million? If you brought those trade volumes to Malaysia you would need just 7 different calculators to add it up, that's the amount. The punishment must commensurate with the damage you have caused. Here it is 10,000 ringgit because 10,000 ringgit was considered very big once upon a time.

Another participant, P11, an academic, highlighted the fact that imposing so many laws might not overcome the fundamental problems with futures and options in *Shariah*. P11 also opined that market users of derivatives would find loopholes on how to get around the law and thereby implied that this would render the laws redundant, and further, imposing various laws would make the market complicated:

> Yes, I believe this [imposing stiff penalties] can somehow contribute. But if you impose so many laws for the derivative [exchange] you make the market so complicated and this will be a lose-lose situation, because you will not attract the investors to come [and invest], and at the same time there's no consumer confidence in the market.

Participant P21, an Islamic banker, also opined that imposing very stringent rules in the Islamic derivative market would actually hurt the industry, especially in jurisdictions like Malaysia which was under a dual system (where Islamic banking and conventional banking is offered within the same jurisdiction):

> Again this would have a deterrent purpose. Probably there would have to be such laws especially in the initial stages until people get used to the activity. Also you cannot put a fear in people that in Islamic finance if you don't do things properly you will be penalised. We need to help this industry, by putting very stringent things this may not help the industry, we have to take that into consideration. Unless in a scenario when the country is practicing only Islamic finance then you can do this. In our country this is not going to help.

Another participant, P25, an academic, believed that before the penalties are increased a study had to be done as to the effectiveness of imposing stiff penalties. If it has worked in other countries only then should it be imposed in Islamic finance for derivative markets:

> So what do you mean increase the penalties? (Interviewer: In conventional laws what has been done is that in the past the amount or the penalties have gone from like USD2000 to a USD1 million) So has it helped? You have to analyse. We can come up with penalties but just merely making money out of it is not what we want. We are not trying to give it an avenue for the government to collect money; you want to make sure its effective so you have to see. If it hasn't worked then stiff penalties is not going to make a difference, so there must be other things.

Therefore, it can be inferred from the findings that imposing stiff penalties for violations of laws in derivative markets may be needed.

However, some of the participants raised certain reservations such as: the penalties should be commensurate with the violations caused; imposing so many laws deterring violations might make the market complicated and put unnecessary fear into those who want to participate in Islamic financial capital markets; and finally, studies had to be done as to whether increasing penalties had in the past been beneficial in reducing the percentage of violations.

In summary, regarding the sample of laws that were given to the participants, the majority of participants decided in the following manner:

- Limiting the number of days for future delivery or imposing taxes on each futures or options sale will reduce speculation or overcome the other objections towards derivatives in Islamic finance.
- There is a need for licences on individuals, companies, banks and even boards of trades. Licences will ensure that certain standard and pre-set criteria are fulfilled and maintained. Also those with a history of speculative activity or other violations could be weeded out.
- Designating a controlling body is necessary.
- Training is necessary and might be able to prevent speculation and other impermissible acts in *Shariah*.
- Banning of options is not the right approach and may not curb speculation.
- Punishing dishonest behaviour and imposing stiff penalties for violations of the law are necessary.

Now to answer the fifth research question – **Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?**

The following can be inferred from the responses of the respondents:

- Laws can be used to regulate futures and options and are actually needed to do so. Additionally, conventional laws that abide by the principles and guidelines of *Shariah* may be used to regulate futures and options in Islamic finance.
- From the sample of laws suggested it can be inferred that while some laws were opined by the participants as not being useful in overcoming the objections towards derivatives in Islamic finance, there were other laws utilised by the conventional

derivative market which could be used to curb speculation and other abuses on the exchange.

- The conventional laws that were supported as being useful by the participants were laws that imposed licences, designating a controlling body, training of the participants facilitating the usage of derivatives on Islamic and ethical principles, and laws that punish dishonest behaviour and the imposing of stiff penalties for violations of the laws.

Therefore the response for the fifth subsidiary research question would be that conventional laws that abide by the principles and guidelines of *Shariah* may be used in Islamic finance to overcome the objections towards derivatives.

The next section will discuss the questions and responses of the participants to answer the sixth and last subsidiary research question.

7.4 Analysing the Reponses to Interviews - Sixth Subsidiary Research Question Answered

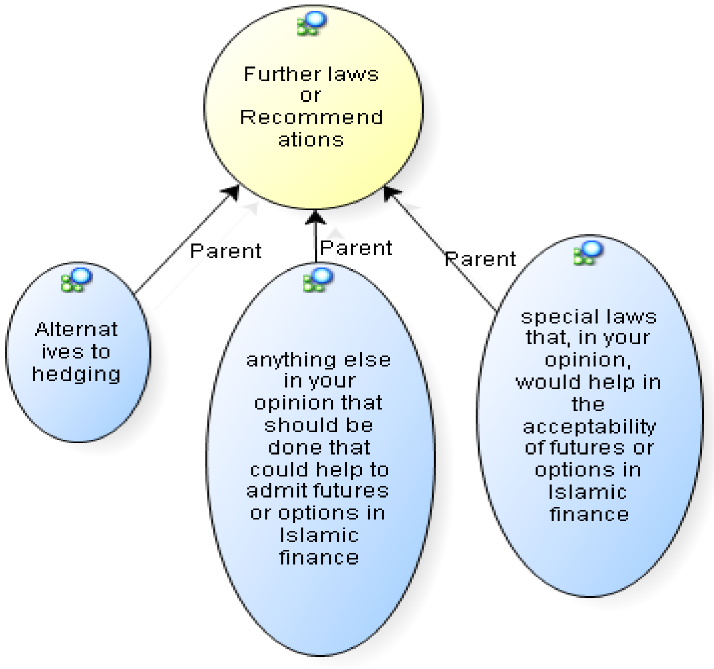
The sixth research question is - **Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?**

The sixth subsidiary research question was answered through three interview questions:

1. Whether the participants could recommend any other special or specific law that in their opinion could be used to overcome the objections of *Shariah* towards derivatives?
2. Whether there was anything else that could be done to help admit derivatives into Islamic finance?
3. Whether there were any other alternatives to hedging other than options and futures that the participants knew of that would be a better choice for Islamic finance?

Below (figure 7.14) is a model of the interview questions asked to answer the sixth subsidiary research question.

Figure 7.14 Tree Node Answering the Sixth Subsidiary Research Question - on Further Laws and Recommendations



The next section discusses the findings for each of the three interview questions.

7.4.1 Participants' Responses to Special Laws

For the question on the participant's recommendation of any special laws that might help in the acceptability of futures and options, the participants answered in four different ways. These responses may be summarised in the following manner:

The first response from the majority of participants (30%) was that further or special laws are unnecessary; instead deeper research into *Shariah* should be done because the answers would be found in *Shariah*.

The second type of response (20% of the participants) was that laws were necessary to curb speculation but the respondents were not aware of any special laws to recommend them.

The third type of response (20% of the participants) was that there are no special laws which are necessary, instead alternative methods to encourage the use of futures and options were suggested like tax incentives, dissemination of information and knowledge on futures and options, education of the scholars and ensuring products are authentic.

The fourth and last type of response (10% of the participants) was the suggestion of special laws such as increasing the margin requirement, limiting the capital an individual or firm can expose to the derivative market, ensuring minimum capital sufficiency requirements are met, and the need to trade futures and options only on exchanges and not over-the-counter.

There were six participants who did not comment on this question.

The four responses are discussed in greater detail next.

First Response – answers are in *Shariah*

The majority of participants who answered this question, nine (9) or 30%, believed that looking at conventional laws alone would not provide a solution to the objections towards derivatives. Instead the answers are within *Shariah*. As participant P6, an academic and *Shariah* advisor. stated:

> I think the laws in *Shariah* are pretty complete, after all the rules on trading are all found in *Shariah*, so laws in line with *Shariah* would be sufficient, perhaps further laws are not required.

The participants believed that since in *Shariah* genuine trading is a requirement, all the rules as to trading could be found within *Shariah* itself and there was no need for any special law. As participant P21, an Islamic banker, stated:

> It's [recommendations are] not from the angle of law but from the angle of *Shariah*. The derivative product needs to be specific in nature to meet the purpose of the financing. The role of the bank or the financial organisation to provide the services from the angle of trading not money market trading. Normally, for derivatives they are referring to money market. For Islamic finance it's beyond that, it's not only money you have to look at. You have to look from the angle that you are acting as a trader we have to buy real genuine goods, real transactions. In that angle then we don't need a special law. We have to look at the *Shariah* requirements and cater more for that.

These participants also stated that if the products, futures and options were seen to provide benefits then this would be *Shariah* compliant and it would then be acceptable. Some of these participants also believed that if we refer to the rules and regulations from the AAOIFI and the Fiqh Academy that should be sufficient. Participants who held this view also believed that there was a lack of research into *Shariah* itself, a lack of *ijtihad*[121]. There was a need to innovate from the sources of *Shariah*. As one participant, P25 an academic, opined:

> I believe that there is a lot in *Shariah* that we don't know and we can use. There is a lack of *ijtihad*, we are going back to the primary source and we are saying okay but actually Islam is for all times and space, so I think that there is a lot contained in *Shariah*.

And another participant, P29, an industry participant, stated:

> I think if you seek in Islamic laws Islamic *Uqud* [contract], you will find some methods in adopting some special Islamic futures and Islamic options for ourselves that follow *Shariah*. It is not necessary that we just follow the ways of conventional finance we can innovate ourselves from our laws, *inshahAllah* [God willing].

<u>Second Response - laws are necessary to curb speculation</u>

Six (6) or 25% of the participants could not suggest any specific laws but believed that laws were necessary to curb speculation, and other prohibited activities within *Shariah*. For example participant, P2, an academic, stated:

> I cannot state any specific law, but we need to ensure everyone at the end will get his right [of justice].

Another participant, P11, also an academic, stated:

> … if there are laws that can ensure that people only use derivatives for hedging and arbitrage, then somehow these kind of laws can reduce the number of speculators, but how and what those laws are, is another question. I recommend those types of laws.

These participants therefore believed laws were necessary but could not suggest any specific laws.

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[121] Ijtihad is 'exerting one's reasoning faculty to determine a point of law' (Abdal-Haqq 1996, p.9).

Third response – no special laws necessary, however alternatives suggested

Another six (6) or 25% of the participants opined that no special laws were necessary. Instead these participants suggested alternatives to the laws that could be used.

Participant P4, an Islamic banker, believed that further laws were not necessary but instead incentives would ensure that the right behaviour would be encouraged. P4 believed that laws should be used to regulate a market and not increase the acceptability or to market a product:

> I don’t think it is laws, I think its concessionary incentives. For example you give tax exemptions like if you engage in options trading above five hundred thousand then you get tax rebates that will help. Using the law to actually create this is going to create a loop hole in my mind. I think things like this should be announced in the budget. Similarly you know we wanted people to move away from BBA towards *ijara* and *istisna* [so] we give them tax exemptions on income expense. So things like that are better than using the law. The law should be for the purpose of regulation and not to increase the acceptability or market a product.

Another participant, a CEO of an Islamic bank, P5, believed that dissemination of information would help. Dissemination of information to the public, scholars, academics, Islamic bankers and laymen on the principles of *Shariah* and also how futures and options can be used for hedging. This opinion was also shared by another industry participant, P8, who believed that ensuring the scholars understand the products and come out with *fatwas* (legal opinions) would be a better choice then imposing further laws.

Participant P16, an industry participant, believed that ensuring the products are authentic was the key to having products permitted into Islamic finance. Participant P16 suggested rules and regulations be used to structure the products:

> Normally I tell people Islamic banking [is] right. The image of Islamicity or authenticity matters a lot. Which [need tobr authentic] conventional banking does not suffer, Islamic banking does. Authenticity is the key thing, so when you have authenticity, you need some types of rules and regulation to structure it, to make it authentic and make it look more authentic.

Fourth Response – Laws Suggested

The minority, three (3) or 13% of the participants gave suggestions of special laws they opined would actually help in the acceptability of futures and options.

Participant P1, an industry participant, believed that laws that manage the process of checking the tradability, and the price of commodities between the purchase date and the delivery date should be introduced:

> If modern Islamic scholars come to some sort of understanding of futures and options they're going to seek to impose laws to check the tradability and the price of commodities between the purchase date and the delivery date, so that's where they're going to effect the laws that manage the process.

Participant P19, an academic, suggested increasing the margin requirement to a higher level in order to reduce speculation. P19 also recommended limiting the amount of capital an individual or firm can expose to the derivative market:

> Among the laws that would be helpful is to increase margin requirement to reduce the markets' attractiveness. Another regulatory aspect might be to limit the amount of capital an individual or firm can expose to the derivative market.

Another participant, P18, an academic, opined in the same manner, that there should be certain minimum capital sufficiency requirements to be met. P18 also strongly recommended that all options and futures should be traded on an exchange rather than over-the-counter to ensure transparency, liquidity, and solvency issues are resolved and guaranteed by the exchange:

> Ideally all options, forwards and futures should be traded on an exchange. I strongly believe that exchange traded options and exchange traded futures are much better or much safer than over the counter options… as I stated in my earlier comment, derivative trading should be done on an exchange, whose transparency and liquidity issues and solvency issues are all resolved and guaranteed by an exchange.

The next section discusses the responses to the second interview question for the sixth subsidiary research question.

7.4.2 Participants' Responses to Anything Else that Should be Done to Admit Futures or Options into Islamic Finance

The second question asked in response to the sixth subsidiary research question was whether there was anything else that could be done to help admit futures and options into Islamic finance. The findings were categorised into seven (7) types of responses to provide greater clarity. The responses may be summarised in the following manner:

The first response (33% of the participants) was that there was a need to disseminate information and create better awareness about futures and options in Islamic finance.

The second response (20% of the participants) was that more research had to be conducted in Islamic finance in the area of futures, options and derivatives in general.

The third response (13% of the participants) was that the participants did not know of anything else that could be done to admit futures and options into Islamic finance.

The fourth response (10% of the participants) urged scholars to be more open minded and more conscious of the changes in the needs of businesses.

The fifth response (10% of the participants) was the recommendation of using Islamic contracts such as *wa'ad* and *salam* instead of futures or options.

The sixth response (10% of the participants) was the recommendation of having proper guidelines based on *Shariah*.

The last recommendation (3% of the participants) was the reduced usage of futures and options in investment portfolios.

The seven responses are discussed in greater detail in the next section.

First type of response – Awareness

The majority, ten (10) or 33% of participants, believed that disseminating information, creating awareness and educating people, especially farmers (because of their need to hedge) and *Shariah* scholars was needed. Participants opined that this was needed because there was a lack of understanding of how futures and options work. There was also a lack of understanding of hedging as well as speculation. Some participants felt that *Shariah* scholars did not really understand how futures and options worked and because of this futures and options have been viewed as a gambling tool for speculation and not for hedging. Participant P18, an academic, stated:

> I think the main thing is that Muslim religious scholars need to sort of understand that the purpose of these transactions is reducing the risk in commerce; it facilitates real trade it's not gambling. They have to understand how it works. Yes, it can be used for gambling, but in fact the purpose of it is quite the opposite of gambling. So they should take a look at the big picture and not just small parts of the transactions.

And P5, a CEO of an Islamic bank, stated:

> You need to disseminate knowledge. You need to educate the farmers. Farmers do not know why they should be hedging, the plantation may not know. I'm sure the ones who don't know don't know at all and the ones, who know, know very well. The business houses that buy the raw materials should know how to hedge.

Thus the findings showed that an awareness and understanding of how futures and options work was necessary. In fact, opinions of these participants that dissemination of information is necessary closely resembled the opinions of the participants who responded that research is lacking and very much needed in Islamic finance in the field of derivatives. This is discussed next.

Second type of response – Research

The second type of response by the participants focussed on the need for research. Another six (6) or 20% believed that more in-depth research in this area of futures, options and derivatives in general is necessary. Many of the participants believed that research was necessary to create awareness and also to educate those who didn't understand how futures and options actually worked. Participants opined that research would educate people and scholars alike. As one participant, P14, an academic, stated:

> I think the scholars don't really understand. For your information the futures and options market in Malaysia are not very popular because people don't understand. They don't know [how] it works. Every day you might have to top up. That's what happened in Barings bank, even the CEO did not understand how it works, they just relied on Leeson. This guy knows nobody understands so he goes on. It's not easy actually, this thing is very technical.

And another participant, P8, a partner of a legal firm and industry participant, stated:

> I can guarantee you that the scholars who say 'no', don't really understand what futures and options are all about. They don't understand how that works within the whole business structure and a lot of people just want to avoid discussing it because they don't want to fight with the scholar. But if somebody can go deep into research as you are doing it and try to rationalise it like you are doing.

Thus the findings show that the participants believed that futures and options were still not well understood in Islamic finance, and there was a need for further research and dissemination of the knowledge gained through research. It can be inferred from the findings that the participants believed that because there was insufficient information distribution, the scholars who actually came out with *fatwas* may not be fully informed of the workings of futures, options, the exchange, and the clearing house.

<u>Third type of response – nothing else can be done</u>

Then there were four (4) or 13% of the participants who did not know of anything else that could be done to admit futures and options into Islamic finance.

As P6, a *Shariah* advisor and academic, stated:

> Not that I know of.

Fourth type of response – open-mindedness

Three (3) or 10% of the participants believed that it was necessary for scholars to be more open minded, in other words, more conscious of the changes in the needs of businesses. These participants opined that in the current business and financial world it was not possible to be too rigid by sticking to the principles or theory without regards to the business needs of Islamic finance. As one industry participant, P16, an industry participant, stated:

> I want *Shariah* scholars to be open minded. If you talk about the sources of *Shariah*, there is one thing that states that if it is for the betterment of society and the society needs it then it should be taken in a good way, and if the *niyyah* [intention] is good then it should be taken. So this is something that should be looked at here. Like I said there are genuine people who need this, there is a need otherwise in today's world money is important. If Islamic finance does not provide for it then we will fall back on conventional finance, better to have something in Islamic finance.

And P3, an Islamic banker, stated simply:

> Ya [yes], open your mind [to futures and options].

Fifth type of response – using Islamic contracts

Three (3) or 10% of the participants believed that one must turn to Islamically approved instruments such as *wa'ad* [122] and *salam*[123].

Participant P7, a *Shariah* scholar and academic, believed that the usage of *wa'ad* or promise in Islamic finance could be used to perform the functions of the more controversial futures and options. However the same participant also raised issues of using the *wa'ad*. Even though the *wa'ad* was accepted by the OIC Fiqh Academy there were still unresolved issues which faced users of the *wa'ad*, such as enforceability of the promise:

> Now most Islamic jurists are talking about *wa'ad*, so this is one of the possible methods of allowing controversial instruments like futures and options. But still the intention and the operation is still debatable. How to use *wa'ad*? Because a mere promise cannot be enforced. The only problem is when this *wa'ad* is to have an effect,

122 Explained in glossary – Appendix 10.
123 Explained in glossary – Appendix 10.

> to the extent that you can take [an] action [and whether] you can impose an obligation or not. Enforcement and performance of a promise, because we have to execute a contract first to give rights and obligations, right? Only when there is an obligation only then can we perform the obligation and penalise for non-performance, but another question is whether this could also be done on a promise.

It is opined that it is difficult to see why *wa'ad* should be allowed and not futures and options. A *wa'ad* is traded over the counter where the terms of the contract are dictated on contract to contract basis. There is no standardisation and naturally there is no guarantee of performance by an exchange. There is also the issue of enforceability of a promise, as opposed to a regulated exchange where a margin is imposed and marked on a daily basis. In the case of futures and options all the terms of the contract are transparent and there is free consent when entering into the contract. Further there are strict laws and rules within the exchange itself that punish deviant behaviour, including the fact that those who do not perform their part of the contract will face certain consequences.

Another participant, an academic, P20, believed that at least half of the commodities transacted for delivery in the future should be required to be delivered at the time of the contract, in other words similar to *salam*:

> I suggest you contribute at least half of the goods. (Interviewer: In other words require pre-delivery ... something like *bai-salam*?) It can be in a way. At least in that way the buyer will not be disadvantaged the moment you are losing your position you just pay out your security money and you can get out of the contract. In that way if you put up [pre-deliver] a certain amount of goods at least the buyer is not disadvantaged, at least he can get a certain amount of goods and then from the current market price, or whatever, he can get the rest of it. He is not losing completely, at least it is reducing his risk.

While this suggestion may reduce or prevent speculation it is difficult to enforce for commodities which are only harvested in the future, or for commodities which are perishables. Therefore this may not be a solution for all types of commodities.

Lastly, an industry participant, P29, opined that in Islam there are enough methods and contracts within which solutions can be found for the problems of derivatives in Islamic finance. P29, an industry participant, suggested that research be done to find these solutions:

> As I mentioned, Islam has enough methods of *Uqud* and contracts for us to function without [looking into conventional laws], we don't have enough studies done, in Islamic laws, Islamic *Uqud* and in this case studying, we can find some solutions to apply something similar to futures and options.

<u>Sixth type of response – *Shariah* guidelines</u>

Three (3) or 10% of the participants believed that guidelines based on *Shariah* for futures and options were necessary, such as guidelines on the types of trading activity, including audit standards. As participant P23, a managing director of a consulting firm and industry participant, stated:

> Regulatory framework is not enough there should be specific attention given to come up with standard regulatory framework, court guidelines in futures and options, including the audit standards justified by the *Shariah* principles.

<u>Seventh type of response – reduce usage of futures and options</u>

Lastly, one (1) participant, P11, an academic, commented that the usage of futures and options should be reduced in investment portfolios and should only be used for the purposes of hedging:

> I believe if you're sincere in introducing derivatives in Islamic finance, then we should reduce the number of futures and options in our investment and portfolios, because most of the scholars said that the purpose of derivatives is hedging and then again we have to use it because of the market needs and we are operating in a conventional market.

The next section discusses the responses to the third and last interview question for the sixth subsidiary research question.

7.4.3 Participants' Recommendations and Responses to Alternatives to Hedging

The last question asked the interviewees their opinion on whether there were alternatives to hedging which in their opinion would be a better choice in Islamic finance as compared to futures and options. The recommendations or responses can be divided into five categories:

The first recommendation (40% of the participants) was that a better alternative was to turn to the *Shariah* or Islamically approved contracts and instruments such as *istisna*, *istijrar*[124], *hamish jiddiyah*[125] (security deposit), *salam* and *wa'ad*.

The second response (37% of the participants) was that there were no alternatives to futures and options. In other words, futures and options are the best tools for hedging in Islamic finance.

The third recommendation (13% of the participants) was to try risk sharing or shifting strategies.

The fourth recommendation (3% of the participants) was the use of the money market.

The last response (7% of the participants) was no recommendation or solution offered.

The five responses are discussed in greater detail below.

<u>First type of response – Islamically permitted contracts</u>

The majority of participants, twelve (12) or 40%, believed that the alternatives to futures and options which would be a better choice in Islamic finance are the Islamically permitted contracts which have derivative-like features, such as the *istisna, istijrar, hamish jiddiyah, salam* and *wa'ad* contracts. These participants believed that if in *Shariah* there already are contracts which have derivative-like functions, they should not be abandoned for futures and options.

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[124] For a definition see glossary at Appendix 10.

[125] Full definition is found in Glossary at Appendix 10.

As one participant, P11, an academic, stated:

> We [Islamic finance] already have our own derivative[s] which is *istisna* and *salam* and *istijrar* as well. So why should we use the conventional one and abandon our own product? I am in favour of the Islamic finance industry to use Islamic derivative products such as the *istisna, salam, istijrar, wa'ad, hamish jiddiyah* – this is like a deposit, like *urbun*.

One participant explained in-depth *hamish jiddiyah* as an alternative to *urbun*, by stating:

> The AAOIFI standards has mentioned about the *hamish jiddiyah. Hamish jiddiyah* is different from *urbun*. *Urbun* is like paying a deposit like if you want to book, like if you want to buy a property the deposit will be part of your purchase price. But *hamish jiddiyah* is like [a] security deposit and it does not form part of the purchase price. It's like a booking fee, so if you want to proceed with the transaction you just continue but if you want to cancel it the payment will not be returned, it's just burnt. (Interviewer: In *hamish jiddiyah* does the money go back into the contract price?) No it won't (Interviewer: so it's very much like an option) Ya, it's just like giving you a right to exercise your option when you want to. (Interviewer: And how do they charge? Is it like 1% of the contract price or something like that) No it's just something for your undertaking, like a *wa'ad*, you can refer to the latest AAOIFI standards.

Even though Islamic finance has contracts that have derivative-like features such *as wa'ad, Hamish jiddiyah* and *istisna*, these instruments are not as flexible as the conventional futures and options. As one participant, a *Shariah* advisor and academic, P6, stated:

> Okay, if you're looking at futures, the main objection under Islamic law is basically because you are deferring both the goods, and the price, and [the] suggestion for futures [is] it can be done if it follows the *salam* principle. Where the full price is paid upfront and you get the delivery later or you can still use *urbun* you pay part of the price, but for *urbun* the goods must be ready it's not "future" goods. So it's an either/or kind of thing (Interviewer: In *urbun* the goods must be ready it cannot be something that is going to be manufactured later?) that would be under *istisna*, the price payable is flexible pay partially upfront or you can pay later, but it would involve manufacturable items (Interviewer: So in *urbun* the thing has to be in existence now?) Yes, normally it's a done contract, but you pay the down payment just a margin of it instead of the whole thing. So it's not a perfect solution, not a perfect alternative to what you conventionally understood as futures and options, you cannot also trade with the futures as the contract itself.

Thus the participants recognised that there are Islamically permitted alternatives, however, they may not at the moment have the same flexibility as the conventional futures and options contracts. One participant blamed this on the lack of innovation in Islamic finance today. According to participant P22, a *Shariah* scholar and academic:

> In Islamic finance we have the contracts that allows you to do the derivative contract, based on *bai-salam*, and *wa'ad* promise to do something, so based on that I believe that the contract is already there the only problem is our innovation. We are not innovative enough to utilise the *Shariah* contract to be introduced or implemented in [a] derivative market. For me, the conventional derivatives cannot be applied, but I agree that the derivative market can be implemented using the existing contract like *wa'ad, bai-salam*, *istisna* and all that, because we have the contract that can be used as a basis to introduce that product.

According to P22, the contracts that exist today in *Shariah* such as *salam*, *wa'ad* and *istisna* should be used to create an Islamic derivative market. There should be more innovative steps taken to do so.

Although the participants mentioned the *urbun*[126] contract, all the participants opined that at the moment scholars have not accepted the *urbun* contract in *Shariah.* P22, a *Shariah* advisor and academic, had this to say about the *urbun* contract:

> (Interviewer: What do you think about *bai-arbun*?) Banks are not using that currently because in my view we don't have a concrete reason or we have not come to a stage that this concept can be introduced in the derivative market. We have to understand first the *urbun* contract before it can be used in Islamic finance. We are in the process of understanding the contract first before we can apply it in the derivative market. Currently I don't think there are any products using *urbun*, they use *wa'ad* and *murabaha*.

<u>Second type of response – no better alternatives</u>

The second type of response from eleven (11) or 37% of the participants was that there may not be any better alternatives to hedging other than futures and options in Islamic finance. The participants opined that if in conventional finance these are the instruments used, then there was nothing better that could be used to hedge. The participants also believed that while the Islamically permitted contracts such as *salam* may have their own merits, they may not be so good or efficient in the modern economy to hedge. As P18, an academic, stated:

> I don't think so, (Interviewer: What do you think of contracts like *wa'ad, arbun istisna*, *salam*?) *Bai-salam* is a primitive futures contract, and that is the main evidence that I have to say that futures contracts should be permissible, there's not a lot of difference between the *salam* and futures contracts and the purpose of both is to hedge and price risk so I don't think that going back to a more basic form of futures is

126 For a full definition see glossary – Appendix 10.

> useful. *Salam* is good for what it does but you can't expect modern firms in the modern economy to [use *salam*] as efficiently as a futures contract.

One participant, P1, an industry participant, who opined in this manner also believed that Kamali's (2002) argument, that modern day futures and options have substantially reduced *gharar* and may actually be superior financial instruments to the privately negotiated *bai-salam* and other Islamic permitted contracts, should be given more thought:

> And Kamali counter argued that the modern futures and options have a substantial reduction of *gharar,* and that as a result maybe the modern option and futures are superior instruments than the privately negotiated *bai-salam,* where nobody can see. It's a very compelling argument, and as a result maybe all these "work arounds" also privately negotiated are also inferior. So it's something which really needs to be thought about deeply.

Another participant, an Islamic banker and industry participant, P3, opined that derivatives encompass all types of instruments which derive a value from something else. Therefore if it were to be banned or considered impermissible in Islamic finance, it would be like banning everything and there would not be any alternative:

> Derivatives is a catch all phrase, and derivatives is supposed to include any product that has value from another thing. So if you ban derivatives, it is a catch all phrase, it covers everything that derives a value from something else, so you are actually banning everything so there's no alternative to everything. It's everything or none …

This opinion was shared by another Islamic banker and industry participant, P4, who believed that futures and options are necessary to work within the whole financial system, if there were alternatives they would already have been found. Participant P4 opined that at the moment, in Islamic finance, the better option is not to take risk and this would be the biggest downfall of Islamic finance because, P4 stated:

> If you stop taking risk you stop your business.

Another participant, P20, an academic, who held the same view, felt that there was no other instruments that could give the same advantage to investors as futures and options. P20 thus came to the conclusion that people and businesses may actually forget about Islamic finance and instead invest in the conventional capital markets:

> I think that you should just forget about Islamic finance and go and play in the conventional market. I can't think of any other product that can be replacing derivatives in Islamic finance and give the same advantage for the investors but you can play in the capital market and you can still earn some money and invest in the sukuk and all which is a growing market but not in the same aspect as the derivatives.

Third type of response – risk sharing or shifting strategies

The third most popular response came from four (4) participants or 13% of the participants who suggested alternatives to risk management based on risk sharing or risk shifting.

Participant P2, an academic, proposed a risk sharing alternative where the participants consent ahead of the contract to share the risk by agreeing to share any profits or losses (e.g. 50-50):

> Like sharing risk (Interviewer: Like *musharakah*?) Not exactly. Like if there is a risk, I am exposed to the risk and you are exposed to the risk why don't we share the risk, because sometimes the risk happened to me this means that you may win, since you won't know, why don't we share the risk 50-50, and from the loss[es] we also share.

This opinion was shared by another participant, P21, an Islamic banker and industry participant, who believed that if a customer was to approach the bank, the bank should insist on sharing the risk and the profits. In that way there would be no need to hedge or look for alternatives like derivatives:

> Anybody depositing money is an investor, and we already tell the customer that we will share the profits, if the profits are less we give less if there's no profit then there's no profit to be given, why do we need to hedge?

It is opined that it may be difficult for banks or financial institutions to negotiate such a deal. How many counter parties want to share the risk and losses with an Islamic bank or other Islamic financial institution? They may easily seek another bank (possibly conventional) which is willing to take up all the risk, and hedge through derivatives.

Another participant, P9, an academic, suggested shifting the risk or using methods which are on-balance sheet as compared to off-balance sheet (which use instruments such as futures and options):

> You see there are always things that you can do, we can do things like, on balance sheet versus off balance sheet. All derivatives are off-balance sheet. That means you do business the way you go out and manage the risk, for example if I exported to Japan and I'm going to paid in Yen I face a risk, so what do I do I keep exporting because I want the business and that risk I use currency futures or currency forwards to manage the risk, when I take those positions in derivatives it doesn't show anywhere in my balance sheet that is off balance sheet. Now what is acceptable in *Shariah* – they say you balance your risk by using on balance sheet products that means change the way you do business to remove your risk, reduce your risk. How? For example, a Japanese customer comes to me I say for example you can buy rubber from me but you have to pay me in ringgit otherwise I cannot sell you the rubber, in that way I am not managing the risk I am shifting the risk on to the customer so that would be acceptable. The problem is, it is not risk management it is risk shifting and you could lose your business. The customer will go to competitors who are willing to accept Yen why should they go with you. So this is the problem.

Therefore, P9 opined that businesses could opt to shift their risk to the buyer or customer, and thus comply with *Shariah* requirements. However, as stated earlier, there is the difficulty of the customers leaving Islamic banks and financial institutions for competitors who do not require shifting the risk.

Another participant, P25, an academic suggested using a method in finance known as 'netting'. Under this method a business tries to match its own payments and receipts to hedge internally:

> It's a finance term I don't know how useful it is; we used to use "netting" matching of payments and receipts. Thinking from the finance point of view, where your expect[ed] to receive a certain amount of foreign currency, and you hedge, if you don't want that then you can find "netting" or try to match your receipts and payment in such a way that you don't have to deal with this (Interviewer: all of this is done on the spot right?) Yes, it has to be on the spot. (Interviewer: so that would exclude the need for futures and options?) Yes.

While this method may work for some of the business transactions, it will not be possible to match every payment with a receipt. There will possibly be a surplus on either side that will not have matching receipts. Therefore this method may not be an ideal risk management tool.

Fourth response – money market

The fourth response by one (1) or 3% of the participants (P14, an academic), was that an alternative to the use of derivatives would be using the money market.

> Other than futures and options? [The] Money market.

The money market could be an alternative for businesses such as banks; however instruments in the money market are usually for short terms and for financial dealings. Hedging for commodities would not be possible in the money market, thus the money market, although an alternative for financial instruments, would not be able to help when it comes to commodities.

Sixth Response – no comment

Two participants did not have a solution for this part of the question. P 12, a *Shariah* scholar, stated:

> In fact I expect your thesis to answer this question.

Thus to summarise the findings for this third question, where the participants were asked their opinion on possible alternatives to futures and options in Islamic finance the majority of participants recommended searching for answers within *Shariah* itself. More focus, research and innovation are needed regarding Islamically approved instruments. These participants believed that the use of futures and options should not be considered in Islamic finance when there were alternatives available in *Shariah*. The second major response from the participants was diametrically opposite to the first response. The participants believed that there were no other alternatives which would best suit the business needs of risk management like futures and options do. The instruments which exist now in Islamic finance, the participants felt, were inferior in flexibility to the risk management advantages of futures and options. This response was opined by only one less participant than the number who opined that within *Shariah* itself there were sufficient instruments to meet the industry's need for risk management. The third and much smaller group of participants believed that risk sharing methods should be used. One participant believed that as an alternative the money market should be used, and the final participant did not have an answer to alternatives to hedging.

Thus to answer the sixth research question - **Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*? -** it can be inferred from the findings that:

Participants believed that more research was needed within *Shariah* itself to find the legal guidelines and also instruments that could be used as alternatives to hedging. Participants also believed that dissemination of information and awareness was an utmost priority to enable derivatives to be understood by people and especially *Shariah* advisors and scholars.

7.5 Summarising the Findings for the Fourth, Fifth and Sixth Subsidiary Research Questions

This chapter sought to answer the fourth, fifth and sixth subsidiary research questions by semi-structured interviews through the case study approach. The findings from the responses of the participants answered the fourth, fifth and sixth subsidiary research questions in the following manner:

4#: Are derivatives needed in Islamic finance?

The following inferences were made from the findings.

Participants believed that futures and options were useful because of their hedging and risk management qualities; however they also recognised the harmful side of derivatives, that is, the speculative and possible gambling nature. Although a majority of participants believed that futures and options were not acceptable in Islamic finance, they also answered that if the harmful effects of derivatives could be overcome futures and options could be accepted and used in Islamic finance. Thus it may be inferred that if the objections towards futures and options could be overcome they would be accepted in Islamic finance.

Participants also believed that futures and options are needed in Islamic finance today to hedge risk and also to allow businesses to cope with the uncertainties and the differing demands of modern day businesses.

When comparing futures and options, participants generally believed that futures were more in line with *Shariah,* whereas a number of fundamental objections towards options made options more unacceptable. But at the same time, when the participants were asked, 'If all the objections against derivatives could be overcome would they be accepted?', the vast majority of the participants believed that they would be accepted, and those who objected to this did not state that options would not be accepted as compared to futures. Therefore, if the objections against derivatives could be overcome they would be accepted in Islamic finance.

The fourth subsidiary research question – Are derivatives needed in Islamic finance? – brought the following response: the findings showed that the majority of participants believed that derivatives are needed subject to overcoming the objections in *Shariah*.

5#: Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?

The following inferences were made from the findings.

Laws can be used to regulate futures and options and are actually needed to do so. Additionally, conventional laws can be used to regulate futures and options in Islamic finance.

From the sample of laws suggested it can be inferred from the responses that while some laws were opined by the participants as not useful in overcoming the objections towards derivatives in Islamic finance, there were other laws from conventional laws which could be used to curb speculation and other abuses on the exchange.

The conventional laws that were approved by the participants were laws that impose licences, designating a controlling body, training of the participants facilitating the usage of derivatives on Islamic and ethical principles, and laws that punish dishonest behaviour and the imposing of stiff penalties for violations of the laws.

Therefore the response to the fifth research question would be that conventional laws can be used in Islamic finance to overcome the objections towards derivatives.

6#: Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?

From the findings it can be inferred that:

For the question on the participants' recommendation of any special laws that might help in the acceptability of futures and options, the participants answered in four different ways. The first response from the majority of participants was that further or special laws are unnecessary; instead deeper research into *Shariah* should be carried out because the answers would be found in *Shariah*. The second type of response was that laws were necessary to curb speculation, but that the respondents were not aware of any special laws to recommend them. The third type of response was that there are no special laws which are necessary, instead alternative methods to encourage the use of futures and options were suggested such as tax incentives, dissemination of information, knowledge on futures and options, education of the scholars and ensuring products are authentic. The fourth and last type of response was the suggestion of special laws such as increasing the margin requirement, limiting the capital an individual or firm can expose to the derivative market, ensuring minimum capital sufficiency requirements are met, and the need to trade futures and options only on exchanges and not over-the-counter.

The second question asked whether there was anything else that could be done to help admit derivatives into Islamic finance. The findings were categorised into seven types of responses. The first response was that there was a need to disseminate information and create better awareness about futures and options in Islamic finance. The second response was that more research had to be conducted in Islamic finance in the area of futures and options and derivatives in general. The third response was that the participants did not know of anything else that could be done to admit futures and options into Islamic finance. The fourth response urged scholars to be more open minded and more conscious of the changes in the needs of businesses. The fifth response was the recommendation of using Islamic contracts such as *wa'ad* and *salam* instead of futures or options. The sixth response was the recommendation of proper guidelines based on *Shariah*, and the seventh and last recommendation was the reduced usage of futures and options in investment portfolios.

For the third question, the participants were asked their opinion on possible alternatives to futures and options in Islamic finance. The majority of participants recommended searching for answers within *Shariah* itself. More focus, research and innovation is needed regarding Islamically approved instruments. These participants believed that the use of futures and options should not be considered in Islamic finance when there were alternatives available in *Shariah*. The second major response from the participants was diametrically opposite from the first response. The participants believed that there were no other alternatives which would best suit the business needs of risk management like futures and options do. The instruments which exist now in Islamic finance, the participants felt, were inferior in flexibility to the risk management advantages of futures and options. This response was opined by only one less participant than the number who opined that within *Shariah* itself there were sufficient instruments to meet the industry's need for risk management. The third and much smaller group of participants believed that risk sharing methods should be used. One participant believed that as an alternative the money market should be used, and the final participant did not have an answer to alternatives to hedging.

Thus for the sixth subsidiary research question it can be inferred from the findings that:

The participants believed that more research was needed within *Shariah* itself to find the legal guidelines and also instruments that could be used as alternatives to hedging. Participants also believed that dissemination of information and awareness was an utmost priority to enable derivatives to be understood by people and especially *Shariah* advisors and scholars alike.

Chapter 8 Conclusions and Implications

8.1 Introduction

This chapter presents the conclusions for each subsidiary research question, the conclusion for the research question, implications for the theory, policy and practice and finally, recommended areas that require further research.

8.2 Conclusions about Each Research Issue

This research asked six subsidiary research questions, which are as follows:

1. How do the legal objections directed against derivatives in *Shariah* compare with the legal objections in conventional finance?
2. Why are there similarities in objections towards speculation in *Shariah* and conventional law?
3. What laws passed in conventional finance can be used to overcome the objections to derivatives in Islamic finance?
4. Are derivatives needed in Islamic finance?
5. Can conventional laws be used in Islamic finance to overcome the objections towards derivatives?
6. Are further laws or other recommendations required to be introduced, unique to Islamic finance, to enable derivatives to be incorporated and thereby comply with the requirements of *Shariah*?

Question One was answered in Chapter 3, Question Two was answered in Chapter 4, Question Three was answered in Chapter 6, and Questions Four, Five and Six were answered in Chapter 7 of this thesis.

The following are the conclusions for each of the subsidiary research questions.

8.2.1 Conclusions for the First Subsidiary Research Question

For the first subsidiary research question, a comparison of the literature between current *Shariah* objections towards derivatives and historical objections towards derivatives in conventional finance, was carried out.

First, an explanation of **what** the legal objections were in Islamic finance and conventional finance and then **how** these legal objections compare will be made.

The *Shariah* objections raised by scholars were divided into five criteria, namely:

- futures sale being the deferment of both counter values is a sale of one debt for another, that is, *bai al kali bi al kali,* which is forbidden;
- both counter values in future sales are non-existent at the time of the contract, neither the money nor the goods; it is therefore not a genuine sale but merely a sale or exchange of promises; a sale can only be valid in *Shariah* if either the price or the delivery is postponed but not both;
- options sales is a mere right to buy or sell, charging of fees for this is not permissible;
- for a sale to be valid there must be a transfer of ownership of the item sold; therefore if the seller does not own the item he cannot transfer ownership; and,
- futures and options trading involves speculation and verges on *maisir, qimar* and *gharar.* The most popular objection in *Shariah* towards derivatives were the last two objections, and the underlying reason for most of the objections was the need to minimise or eliminate *gharar*.

As for the conventional law the objections raised were divided into three criteria, namely:

- futures sales involved the mere sale of promises which is unenforceable, that is, future sales do not involve the simultaneous transfer of possession; there is a lack of physical delivery;
- futures sales are contracts for differences, this amounts to wagering and is therefore illegal; and,
- futures and options sales are gaming contracts which involves wagering and betting and are therefore illegal. The most popular objection in conventional law was due to the fact that futures sales are contracts for differences that amount to wagering.

A comparison of *Shariah* objections with conventional law objections showed that all three conventional law objections were similar to *Shariah* objections. Both in *Shariah* and conventional law the paramount objections seem to be similar. In conventional law the paramount objection against derivatives was the gambling nature of derivatives. In *Shariah* the paramount reason was *gharar*; however, since *maisir* is a subset of *gharar*[127], it would mean that it is similar. In other words the paramount objection in conventional law against derivatives is gambling, which is similar to the overriding objection in *Shariah* which is *gharar*.

How the legal objections compare is explained next.

Initially the first conventional law objection seemed to be harsher then the *Shariah* objection on the non-existence of the counter values at the time of the contract. This is because the sale of promises where the goods are non-existent at the time of the contract is void, even where the plaintiff already had in his possession the commodity at the date of delivery - *Bryan v Lewis*. In *Shariah* if *gharar* can be removed from the contract even where there is non-existence of the subject matter, the contract would be valid. However, this harsh test evolved in conventional finance to the 'reasonable expectation' test. This test laid down in *Wells v Porter* was: 'whether there was a reasonable expectation that the object matter of the contract would be obtained at the time of the contract'. If there was such a reasonable expectation, then the contract would be valid even though the goods did not exist at the time of the contract. It is opined that this 'reasonable expectation' test is very similar to the test in *Shariah* where if the object is defined and known and there is a possibility of obtaining it even though it does not exist at the time of the contract, then the prohibition does not apply. It is opined that the two tests developed are the same.

Nevertheless the 'reasonable expectation' test was extended further in *Hibblewhite v M'Morine*. In this case it was decided that as long as the commodity is available and in the seller's possession at the time of delivery the contract would be valid. Therefore, the sale of a promise was allowed so long as the seller could deliver the commodities at the future date. This rule seems to have surpassed the objection in *Shariah* since the requirement of minimising *gharar* still has to be fulfilled before a contract can be valid. In conventional law, notwithstanding the uncertainty or risk of obtaining the subject matter of the contract or being

[127] This was discussed and explained in Chapter 2.

able to fulfil the contract, it would be valid if the seller was able to perform the contract at a future date.

The second objection in conventional law - sales for future delivery where ‘no intention’ to deliver was present - was considered as a wager and therefore void and unenforceable. This was known as the ‘intent test’. In *Shariah* for a sale to be valid there must be a transfer of ownership of the item sold. Therefore if the seller does not own the item he/she cannot transfer ownership. The paramount reason for this prohibition would seem to be due to *gharar*, or the uncertainty about delivery of the goods purchased, (Kamali 1996). However, in Ibn Taymiyah’s opinion, if the item is easily available in the market then the prohibition would not apply. This opinion fits well with the reason for the prohibition, that is, to prohibit *gharar*. If the commodity or asset is easily available there will not be an issue of *gharar*.

Comparing the ‘intent test’ in conventional law with *Shariah* objections, it would seem that two objections in *Shariah* can be found to have similarities with this objection in conventional law.

Firstly, in *Shariah* the requirement that there be physical delivery or taking of possession of the commodity before the reselling of the item is similar to the requirement imposed by the various courts starting with *Grizewood v Blane,* that there has to be intent to deliver the underlying asset for the futures contract to be valid; if not, the contract would be invalid.

Secondly, the *Shariah* objection that futures and options trading verges on *maisir*, *qimar* and *gharar* would also seem to overlap with the underlying reason why the ‘intent test’ was developed. The ‘intent test’ was developed to distinguish those futures and options contracts which were mere contracts of differences or gambling contracts, from those which were true contracts where there was intention to deliver.

The third objection in conventional finance is that futures and options sales are gaming contracts which involve wagering and betting and are therefore illegal. The argument that arises here is that futures transactions are nothing more than gambling transactions - a great evil that causes losses, whereas those who support the continued usage of futures believe that passing a law to halt the usage of futures would not stop its practice. Further, the passing of such a law would cause great hardship to the public who should have the right to dispose of their property as they wish. This includes the right to dispose of their money and commodities through futures and options transactions.

In *Shariah,* scholars opined that speculation in derivatives leads to excessive uncertainty which amounts to gambling, and that derivatives are clear examples of zero-sum games.

These arguments for and against futures in conventional law mimic closely the objections in *Shariah*. In *Shariah* the majority of scholars believe that speculation in derivatives leads to excessive uncertainty which amounts to gambling. They opine derivatives are clear examples of zero-sum games, and are mere contracts of differences - a means of gambling and betting. The counter-argument seeks to highlight the advantages of derivatives, such as price discovery, creating trading vehicles and as an arena for profitable commerce. Further, they argue that standardisation of the contracts, monitoring by third parties and mutual consent between the parties of the contract help minimise *gharar*.

However, there were two *Shariah* objections which did not have any parallel objection in conventional law. Firstly, futures sales being the deferment of both counter values is a sale of one debt for another. Secondly, options sales is a mere right to buy or sell, charging of fees for this is not permissible. These two objections can be overcome by following the reasoning given by Kamali (1996, 1997). Firstly, it is a fact that a clearing house acts as the seller for each buyer and the buyer for each seller in all futures transactions. Each transaction is guaranteed, there is therefore no direct interaction with another trader. There is therefore no exchange of a debt for a debt, since each transaction ends with the buying or selling of the futures contract by the exchange. Therefore, it is opined that this objection can be dismissed as being not applicable to modern day futures. Secondly, since a service and usufruct is considered to fall under the definition of ‘property’ (that is, tangible property) in Islamic finance, a right provided under an option should also be considered a ‘property’. Therefore charging a fee for this ‘right’ should be allowed.

8.2.2 Conclusions for the Second Subsidiary Research Question

Chapter 4 was devoted to answering the second subsidiary research question. Research unveiled four possible explanations as to why there are similarities between the objections to derivatives in *Shariah* and conventional law. These are:

- Islamic origins of Common law
- The concept of stewardship
- Christianity and morality
- Ethics and gambling

The first possible reason is from the research undertaken by Makdisi (1990, 1999). According to Makdisi, the origin of Common law is from Islamic law. The transplant of Islamic law into Common law occurred through Sicily and as a result there are unique features in Common law not found in other legal systems present at that time, except for Islamic law. These unique features include, *inter alia*, the transfer of property through offer and acceptance, trail by jury and a speedy means for the recovery of loss of land ownership through action brought in the king's court. All these unique features of Common law existed also in Islamic law at that time but did not exist in Roman or other Western types of legal systems. Other authors have also made similar claims on the origin of Common law (Cattan 1955; Badr 1978; Gaudiosi 1988; El-Gamal 2006; Abdullah 2007).

Thus this link between Islamic law and Common law may explain why there existed similar objections towards speculation and gambling in *Shariah* and Common law at one point in time.

The second possible reason for the similarity is the concept of stewardship and vicegerency. The concept of stewardship means that as a steward, man is entrusted to take care of property by the owner. The owner of all property and goods, according to religions such as Judaism and Christianity, is God. Since the steward is required to take care of property, gambling and excessive speculation is seen as wrong and against the duties of a steward. In Islam the concept of *khalifa* or vicegerency also exists which imposes on man a duty to take care of the property of the world, which belongs to God. However, some scholars believe that the term ‘*khalifa’* as explained in the *Quran* specifically refers to ‘one who succeeds’. In other words only a ruler and not every human being is a khalifa or steward. If this interpretation is taken than the concept of stewardship may not exist in Islam. However, in Islam there also exist clear injunctions which make gambling and excessive speculation *haram*.

Thus, the concept of stewardship in conventional thought would explain the prohibition of gambling and excessive speculation in conventional law. As for Islam, there exists the concept of vicegerency. However even if a narrow interpretation is taken for the meaning of vicegerency, there are clear injunctions in *Shariah* which dictate that gambling and excessive speculation is *haram*.

The third possible reason for the similarity of objections towards speculation in conventional law and *Shariah* is due to the general prohibitions to gambling in Christianity. Although there is no clear condemnation of gambling found in the scriptures and holy books in Christianity, authors such as Pratte (1985) and Hoffman (200) have argued that gambling is against the tenets of Christianity. A general prohibition of gambling in Christianity may explain the similarity of objections towards excessive speculation with *Shariah*.

The fourth possible explanation is due to ethical reasons. It is argued by anti-gambling activists (e.g. Winkler (1994), and Ethics and Religious Liberty Commission (1997a), (1997b), (1997c)) that in the interest of society, gambling should be outlawed. This school of thought has been described as the ethics of sacrifice, where sacrifice is used as a moral concept to advance a noble goal. The individual and public must sacrifice the right to gamble, which is a vice, for the noble goal of a harmonious society. Those who fall within this school of thought may have influenced the passing of laws and public policies which were anti-gambling and speculation. This might explain the similarities of the objections to derivatives in conventional law and *Shariah*.

Thus, this research unveiled four possible reasons as to why there are similarities in objections to gambling and highly speculative activity in Islamic and conventional finance. It is opined that to prove that one reason overrode the rest and was the only source for explaining the similarities between the objections of derivatives in *Shariah* and conventional law is not possible. Rather it is opined that all four possible explanations may have worked severally but in unison to cause conventional law to have similarities in objections towards derivatives with *Shariah*.

8.2.3 Conclusions for the Third Subsidiary Research Question

The third subsidiary research question was answered through historical methodology. The laws from the 17th century to the present time, from the jurisdictions of the US and the UK, were researched to identify the conventional laws passed which may overcome objections to derivatives in Islamic finance. The laws in the UK and the US were the prime focus in this thesis. The reason for this is firstly because these two countries have a rich legal history which can be traced and followed in discussing legal objections, and further, these two countries are among the top countries in the world that have the largest markets for derivatives trading (Bank of International Settlements 2008, pp. 31 and 109A).

Laws were reviewed beginning from the 17th century because the history of derivatives usage (Chapter 2) shows that it was in the 17th century that derivatives, and particularly futures, were traded at exchanges. It was during this time that the futures trade had similar features with the futures traded in the futures exchange markets today. It is also at this point in history where legislation on derivatives began to emerge. Thus legislation from the 17th century was the starting point where this thesis began analysis for the historical method.

The laws identified were grouped into eight main categories. These laws were matched with each *Shariah* objection. Subsequently, how the *Shariah* objections could be minimised or overcome was explained. Below is the summary of the eight categories of conventional law and the explanation on how these laws can overcome *Shariah* objections.

1. **Conventional laws that restrict derivative trading activity.** These include: limiting the number of days for future delivery, making oral exchanges of promises/executory promises unenforceable, levying taxes on each future/option sale and imposing trading limits.

By restricting and regulating derivative trading activity in such a manner, *Shariah* objections #1[128], #2[129] and #3[130] were addressed in the following ways:

a. Limiting the number of days for future delivery may address *Shariah* objection #2 since the rationale behind the need to take possession is to eliminate or minimise *gharar*. By limiting the number of days allowed for transfer of ownership, this will also minimise *gharar*.
b. Making oral exchanges unenforceable and requiring part payment or part delivery of the underlying asset directly addresses *Shariah* objection #1, since both counter values will no longer be non-existent at the time of the contract. Evidence in writing per se may not be sufficient to satisfy *Shariah* objection #1, but may address *Shariah* objection #3 which is to curb *maisir*, *qimar* and *gharar*.
c. Imposing taxes on each future or option traded in cases of speculators only would address *Shariah* objections #2 and #3, since by inserting a tax requirement this would curb speculation and also the buying and selling of futures by those who do not possess or own the underlying asset.
d. Setting trading limits would address *Shariah* objection #3 since excessive speculation on a certain asset or position can be prevented.

2. **Conventional laws that require licences** to be issued to the board of exchanges, and to those who carry out derivative trading, subject to prerequisites.

The requirement that licences are needed for both,

- boards of trade/exchanges, and
- those who want to carry out derivative trading,

ensure that only qualified persons are allowed to provide the venue and facilities for trading and only qualified persons who are fit and proper carry out trading in derivatives.

[128] Both counter values in future sales are non-existent at the time of the contract, the money, nor goods; it is therefore not a genuine sale but merely a sale or exchange of promises. A sale can only be valid in Shariah if either the price or the delivery is postponed but not both.

[129] For a sale to be valid there must be a transfer of ownership of the item sold, therefore if the seller does not own the item he cannot transfer ownership. The rationale behind taking possession is to prevent gharar.

[130] Futures and option trading involves speculation and verges on maisir, qimar and gharar.

The yearly licensing requirement especially helps to weed out those who have shown previously to have taken part in risky or speculative behaviour. Further, the requirement under US law that contract markets have to comply with the enforcement of rules and regulations further ensures that speculative activity is curbed. Therefore the requirement of licences which are in turn subject to certain prerequisites definitely addresses *Shariah* objection #3, which is the need to prevent *maisir*, *qimar* and *gharar*.

3. **Conventional laws imposed on the regulating body.** These include designation of a regulating body to oversee functions of the boards of trade/exchanges, ensuring laws, rules and regulations are enforced, providing the regulating body with emergency powers, providing the regulating body with power to conduct regular investigations and enacting laws that subject the regulating body's decisions to review.

Designating a regulating body to oversee derivatives trading and ensuring adherence to laws, rules and regulation of the regulating body and also rules and regulation of the boards of trade and exchanges, by investors and others, ensures constant control and monitoring on the overall activities of derivatives trading. This generally prevents *gharar* and therefore would indirectly address *Shariah* objections #2 and #3.

Further, the emergency powers given to the regulating body allows immediate action to be taken by the regulating body to promptly rectify and provide immediate remedies to any unforseen circumstances. The emergency powers could immediately stop any speculative activity or market manipulations from happening. This would address *Shariah* objection #3.

Also, through the investigative powers given to the regulating bodies, any market manipulations, speculative buying and selling, or other activities prohibited in *Shariah* can be monitored and stopped if necessary. This would address *Shariah* objection #3.

The powers of the regulating body are at the same time subject to review (by either an administrative tribunal or judicial review) and therefore not absolute, ensuring a check and balance in the system.

4. **Conventional laws that regulate boards of trade/exchanges.** These include boards of trade/exchanges required to regulate derivatives trade, and boards of trade/exchanges required to maintain records.

Under these laws, boards of trade/exchanges are required to self-regulate derivatives trade. Self-regulation ensures better monitoring over daily trading activity since the board of trade/exchange are closest to the action taking place and would thus be aware of any type of malpractices or abuses occurring. With the existence of numerous boards of trade and exchanges it would be very difficult for a regulating body to oversee every aspect of derivatives trading on a daily basis. It is therefore important to legislate appropriate laws that ensure autonomy and the ability of self-regulation by boards of trade/exchanges. Indirectly, these laws that enable boards of trades and exchanges to self-regulate ensure *Shariah* objection #3 is addressed.

Boards of trade/exchanges, and those who facilitate derivatives trading are to maintain records. These records are subject to scrutiny by a higher authority such as the regulating body, e.g the SC. Volume of derivative contracts traded is also available to the public to view. Through these records the regulating body is able to identify any abnormalities in derivatives trade. These laws prevent uncertainty by ensuring transparency and symmetric distribution of information within the whole system, thereby preventing *gharar*. *Shariah* objection #3 is thus addressed.

5. **Conventional laws that regulate those who facilitate derivative trading.** These include regulation of those who advice/invest on behalf of others, and training those involved in derivatives trading.

The regulation of those who advise or invest on behalf of the investors ensures no improper practices occur. Fraud, false reporting, market manipulations, and negligent or reckless advice are prevented. The requirement to undergo training on ethical issues, and training on rules and regulations of the regulating body and the boards of trade /exchanges is a very useful tool which may include, in the case of Islamic finance, training on issues of *gharar*, *maisir*, *qimar* and how to avoid them. These laws address *Shariah* objection #3.

6. **Conventional laws on investor protection.** These include laws that punish dishonest behaviour, statements issued on the conduct and financial standing expected of persons, laws that ensure investor protection and powers to restrict business.

These laws protect those investing in derivatives by punishing any dishonest or deceitful behaviour, requiring a certain conduct and financial standing of investors, ensuring compensation where a counter party is unable to fulfil its obligations, by providing contract enforceability, and providing powers to restrict business of investors. The laws protect *bona fide* investors, and ensure certainty and stability of the derivatives markets. This would address *Shariah* objection #3.

7. **Prohibitions.** These include prohibiting options dealings and/or future contracts, making wagers not recoverable at law, prohibiting set-off/ ring settlement.

Prohibiting options dealings could possibly address *Shariah* objection #4[131] since according to *Shariah* charging of fees for the mere right to buy or sell is not permissible. Also by making wagers unenforceable, this law directly addresses *Shariah* objection #3. Prohibiting a set-off or ring settlement addresses *Shariah* objections #2 and #1 since disallowing a set-off will ensure transfer of ownership and ensure a genuine sale takes place, respectively.

8. **Conventional law on penalties for violations.** These include penalties imposed for violation of laws/rules/regulations and penalties imposed on boards of trade/exchanges for not imposing any of their guidelines or rules.

Imposing and enforcing penalties in cases of breach of the laws, rules and regulations ensure compliance with laws, rules and regulations. The hefty sum fined in the event of a breach has a deterring effect on participants in the market. Therefore, penalties in general address *Shariah* objections #1, #2 and #3, by ensuring compliance with all the laws.

[131] Option sales is a mere right to buy or sell; charging of fees for this is not permissible.

8.2.4 Conclusions for the Fourth Subsidiary Research Question

The fourth subsidiary research question was answered through the analysis of the responses of the participants through the case study methodology. Four interview questions were asked to answer this subsidiary research question. The interview questions asked the participants their opinions as to: Whether futures and options are acceptable in Islamic finance today? Whether futures are more acceptable than options? Whether futures and options are useful or harmful to the economy? Whether if all the objections in *Shariah* could be overcome to derivatives would they be acceptable in Islamic finance?

The following findings may be made from the responses of the participants:

Participants believed that futures and options were useful because of their hedging and risk management qualities. However, they also recognised the harmful side of derivatives, that is, the speculative and possible gambling nature. Although a majority of participants believed that futures and options were not acceptable in Islamic finance they also answered that if the harmful effects of derivatives could be overcome futures and options could be accepted and used in Islamic finance. Thus, it may be inferred that if the objections towards futures and options could be overcome in Islamic finance they would be accepted in Islamic finance.

Participants also believed that futures and options are needed in Islamic finance today to hedge risk and also to allow businesses to cope with the uncertainties and the differing demands of modern day life.

When comparing futures and options, participants generally believed that futures were more in line with *Shariah*, whereas a number of fundamental objections towards options made options more unacceptable. But at the same time when the participants were asked, ‘If all the objections against derivatives could be overcome would they be accepted?’, the vast majority of the participants believed that they would be accepted and those who objected to this did not state that options would not be accepted as compared to futures. Therefore, if the objections against derivatives could be overcome, they would be accepted.

Thus, to answer the fourth subsidiary research question – Are derivatives needed in Islamic finance? – the findings showed that the majority of participants believed that derivatives are needed subject to overcoming the objections in *Shariah*.

8.2.5 Conclusions for the Fifth Subsidiary Research Question

The fifth subsidiary research question was also answered through the analysis of the responses of the participants through the case study methodology. Two types of questions were asked of the respondents. The first type of question asked the participants' opinion on whether laws could be used to regulate futures and options and whether conventional laws could be used in Islamic finance to regulate derivatives. The second type of question asked the participants to give their opinion on sample laws that were proposed to them. The participants were asked whether these sample laws could overcome the objections in *Shariah* towards derivatives. Eight sample laws were selected from the laws that were identified under the historical laws. Only a sample of laws was chosen because the laws that were identified under the historical method were too numerous to get the participants' opinion on. Thus eight sample laws were selected, one from each of the eight categories from which the historical conventional laws, of the UK and the US, were divided.

The sample laws were on limiting the number of days for future delivery, imposing taxes, requiring licences to be issued, designating a regulating body, training those who facilitate derivative trading on ethical and *Shariah* principles, banning or illegalising options, imposing laws that punish dishonest behaviour and imposing stiff penalties for violations of laws relating to derivatives trading.

From the findings the following may be inferred:

Laws can be used to regulate futures and options and are actually needed to do so. Additionally conventional laws can be used to regulate futures and options in Islamic finance.

From the sample of laws suggested it can be inferred that while some laws were opined by the participants as not useful in overcoming the objections towards derivatives in Islamic finance, there were other laws from conventional finance which could be used to curb speculation and other abuses at the futures exchange.

The conventional laws that were approved by the participants were laws that imposed licences, designating a controlling body, training of the participants facilitating the usage of derivatives on Islamic and ethical principles, and laws that punish dishonest behaviour and the imposing of stiff penalties for violations of the laws.

Therefore the answer to the fifth research question would be that conventional laws can be used in Islamic finance to overcome the objections towards derivatives.

8.2.6 Conclusions for the Sixth Subsidiary Research Question

The sixth subsidiary research question was also answered through the analysis of the responses of the participants through the case study methodology. Three interview questions were posed to the participants to answer the sixth subsidiary research question. The three interview questions asked the participants' opinion on whether, firstly, in their opinion there are any special laws that would help in the admissibility of futures/options. Secondly, whether there is anything else that could be done that could help admit futures/options into Islamic finance. Lastly, whether there are any alternatives to hedging which are a better choice in Islamic finance than futures and options.

From the findings it can be inferred that:

For the question on the participant's recommendation of any special laws that might help in the acceptability of futures and options, the participants answered in four different ways. The first response from the majority of participants was that further or special laws are unnecessary; instead deeper research into *Shariah* should be done because the answers would be found in *Shariah*. The second type of response was that laws were necessary to curb speculation but the respondents were not aware of any special laws to recommend them. The third type of response was that there are no special laws which are necessary. Instead alternative methods to encourage the use of futures and options were suggested such as tax incentives, dissemination of information, knowledge on futures and options, education of the scholars and ensuring products are authentic. The fourth and last type of response was the suggestion of special laws such as increasing the margin requirement, limiting the capital an individual or firm can expose to the derivative market, ensuring minimum capital sufficiency requirements and the need to trade futures and options only through exchanges and not over-the-counter.

The second question asked whether there was anything else that could be done to help admit derivatives into Islamic finance. The findings were categorised into seven types of responses. The first response was that there was a need to disseminate information and create better awareness about futures and options in Islamic finance. The second response was that more research had to be conducted in Islamic finance in the area of futures and options and derivatives in general. The third response was that the participants did not know of anything else that could be done to admit futures and options into Islamic finance. The fourth response urged scholars to be more open minded and more conscious of the changes to the needs of businesses. The fifth response was the recommendation of using Islamic contracts such as *wa'ad* and *salam* instead of futures or options. The sixth response was the recommendation of proper guidelines based on *Shariah,* and the seventh and last recommendation was the reduced usage of futures and options in investment portfolios.

For the third question, the participants were asked their opinion on possible alternatives to futures and options in Islamic finance. The majority of participants recommended searching for answers within *Shariah* itself. More focus, research and innovation was needed towards Islamically approved instruments. These participants believed that the use of futures and options should not be considered in Islamic finance when there were alternatives available in *Shariah*. The second major response from the participants was diametrically opposite to the first response. The participants believed that there were no other alternatives which would best suit the business needs of risk management like futures and options do. The instruments which exist now in Islamic finance, the participants felt, were inferior in flexibility to the risk management advantages of futures and options. The third and much smaller group of participants believed that risk sharing methods should be used. One participant believed that as an alternative, the money market should be used, and the final participant did not have an answer to alternatives to hedging.

Thus for the sixth subsidiary research question it may be inferred from the findings that:

Participants believed that more research was needed within *Shariah* itself to find the legal guidelines and also alternative instruments that could be used for hedging. Participants also believed that dissemination of information and awareness was an utmost priority in enabling derivatives to be understood by people and especially *Shariah* advisors and scholars.

8.3 Conclusions about Problem Statement

The problem statement or primary research question in this research is:

How can the objections towards derivatives in Islamic finance be overcome by adapting laws from the legal history of derivatives usage in conventional finance?

This research unveiled the fact that derivative instruments such as futures and options, that have hedging properties, are needed in the Islamic financial industry today. They are needed for the progress of Islamic finance. This research also revealed that participants believed futures and options are more useful than harmful to the economy. However, the participants also opined that futures and options as they exist in their present form are not acceptable in Islamic finance. At the same time, when the participants were queried on whether if all the objections towards derivatives could be overcome they would be accepted in Islamic finance, the overwhelming majority of participants answered that this was possible. Thus there is a need to overcome the objections towards derivatives in *Shariah* to enable its usage within Islamic finance.

This study also revealed that there are similarities of objections between *Shariah* and the legal history of conventional law towards derivatives. This means that Islamic finance can turn towards the conventional law legal history to finds ways of overcoming similar objections to derivatives.

The findings of this research unveiled that the underlying objection in conventional finance against derivatives usage is the prohibition of gambling, whereas in *Shariah* it is *gharar*.

Gambling and *gharar* are not different types of objections, they are actually related. Analysis of the relationship between gambling and *gharar* led to the unearthing of the fact that *maisir* or gambling falls within the definition of *gharar*. In other words, gambling is a subset of *gharar*. This means that *gharar* includes elements beyond gambling, such as *jahala* or ignorance. Following this reasoning, since the underlying objection towards derivatives in *Shariah* is *gharar* and the underlying objection towards derivatives in conventional law is gambling, it follows that the objections towards derivatives in Islamic finance is broader or wider than in conventional law. Further, in a comparison of the *Shariah* objections and conventional law objections towards derivatives it was discovered that there were two objections in *Shariah* that did not have a similar parallel objection in conventional law.

Thus Islamic finance can learn from the legal history of derivatives development in conventional law in relation to objections which relate to excessive speculation and gambling. Further, from the responses of the participants it was gathered that Islamic finance can turn towards conventional finance to use the laws therein as long as they comply with *Shariah* principles. These laws that have been enacted, deal with issues of speculation, gambling and other abuses in the futures and options exchange such as dishonest behaviour and set-off.

Of the sample laws that were shown to the participants, the participants agreed that laws which required licences, laws that designated a regulating body, laws that required training on *Shariah* and ethical principles, laws that punished dishonest behaviour and imposed stiff penalties can overcome objections towards derivatives in *Shariah*. However the majority of participants did not agree that laws limiting the number of days for future delivery or imposing taxes on each future or option sale would overcome the objections in *Shariah* towards derivatives.

Thus to answer the research question – **How can the laws in conventional laws overcome the objections in *Shariah* towards derivatives?** – the laws that were identified in conventional finance can be used to overcome the objections in *Shariah* in relation to excessive speculation and gambling. As to the other objections in *Shariah*[132], there are no

[132] Futures sale being the deferment of both counter values is a sale of one debt for another, and options sales is a mere right to buy or sell, charging of fees for this is not permissible. Nevertheless, these two objections can be overcome by following the reasoning given by Kamali (1996, 1997) (explained in chapter 3). Firstly that it is a fact that a clearing house acts as the seller for each buyer and the buyer for each seller in all futures transactions, each transaction is guaranteed, there is therefore no direct interaction with another trader, there is

parallel objections in conventional law. The legal history in conventional laws cannot be used to find solutions to overcome these objections.

For the other objections[133] in *Shariah* against derivatives, this research showed that research within *Shariah* itself is required. The findings also revealed that alternatives for hedging may be found within *Shariah* itself. Further, the laws that regulate derivative-like instruments in Islamic finance can be found within *Shariah* sources.

The findings also revealed that there is an urgent need in Islamic finance for the dissemination of information, research on issues involving derivatives and also a greater need of awareness among the *Shariah* scholars, and the general population.

8.4 Implications and Recommendations for Policy and Practice

This research would help the Islamic financial industry and policy makers understand that Islamic finance can learn from the legal history usage of derivatives in conventional finance. As one participant succinctly stated:

> And for emerging markets like ours we don't have to reinvent the wheel we can look at what has happened in the US, UK etc. and then learn from them because they have gone through long history full of experience and regulation and fine tuned so we learn from all of those things. (Participant P9, an academic.)

This research indicates that the Islamic banking and financial industry needs instruments for hedging and managing risk. Policy makers can turn to the laws from conventional finance and learn from the legal history usage of derivatives in conventional finance to overcome excessive speculation and gambling.

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therefore no exchange of a debt for a debt, since each transaction ends with the buying or selling of a futures contract by the exchange. Therefore it is opined that this objection can be dismissed as being not applicable to modern day futures. Secondly, if a service and usufruct is considered to fall under property (i.e. tangible property) and therefore allowed to be a subject matter of a sale, a right provided under an option should also, therefore charging of a fee should be allowed for a right provided under an option, again this objection can be dismissed.

[133] Ibid.

In Malaysia the Securities Commission may consider setting up a board of exchange to handle the buying and selling of commodities through derivative-like instruments for Islamic finance. One commodity, such as crude palm oil, may be used as a test case. Strict conditions to obtain a license to trade derivatives for the board of exchange and also individuals and companies should be created and imposed. Laws identified in this thesis that increase certainty and eliminate gambling and *maisir* may be imposed.

On the international level, it may arise for the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)[134] to look within conventional laws for guidance to create guidelines and codes of conduct in relation to derivative instruments that are introduced in Islamic finance. Further, the Islamic Development Bank[135] (IDB), together with its research arm the Islamic Research and Training Institute[136] (IRTI), could utilise the findings of this research to develop a system of laws for an international derivatives trading exchange based on *Shariah* principles.

This research would also provide ISDA and IIFM with the relevant laws that could be used in their master agreement for documenting privately negotiated *Shariah* compliant derivatives transactions[137]. The master agreement could become a standard document used for *Shariah* compliant privately negotiated derivatives around the world. The laws that were identified in this thesis may also be used for future exchange traded derivatives that are developed in the Islamic capital markets by ISDA in association with Islamic institutions such as IIFM.

This research also shows that further in-depth research is required within *Shariah* itself. Policy makers, the industry, *Shariah* advisors and academics must take steps to create greater awareness of derivatives through the dissemination of information and ideas and more in-

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134 AAOIFI is a not-for-profit organization that was established to maintain and promote *Shariah* standards for Islamic financial institutions, participants and the overall industry. From http://www.aaoifi.com/, accessed, 29 January 2009

135 IDB is a multilateral development financing institution, established to foster social and economic development of it's member countries and Muslim communities world-wide. From http://www.isdb.jobs/careers/isdb/Page.aspx?PageID=2502, accessed ,29 January 2009.

136 IRTI undertakes research and provides training and information services for the member countries of the Islamic Development Bank and Muslim communities in non-member countries to help bring their economic, financial and banking activities into conformity with *Shari'ah* and to further economic development and cooperation amongst them. From http://www.irti.org/irj/portal/anonymous?NavigationTarget=navurl://4023767103ddda634d57f445f51ce347&guest_user=irti_en, accessed, 29 January 2009.

137 See section 2.2.5 above.

depth research. Policy makers should budget more funds for research, especially on derivatives and *Shariah* issues in Islamic finance.

8.5 Recommendations for Further Research

Research for this PhD thesis has focussed on the legal aspects of conventional derivatives. During the course of this PhD research, there were areas where further research was required but could not be undertaken due to the limited focus of this topic, and also due to other limitations such as time and resources. This section will outline further research areas that can be undertaken within Islamic finance on derivatives. The following areas are identified to complement this PhD research:

Firstly, further research is required on the internal rules, regulations and guidelines of current boards of trade and exchanges existing in conventional finance today. Here two issues should be addressed:

- The rules and regulations of the boards of trade and exchanges from different jurisdictions should be studied to determine whether these would overcome objections in *Shariah*; and,
- Whether further rules and regulations unique to Islamic finance are required should also be investigated and researched.

Secondly, further research is required on whether self-regulation of the boards of exchange and trade would be a better option than governmental control of derivatives trading. This type of research will determine whether more laws should be passed by the parliament to regulate derivatives trading or whether the boards of trades should self-regulate derivatives trading with internal rules and regulations.

Thirdly, further research is required to find out the effectiveness of the conventional laws in overcoming speculative activity in the past. In other words, were the laws that were passed in conventional finance effective in curbing speculative activity? Those laws which are found to be effective in curbing excessive speculation can be used in Islamic finance as well. In that way Islamic finance can adopt and adapt the appropriate laws in a tried and tested manner.

Fourthly, further research is required to study those jurisdictions that actually banned futures and options in certain commodities for certain periods of time to find out if, whether during the period of the bans there was reduced price volatility in the commodities which were not traded through futures or options.

8.6 Closing Comments

This study explored how the legal history of derivatives usage in conventional finance can be utilised to overcome the objections towards derivatives in *Shariah*. Specifically, the legal development of futures and options in conventional finance was identified and its possible usage in Islamic finance was researched. Highlighted in the literature were the similarities in the objections towards derivatives in *Shariah* and in the legal history of conventional law. This parallel and separate occurrence of objections towards derivatives led the researcher to explore the laws passed in conventional laws.

In concluding this thesis the major findings are reiterated here. It is established that risk management tools are needed in Islamic finance. However, futures and options as they exist in their current form are considered not to be Islamically permissible. Nevertheless, if all the objections imposed by *Shariah* could be overcome towards derivatives then they would be accepted in Islamic finance. Conventional laws, when they comply with the principles of *Shariah*, can be used in Islamic finance. The conventional laws identified from the legal history usage of derivatives in conventional finance can be used to overcome excessive speculation and gambling. However to overcome other objections towards derivatives in Islamic finance, the solutions will have to be found within *Shariah* itself, to achieve complete acceptance of derivatives. Lastly more in-depth exhaustive research is needed within *Shariah* to discover its contents for the use of Islamic finance. Also the dissemination of information and research uncovered is also necessary to enable greater awareness.

Encouragement and gratitude is extended to all those who participated in this research. Working with professionals, *Shariah* advisors and academics from the Islamic financial industry turned this research from a theoretical and historical study to one with practical and current value to the industry.

On reflection, one participant's (P17, an industry participant) comment may summarise the dilemma of futures and options in Islamic finance:

> Futures and options do add leverage to markets, and are likely a cause on its own and not only a remedy for volatility. In perfect market conditions [futures and options are] nice tools, if people would ever behave rational[lly]. Unfortunately Allah [swt] created man weak, and we shall accommodate to His wisdom of doing so.

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Appendix 1 Human Ethics Certificate of Approval

Standing Committee on Ethics in Research Involving Humans (SCERH)
Research Office

Human Ethics Certificate of Approval

Date	**27-FEB-2008**
Project Number	**CF08/0510- 2008000248**
Project Title	**Overcoming Objections to Derivatives in Islamic Finance**
Chief Investigator	**Prof Balachandran Shanmugam**
Approved	**From: 27-FEB-2008 To: 27-FEB-2013**

Terms of approval

1. Approval is only valid whilst you hold a position at Monash University.
2. It is the responsibility of the Chief Investigator to ensure that all pending information (such as permission letters from organisations) is forwarded to SCERH. Research cannot begin at an organisation until SCERH receives a permission letter from that organisation.
3. It is the responsibility of the Chief Investigator to ensure that all investigators are aware of the terms of approval and to ensure the project is conducted as approved by SCERH.
4. You should notify SCERH immediately of any serious or unexpected adverse effects on participants or unforeseen events affecting the ethical acceptability of the project.
5. The Explanatory Statement must be on Monash University letterhead and the Monash University complaints clause must contain your project number.
6. **Amendments to the approved project:** Requires the submission of a Request for Amendment form to SCERH and must not begin without written approval from SCERH. Substantial variations may require a new application.
7. **Future correspondence:** Please quote the project number and project title above in any further correspondence.
8. **Annual reports:** Continued approval of this project is dependent on the submission of an Annual Report. This is determined by the date of your letter of approval.
9. **Final report:** A Final Report should be provided at the conclusion of the project. SCERH should be notified if the project is discontinued before the expected date of completion.
10. **Monitoring:** Projects may be subject to an audit or any other form of monitoring by SCERH at any time.
11. **Retention and storage of data:** The Chief Investigator is responsible for the storage and retention of original data pertaining to a project for a minimum period of five years.

[redacted]

Dr Souheir Houssami
Executive Officer, Human Research Ethics (on behalf of SCERH)
Cc: Ms Sherin Kunhibava

Appendix 2 Explanatory Statement

MONASH University

<date>

Explanatory Statement

Title: Overcoming Objections to Derivatives in Islamic Finance

This information sheet is for you to keep.

My name is Sherin Kunhibava and I am conducting a research project with Dr. Bala Shanmugam, a professor in the Department of Accounting and Finance, towards a PhD at Monash University. This means that I will be writing a thesis which is the equivalent of a 300 page book.

The aim of this study is to investigate whether laws that have been enacted in conventional finance in the past can be used in Islamic finance to overcome objections towards derivatives. This research has so far found that the objections that exist today in Islamic finance towards derivatives are similar to the objections that existed in conventional finance in the past (from the 17th century onwards). In conventional finance, laws were enacted which eventually led to the legalisation of derivatives. This research attempts to investigate whether these laws can be used in Islamic finance to overcome similar objections towards derivatives.

The findings will be used to develop recommendations on the necessary laws that could be introduced to manage the possible problems associated with the usage of derivatives in Islamic finance.

You have been selected because of your knowledge and experience, of not less than 5 years, in both the fields of Islamic finance and conventional finance and/or law, and your ability to converse in English. I obtained your contact from < the conference we attended dated …at… /the article(s) you have written in… titled…/participant…who after obtaining permission from you, gave me your contact details>.

The research process will mean that with your consent, the researcher will conduct an in depth interview with you, which will be audio taped with your consent. The researcher will only ask questions pertaining to derivatives in Islamic finance and your opinion as to the ability of conventional laws to overcome the objections. It is anticipated that the interview will take a maximum time of 90 minutes. A small token of appreciation for the time taken to answer the researcher's questions will be given in the form of Monash souvenir.

Participation in this study is completely voluntary. You are under no obligation to consent to participation. However, if you do consent to participate, you may only withdraw prior to having approved the interview transcript.

We at Monash University commit ourselves to protecting your right to privacy. A report relating to the study may be submitted for publication in an academic journal or conference paper, but personal anonymity of all participants will be maintained under all circumstances. Codes will be used to identify participants when applicable, such as P1, P2 etc. All interview materials (i.e. the audio-tapes and interview transcripts) will be kept secure on University premises, by the research project supervisor, in a locked filing cabinet for 5 years in accordance with University regulations.

If you would like to be informed of the aggregate research finding or contact the researchers about any aspect of this study, please contact the Chief Investigator:

Professor Bala Shanmugam
Phone: 03 – 55146282
Email: bala.shanmugam@buseco.monash.edu.my

If you would like to contact the researchers about any aspect of this study, please contact the Chief Investigator:	If you have a complaint concerning the manner in which this research CF08/0510- 2008000248 is being conducted, please contact:
Professor Bala Shanmugam Phone: 03 – 55146282 Email: bala.shanmugam@buseco.monash.edu.my Fax: 03 - 55146326	Human Ethics Officer Standing Committee on Ethics in Research Involving Humans (SCERH) Building 3e Room 111 Research Office Monash University VIC 3800 Tel: +61 3 9905 2052 Fax: +61 3 9905

Thank you very much for your time and your cooperation.

Sherin Kunhibava

Appendix 3 Consent Form

Consent Form

Title: Overcoming Objections to Derivatives in Islamic Finance

NOTE: *This consent form will remain with the Monash University researcher for their records*

I agree to take part in the Monash University research project specified above. I have had the project explained to me, and I have read the Explanatory Statement, which I keep for my records. I understand that agreeing to take part means that I am willing to:

1. I agree to be interviewed by the researcher ☐ Yes ☐ No
2. I agree to allow the interview to be audio-taped ☐ Yes ☐ No
3. I agree to make myself available for a Further interview if required ☐ Yes ☐ No

I understand that I will be given a transcript of data concerning me for my approval before it is included in the write up of the research.

I understand that my participation is voluntary, that I can choose not to participate in part or all of the project, and that I can withdraw at any stage of the project without being penalised or disadvantaged in any way.

I understand that any data that the researcher extracts from the interview for use in reports or published findings will not, under any circumstances, contain names or identifying characteristics.

Participant's name

Signature

Date

Appendix 4 Interview Guide

Section A. Introduction: Acceptability of futures and options in Islamic Finance

1. In light of Islamic law, do you think futures and/ or options in *halal* (permissible) commodities should be allowed in Islamic finance?
   i. If no, why not?
   ii. If yes, why?

2. In your opinion, how acceptable are futures in Islamic finance today, compared to options, in other words is either one instrument more acceptable than the other?

3. In your opinion are futures and options more useful or harmful? In what manner are they useful/ harmful?

Section B – Ability of Laws to Overcome Objections in Islamic Finance

4. Do you think laws can be used to regulate futures and options? How?

5. What is your opinion of using conventional laws in Islamic finance to regulate derivatives?

6. Here I am going to suggest a few general regulations. These regulations were taken from conventional laws of the past which were enacted in conventional finance to overcome excessive speculation in conventional markets. Please indicate whether you think these regulations would be useful in reducing the objections in *Shariah* against derivatives:

   a. Laws that limit the number of days for future delivery.

   b. Imposing taxes or fees on the usage futures or options (this is not the tax imposed on profits).

   c. Enacting laws that require licences to be issued to boards of trade and those who carry out investment business.

d. Designating a regulating body to oversee functions of boards of trade, exchanges and others who engage in derivative trading.

e. Training those who provide services to users of derivative trading on ethical and Islamic law principles.

f. Imposing laws that punish dishonest behaviour on an exchange.

g. Banning or illegalising options totally or on certain commodities.

h. Imposing stiff penalties for violations of laws relating to derivative trading.

Section C – The Need for Further Laws or other Requirements

7. Are there any special laws that, in your opinion, would help in the acceptability of futures or options in Islamic finance?

8. Is there anything else in your opinion that should be done that could help to admit futures or options in Islamic finance?

9. Are there alternatives to hedging in your opinion that would be a better choice in Islamic finance as compared to futures or options?

Section D - Conclusion

10. If all the objections against futures or options could be overcome in Islamic finance, do you think they (futures or options) would be accepted in Islamic finance? If not, why not?

Appendix 5 Email Inviting Potential Participants to be Interviewed

Dear ....,

Assalamualaikum/Greetings, I hope you are fine and in good health.

My name is Sherin binti Kunhibava. We have not met, I obtained your contact from ....

I would like to request for your participation in my PhD research at Monash University. I am at the stage of interviewing professionals who have experience in Islamic finance and conventional finance and/ or law, and I would like to interview you on your views and opinions on derivatives in Islamic finance. There are no right answers to the questions and the questions I will pose are very simple and require only your opinions.

Participation is voluntary, but your participation will be highly appreciated. You do not have to answer any questions that you are not comfortable with. If you like I can send you a copy of the questions that will be asked.

If you agree to being interviewed please have a look at the attached explanatory statement and the consent letter to have a clearer understanding of my research and the objectives of my research.

The interview will take a maximum time of 90 minutes, I will come to your office during office hours at a date and time convenient to you.

If you agree to being interviewed please reply to this email with a date your office address and time most convenient to you, or call me at 0166154073. I am free on any working day except Fridays when I am committed to my teaching obligations at Monash University.

The consent letter I am attaching does not have to be filled, I will bring a hardcopy with me on the day of the interview so that you may sign, if you agree to be interviewed.
I thank you very much for your time and patience.

Regards,

Sherin binti Kunhibava
Doctoral Candidate Monash University

Appendix 6 Email Requesting Participants to Review Transcript

Assalamualaikum/Greetings

Dear ……….,

Hope you are fine, thankyou again for the interview.

Here attached is a transcript of your interview for your approval, I hope to use it for my research. If I don't receive any objections from you within four weeks I'll assume it’s alright and I can use it for my research.

Regards,

Sherin binti Kunhibava
Doctoral Candidate
Monash University

Appendix 7 Table of Meeting with Participants, When and Where

Participant	When Interview took Place In 2008	Where Interview took Place
P1	20th June, 9.30am	Jalan Bukit Bintang, KL
P2	1st August, 10am	Jalan Lagoon Selatan, Bandar Sunway
P3	19th May, 5pm	Jalan Semantan, KL
P4	30th June, 3pm	Jalan Pinang, KL
P5	2nd September, 9am	Jalan Bukit Bintang, KL
P6	24th April, 10.30am	IIUM Gombak
P7	24th April, 2.30pm	IIUM Gombak
P8	10th June, 8.30am	Pusat Damansara, KL
P9	12th June, 11.30am	IIUM Gombak
P10	13th July	Overseas Participant
P11	17th July, 2.30pm	UM, KL
P12	5th July	Overseas Participant
P13	9th July 4pm	Jalan Raja Laut
P14	3rd September, 10am	Sungai Buloh, Selangor
P15	2nd September, 10.30am	Jalan Bulit Bintang, Kl
P16	21st May, 1.30am	Jalan Sentul, KL
P17	3rd July	Overseas participant
P18	7th July	Overseas Participant
P19	9th July	Overseas Participant
P20	11th April	Jalan lagoon Selatan, Bandar Sunway
P21	16th April, 11.30am	Jalan Munshi Abdullah, KL
P22	1st July, 10am	UKM, Bangi
P23	3rd August, 5pm	Ampang Point, KL
P24	9th April, 3.30pm	Jalan Dungun, Kl
P25	29th May, 2.30pm	Bandar Utama, PJ
P26	16th June, 12.00pm	Jalan Semantan
P27	13th August, 10am	IIUM, Gombak
P28	4th June, 11am	Jalan Lagoon Selatan, Bandar Sunway
P29	30th July, 3pm	Jalan Tun Razak, KL
P30	2nd July, 10am	Jalan Lagoon Selatan, Bandar Sunway

Appendix 8 Email of Research Results

Assalamualaikum/Greetings

Dear ……….,

I am writing to you to thank you again for granting me the privilege of an interview with your good self. Enclosed is the final report I promised to send to you.

Thanks for everything and please revert back to me if you have any enquiries.

Warm regards,

Sherin Kunhibava
Doctoral Candidate
Monash University

Appendix 9 Table 6.1 Matching Conventional Laws with *Shariah* Objections

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
1.Laws regulating derivative trading activity	**Limiting number of days for future delivery**	William III, 1696-7: An Act to Restrain the Number and Ill Practice of Brokers and Stock-Jobbers. This Act limited the number of days within which share sales could take place. Share sales were required to take place within **three days** and they were required to be recorded.		By regulating derivative trading activity *Shariah* objection #1, #2 and #3 will be addressed in the following ways: o By limiting the number of days for future delivery this may address *Shariah* objection #2 since the rationale behind the need to take possession is to eliminate or minimise *gharar*, by limiting the number of days allowed for transfer of ownership this will also minimise *gharar*. o Making oral exchanges unenforceable and requiring part payment or part delivery of the underlying asset, directly addresses *Shariah* objection #1 since both counter values will no longer be non-existent at the time of
	Oral exchanges of promises/ executory promises unenforceable	Charles II, An Act for Prevention of Frauds and Perjuryes - oral exchange of promises or executory promises were unenforceable contracts. The buyer shall accept part of the goods so sold, or give something or part payment in earnest to bind the bargain, or that some note or memorandum in writing of the said bargain be made and signed by the parties Banking Companies' (Shares) Act 1867 –s.1 required contracts of sale involving shares in banking companies to be in writing and to designate the identifying numbers of the shares. Contracts not complying with the Act were legally null, void and criminal.	Cotton Futures Act - s.4 - each contract of sale of cotton had to be in writing Futures Trading Act - s.6 - where a future contract is traded in a contract market the transaction had to be evidenced by a contract or memorandum in writing Grain Futures Act - s.4 -Where a contract is made by or through a member of a board of trade which has been designated by the Secretary of Agriculture as a "contract market," has to be evidenced by a record in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery	

Laws Grouped	**Laws Specified**	**UK Laws**	**US Laws**	***Shariah* Objections**
				the contract. Evidence in writing per se may not be sufficient to satisfy *Shariah* objection #1, but may address *Shariah* objection #3 which is to curb *maisir*, *qimar* and *gharar*.
	Taxes levied on each future/option sale		Cotton Futures Act s.3 - That upon each contract of sale of any cotton for future delivery made at, on, or in any exchange, board of trade, or similar institution or place of business, there is hereby levied a tax in the nature of an excise of 2 cents for each pound of the cotton involved in any such contract. Futures Trading Act – s.3. That in addition to the taxes now imposed by law there is hereby levied a tax amounting to 20 cents per bushel on each bushel involved therein, whether the actual commodity is intended to be delivered or only nominally referred to, upon each and every privilege or option for a contract either of purchase or sale of grain, intending hereby to tax only the transaction known to the trade as 'privileges", "bids," "offers," "puts and calls," "indemnities," or "ups and downs". - S.4. That in addition to the taxes now imposed by law there is hereby levied a tax of 20 cents a bushel on every bushel involved herein, upon each contract of sale of grain for future delivery except – (a) Where the seller is at the time of making	o Imposing taxes on each future or option traded in cases of speculators only, would address *Shariah* objection #2 and #3. Since by inserting a tax requirement this would curb speculation and also the buying and selling of futures by those who do not possess or own the underlying asset. o Setting trading limits would address *Shariah* objection #3 since excessive speculation on a certain asset or position may be minimised.

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			such contract the owner of the actual physical property covered thereby, or is the grower thereof, or in case either party to the contract is the owner or renter of land which the same is to be grown, or is an association of such owners, or growers of grain, or of such owners or renters of land; or Where such contracts are made by or through a member of a board of trade which has been designated by the Secretary of Agriculture as a "contract market," as hereinafter provided, and if such contract is evidenced by a memorandum in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery, and provided that each board member shall keep such memorandum for a period of three years from the date thereof, or for a longer period if the Secretary of Agriculture shall so direct, which record shall at all times be open to the inspection of any representative of the United States Department of Agriculture or the United States Department of Justice.	
	Trading limits imposed		Commodities Exchange Act – s.4a(1) - For the purpose of diminishing, eliminating, or preventing excessive speculation, the commission shall, from time to time, after due notice and opportunity for hearing, by order, proclaim and fix such limits on the	

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			amounts of trading which may be done or positions which may be held by any person under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market as the commission finds are necessary to diminish, eliminate such limits, the position held and trading done by any persons directly or indirectly controlled by such person shall be included with the positions held and trading done by such person; and further, such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading were done by, a single person.	
2. Laws on licensing	**Licensing requirement subject to prerequisites**	Prevention of Frauds (Investment) Act 1939 – ss. 1 & 3 – board of trade to issue licenses to those who want to deal in securities. These licenses are renewable on a yearly basis. Financial Services Act 1986 – - s. 3 – only **authorized** or **exempted** persons could carry on, or purport to carry on, investment business in the United Kingdom. **Authorized:** - s. 4 - any **unauthorized** person who carries	Futures Trading Act – s.5 – the Secretary of Agriculture is authorized to designate boards of trades as “contract markets” Grain Futures Act – s.4 trading in futures was unlawful unless conducted on exchanges designated by the commission as a "contract market”. Commodities Exchange Act - s.4d - it was necessary for any person who wanted to engage as a futures commission merchant to be registered under the Commodities Exchange Act with the Secretary of	The requirement that licences are needed for both, • boards of trade/ exchanges, and • those who want to carry out derivative trading ensures that only qualified persons are allowed to provide the venue and facilities for trading and, only qualified persons who

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
		on, or purports to carry on, investment business, would be guilty of an offence and liable to imprisonment for a term not exceeding two years or to a fine or to both. - s.6 provided rights to obtain an injunction restraining the contravention of s.3 - S.25 authorization is obtained from the Secretary of State. - S.27 authorization is granted where the person is 'fit and proper'. - S.28 authorization may be suspended or revoked where the person is found to not be a fit and proper person to carry on the investment business. **Exempted:** Chapter IV provides a long list of those who are exempted persons i.e. those who do not need to obtain authorisation, such as the Bank of England (s.35), Investment exchanges (s.36), clearing houses (s.38), overseas investment exchanges and clearing houses (s.40)	Agriculture. - s.4e - laid down that it would be illegal for any person who has not registered, to act as floor broker - s.4f - laid down the requirements for application of registration. - s.4g(1) laid down the circumstances when revocation or suspension of registration would take place, i.e. on violations of the provisions of the Commodities Exchange Act or the rules and regulations set by the Secretary of Agriculture. - s.5 - Designation of boards of trade as contract markets. A board of trade applying to the Commission for designation as a contract market shall submit an application to the Commission that includes any relevant materials and records the Commission may require consistent with this Act. - s.5a - a board of trade may elect to operate as a Derivatives Transaction Execution Facility rather than a contract market if it met designation requirements which included - (a) establishing and enforcing trading rules that would deter abuses, provide market participants with impartial access to the markets and capture information that may be used in rule enforcement; (b) defining trading procedures to be used; and (c) Providing for the financial integrity of Derivatives Transaction Execution Facilities transactions.	are fit and proper carry out trading in derivatives. The yearly licensing requirement especially helps to weed out those who have previously taken part in risky or speculative behaviour. Further the requirement under US law that contract markets have to comply with the enforcement of rules and regulations further ensures speculative activity is curbed. Therefore the requirement of licences which are in turn subject to certain pre-requisites definitely addresses *Shariah* objection #3 which is the need to prevent *maisir*, *qimar* and *gharar*.

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			The Derivatives Transaction Execution Facility could trade futures and options on any commodity which was a nearly inexhaustible supply, was not susceptible to manipulation, or which did not have a cash market in commercial practice.	
3. Laws governing the regulating body	**Designation of regulating body to oversee functions of the boards of trade/ exchanges, enforce laws, etc.**	FSMA – s.1 - provided the framework for a single regulator to regulate the financial services industry- the Financial Services Authority The general functions of the Financial Services Authority are laid down in s.2(4) — (a) its function of making rules under the FSMA; (b) its function of preparing and issuing codes under the FSMA; (c) its functions in relation to the giving of general guidance; and (d) its function of determining the general policy and principles by reference to which it performs particular functions.	Commodities Exchange Act – s.2a (2) - provided for an independent agency of the United States Government- a Commodity Futures Trading Commission. Its functions include regulating commodity futures and option markets in the United States. The Commission's mission is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.(US Commodity Futures Trading Commission 2007).	Designating a regulating body to oversee derivative trading ensures adherence to laws, rules and regulation by the boards of exchange, and also the rules and regulation of the boards of trade and exchanges, by investors and others. Further constant control and monitoring on the overall activities of derivative trading will also be ensured by the designation of a regulating body. This minimises *gharar* and therefore indirectly addresses *Shariah* objections #2 and #3.
	Regulating body's emergency powers		Commodity Exchange Act -s.8a(9) - Commission had the power to direct a contract market, whenever it has reason to believe that an emergency exists, to take such action as in the Commission's judgment is necessary to maintain or restore orderly trading in or liquidation of any futures contract, including, but not limited to, the setting of temporary emergency	Further the emergency powers given to the regulating body allows immediate action to be taken by the regulating body to

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			margin levels on any futures contract, and the fixing of limits that may apply to a market position acquired in good faith prior to the effective date of the Commission's action. s. 9 - persons convicted of knowingly violating the Commodities Futures Trading Commission or exchange speculation limits would suffer a registration suspension and market bar for two years or such longer period as the Commission may determine.	promptly rectify and provide immediate remedies to any unforseen circumstances. The emergency powers could immediately stop any speculative activity or market manipulations from happening this would address *Shariah* objection #3. Also, through the investigative powers given to the regulating bodies any market manipulations, speculative buying and selling or other activities prohibited in *Shariah* can be monitored and stopped, if necessary. This would address *Shariah* objection #3. The powers of the regulating body are at the same time subject to review and therefore not absolute, ensuring a check and
	Regulating body's power to conduct regular investigations		Commodities Exchange Act –- s.8(a) For the efficient; execution of the provisions of this Act, and in order to provide information for the use of Congress, the Commission may make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to the provisions of this Act. The Commission may publish from time to time the results of any such investigation and such general statistical information gathered there from as it deems of interest to the public. -s. 16 . (a) - The Commission may conduct regular investigations of the markets for goods, articles,	

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			services, rights, and interests which are the subject of futures contracts, and furnish reports of the findings of these investigations to the public on a regular basis. These market reports shall, where appropriate, include information on the supply, demand, prices, and other conditions in the United States and other countries with respect to such goods, articles, services, rights, interests, and information respecting the futures markets.	balance in the system. Thus ensuring certainty, this would address Shariah objection #3.
4. Laws regulating Boards of trade/ exchanges	**Boards of trade /exchanges required to regulate derivative trade**		Commodities Exchange Act - s. 5 - for a board of trade to be designated as a contract market it shall ensure, *inter alia* – • Prevention of market manipulation. • Ensure fair and equitable trading by detection and enforcement of rules • Establish and enforce rules • Establish and enforce disciplinary procedures • Provide public access to the rules and regulations and contract specifications of the board of trade.	Under these laws, boards of trade/ exchanges are required to self-regulate derivative trade. Self-regulation ensures better monitoring over daily trading activity. With the existence of numerous boards of trade and exchanges it would be very difficult for a regulating body to oversee every aspect of derivative trading on a daily basis, it is therefore important to legislate

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			• Monitor and enforce compliance with the rules of the contract market	appropriate laws that ensure autonomy and the ability of self-regulation by boards of trade/exchanges. Indirectly these laws that enable boards of trades and exchanges to self regulate ensure *Shariah* objection #3 is addressed.
	Boards of trade /exchanges required to maintain records		Grain Futures Act - s.8 -required exchanges and their members to keep records and file reports, and authorized the Secretary of Agriculture to conduct investigations of exchange operation. Commodity Exchange Act -s.4g(2) - Every clearinghouse and contract market shall maintain daily trading records by rule. (3) Brokers and futures commission merchants shall maintain daily trading records for each customer in such manner and form as to be identifiable with the trades referred to in subsection (2). (4) Daily trading records shall be maintained in a form suitable to the Commission for such period as may be required by the Commission. Reports shall be made from the records maintained at such times and at such places and in such form as the Commission may prescribe by rule, order, or regulation in order to protect the public interest and the interest of persons trading in commodity futures. (5) Before the beginning of trading each day, the exchange shall, insofar as is practicable and under terms and conditions specified by the Commission, make public the volume of trading on each type of	Boards of trade/ exchanges, brokers and future commission merchants are to maintain records; these records are subject to scrutiny by a higher authority. Volume of derivative contracts traded is also available to the public to view. Through these records the regulating body is able to identify any abnormalities in derivative trade. These laws prevent uncertainty by ensuring transparency and symmetric distribution of information within the whole system thereby preventing *gharar*. *Shariah* objection #3 is thus addressed.

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			contract for the previous day and such other information as the Commission deems necessary in the public interest and prescribes by rule, order, or regulation.	
5. Laws regulating those who facilitate derivative trading	**Regulation of those who advise/ invest on behalf of others**		Commodities Exchange Act -s. 4n - commodity trading advisors and commodity pool operator required to be registered s.4n (4)(A) - commodity trading advisors and commodity pool operators required to maintain books and records, for a period of three years, or longer if the Commodity Futures Trading Commission so required, and these records was open to inspection by any representative of the Commission or the Department of Justice. - s.4o commodity trading advisors and commodity pool operators were guilty of an offence if they were guilty of false reporting, market manipulations, and negligent or reckless advice being given.	The regulation imposed on those who advise or invest on behalf of the investors ensures no improper practices occur. Fraud, false reporting, market manipulations, and negligent or reckless advice being given are prevented. The requirement to undergo training on ethical issues, and training on rules and regulations of the regulating body and the boards of trade /exchanges is a very useful tool which may include, in the case of Islamic finance training, issues of *gharar, maisir, qimar* and how to avoid them. These laws addresses *Shariah* objection #3
	Training of futures commission merchants, floor brokers and those associated to the above		Commodities Exchange Act – -s.4p(1) - The Commission may specify by rules and regulations appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable to insure the fitness of futures commission merchants, floor brokers, and those persons associated with futures	

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			commission merchants or floor brokers. In connection therewith, the Commission may prescribe by rules and regulations the adoption of written proficiency examinations to be given to applicants for registration as futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers, and the establishment of reasonable fees to be charged to such applicants to cover the administration of such examinations. - s.4p(b)- The Commission shall issue regulations to require new registrants, within six months after receiving such registration, to attend a training session, and all other registrants to attend periodic training sessions, to ensure that registrants understand their responsibilities to the public under this Act, including responsibilities to observe just and equitable principles of trade, any rule or regulation of the Commission, any rule of an appropriate contract market, registered futures association, or other self-regulatory organization, or any other applicable Federal or state law, rule or regulation.	
6. Laws on investor protection	**Punishing dishonest behaviour**	Financial Services Act 1986 - s.47 - any person who makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals any material facts; or recklessly makes	Commodities Exchange Act - - s.4b and s.4c- prohibited fictitious and fraudulent transactions – it was unlawful for any member of a contract market to, *inter alia*, cheat, defraud, falsely report, deceive or carry out fictitious sales.	These laws protect those investing in derivatives by punishing any dishonest or deceitful behaviour. Requiring a certain conduct and financial

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
		(dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence FMSA – s.118 – It was an offence to engage in market abuse, this involved, *inter alia*, behaviour based on information not generally available to the rest of the market; behaviour likely to give the regular market user a false or misleading impression; or that the regular user would be likely to regard the behaviour as behaviour which would distort the market	- ss.6(b) & (c) provided provisions to order any person to cease and desist from manipulating or attempting to manipulate the market price of any commodity, in interstate commerce, or for future delivery or has violated any of the provisions of the Commodities Exchange Act or the rules or regulations or orders of the Commodities Exchange Commission.	standing of investors, ensuring compensation where a counter party is unable to fulfil his/her obligations, by providing contract enforceability, and providing powers to restrict business of investors .The laws protect *bona fide* investors, and ensure certainty and stability of the derivative markets. This would address *Shariah* objection #3.
	Statements issued on the conduct and financial standing expected of persons	Financial Services Act 1986 – s.47A provides that the Secretary of State could issue statements of principle on the conduct and financial standing expected of persons authorized to carry on investment business. Section 47A further explains that the conduct expected may include 'compliance with a code or standard issued by another person'. Contravention of the standard of principle would amount to disciplinary action being taken against them s.47A(3).		
	Ensuring investor protection	Financial Services Act 1986 – s.54 provides that the Secretary of State may by rules,	Commodities Exchange Act - s.22(a) of the Commodity Exchange Act which provided for the	

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
		establish a scheme for compensating investors in cases where persons who have been authorised persons are unable to satisfy claims in respect of any description of civil liability incurred by them in connection with their investment business.	contract enforcement between eligible counter parties. A transaction between eligible contract persons was not to be unenforceable under Federal or state laws based solely on the failure of an agreement to comply with the terms or conditions of an exclusion from any of the provision of the Commodities Exchange Act or regulation of the Commission.	
	Powers to restrict business	Financial Services Act 1986 - s.65 - Secretary of State may prohibit an authorised person from- (a) entering into transactions of any specified kind or entering into them except in specified circumstances or to a specified extent; (b) soliciting business from persons of a specified kind or otherwise than from such persons or in a specified country or territory outside the United Kingdom; (c) carrying on business in a specified manner or otherwise than in a specified manner.		
7. Prohibitions	**Prohibiting option dealings and/or future contracts**	John Barnard's Act rendered null and void both options dealings and futures in public stock and securities	Commodity Exchange Act s.4c(B) banned trading in options in commodities.	Prohibiting option dealings could possibly address *Shariah* objection #4 since according to *Shariah* charging of fees for the mere right to buy or sell is not
	Wagers not recoverable at law	The Gaming Act 1845 - s. 18 - This section caused sales for future delivery where no	U.S state laws – prohibited transactions where there was no intention to deliver, and bucket shop	

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
		intention to deliver was present but settled by payment of differences, to be considered as void and unenforceable	transactions.	permissible. Also by making wagers unenforceable this directly addresses *Shariah* objection #3.
	Set-off/ ring settlement prohibited		Cotton Futures Act s. 10 - provided that delivery of cotton shall not be affected by "set-off" or "ring settlement', but only by the actual transfer of the specified cotton mentioned in the contract	Prohibiting a set-off or ring settlement addresses *Shariah* objection #2 and #1 since disallowing a set-off will ensure transfer of ownership and ensure a genuine sale takes place, respectively.
8. Penalties for violations	**Penalty imposed for violation of laws/rules/regulations**		Futures Trading Act - s. 10 - any person who shall fail to evidence futures transaction by a memorandum in writing, or keep the record, or make a report, or who fails to pay the tax, shall pay in addition to the tax a penalty equal to 50 per centum of the tax levied against him under the Act, and shall be guilty of a misdemeanour, and upon conviction thereof fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution. Commodities Exchange Act - s. 6b any board of trade, director, officer agent or employee of any board of trade who is violating or has violated any of the provisions of the Commodities Exchange Act or	Imposing and enforcing penalties in cases of breach of the laws, rules and regulations ensure compliance with the laws, rules and regulation. The hefty sum imposed in the event of a breach has a deterring effect on participants of the market. Therefore penalties in general address *Shariah* objections #1, #2, and #3 by ensuring compliance with the laws.

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			any of the rules and regulations of the Secretary of Agriculture would be guilty of a misdemeanour and fined not less than $500 nor more than $10, 000 or imprisoned for not less than six months nor more than one year, or both. Commodities Exchange Act - ss.6(b) and (c) included provisions to order any person to cease and desist where any person has violated any of the provisions of the Commodities Exchange Act or the rules or regulations or orders of the Commodities Exchange Commission. Failure to comply with such an order would cause such person to be guilty of a misdemeanour and liable on conviction to a fine of not less than $500 nor more than $10,000 or imprisonment of not less than six months nor more than one year or both. Commodity Exchange Act - s.9 - whereby persons convicted of knowingly violating the Commodities Futures Trading Commission or exchange speculation limits would suffer a registration suspension and market bar for two years or such longer period as the Commission may determine and criminal penalties in the event of breaching the provisions of the Commodity Exchange Act. The penalty was a sum of $1,000,000 (or $500,000 where	

Laws Grouped	Laws Specified	UK Laws	US Laws	*Shariah* Objections
			the person is an individual).	
	Penalty imposed on boards of trade/exchanges		Commodities Exchange Act – s.6(a) provides the Commodities Exchange Commission authorization to suspend for a period of six months or to revoke the designation as a contract market any board of trade which is found to have not enforced its rules.	

Appendix 10 Glossary

This Appendix lays down definitions and explanations of terms that are used throughout this thesis.

Conventional laws – laws that govern conventional finance from the jurisdiction of US and UK.

Conventional finance – finance used in business that does not include Islamic finance.

Derivative – a derivative instrument is a financial contract or asset that derives its value from the value of some other underlying asset (Bacha, 1999).

Forwards – The forward contract has been recorded as the first derivative instrument to be used and is also the simplest in form (Bacha 2001). A forward contract is where two parties undertake to complete a transaction at a future date but at a price which is determined today. A good example would be a farmer who anticipates his crop (maize) to be harvested in the near future and a consumer who is need of the maize in the near future as well. Both parties are faced with the possible risk that the price of the maize may decrease or increase respectively. Therefore to hedge their risk they enter into a forward contract to lock-in the price of the maize to be paid and delivered in the future. At this point there is no exchange of money or commodity.

The forward contract poses a number of problems such as the necessity that there is a multiple coincidence. A party to the forward contract must find another who has diametrically opposite needs to him; secondly since the forward price is arrived at by negotiation it may be forced on one of the parties who is in a better bargaining position compared to the other. Thirdly the counterparty risk or the risk by one of the parties to default (Bacha 2001). Thus the need for futures arose, a derivative which could solve all these problems.

Futures – A futures contract is basically a forward contract which is standardized with respect to contract size, maturity, product quality, place of delivery etc. Future contracts are traded on exchanges, where all buyers and sellers transact through the exchange. Since there are many buyers and sellers transacting through the exchange multiple coincidence will be solved (Bacha 2001). Further prices at the futures are considered to be fairer since the prices are arrived at by the interaction of many buyers and sellers and therefore there would not be a situation of prices forced upon by one party. As for counterparty risk this is solved by the exchange itself being the guarantor for each trade; by being the buyer to each seller and the seller to each buyer (Bacha 2001). The exchange also has to minimize the risk which it bears which is the potential default risk. This the exchange achieves by a process known as the margining process and marking to market. The exchange requires each party to deposit initial deposits known as initial margins and when losses occur it will require the party whose position is losing to pay up as the losses occur, known as margin calls. Marking to market means that the gain or loss in each contract position resulting from changes in the price of the futures (or option) contracts at the end of each trading day are added or subtracted to each account balance (Bacha 2001).

Another unique feature of the futures is the ability of the buyers and sellers to reverse out of their position before delivery or maturity. Therefore in commodity futures physical delivery hardly ever takes place, as compared to forward contracts where delivery does take place (Kamali 2007).

Hamish Jiddiyah **(security Deposit) -** *Hamish jiddiyah* is the total payment that is given by the buyer to the seller based on a request for payment by the seller to ensure commitment by the buyer under a transaction. If the buyer decides not to go ahead with the transaction after being binding on the parties, the seller can use the Hamish jiddiyah (deposit) as a payment of damages for the breach. In the event the *Hamish jiddiyah* is not sufficient to cover the breach the seller can claim the remaining from the buyer (al-muamalat.blogspot.com 2008).

Hedgers - Hedgers are those who use derivative markets to manage or reduce risk

Options - An option entitles the holder the right but not the obligation to buy (or sell) the underlying asset at a predetermined exercise price at or anytime before maturity. To acquire this right under an option a payment of a premium is required (Hull 2005).

There are three basic types of options, a call option, a put option and a double option. A call option provides the holder the right to buy, while a put option provides the holder the right to sell the underlying asset at a predetermined price (Hull 2005), and a double option provides the right either to buy from or sell to the grantor a specified underlying asset during a fixed period at a predetermined price (Kamali 1997).

In futures and forwards unless the holder reverses his position before maturity there will be an obligation to exercise the contract (pay the predetermined price or deliver the commodity), however at maturity for options no such obligation exists until the option holder decides to exercise the option. So in other words for an option holder inactivity will just cause the option contract to expire with the net result that the premium paid will be lost, however in a futures or forward contract inactivity will cause the holder to have to pay up or deliver the commodity.

Options are priced according to a number of methods (Black 1973; Cox 1979) the discussion of which is beyond the scope of this study.

Speculators - are those who expose themselves to risk in the market and hope to profit from their positions taken.

Swaps - A swap on the other hand is a contractual agreement in which two parties agree to exchange payments over a period of time based on a notional amount of the underlying asset (Rusinko & Matthews 1997). The rate at which the payments would be exchanged would be predetermined based on either a fixed amount or an amount based on a reference measure (Bacha 2001).

***Salam* -** The *bai-salam* (*bai* means contract) allows delivery of an asset at a predetermined future date where the price is paid in full today. *Bai-salam* can be compared to a forward contract except for the fact that in a *salam* contract only one party is deferring his obligation under the contract. Further in a *salam* contract the goods have to be defined and the date of delivery has to be fixed. The objects of this type of sale are mainly tangible things but exclude gold or silver. Barring these, *bai-salam* covers almost all things which are capable of being definitely described as to quantity, quality and workmanship. It should be noted that the parties cannot reserve their option of rescinding the contract, but the option of revoking it on account of a defect in the subject matter is allowed. Islamic banks also adopt it as a mode of financing (Rosly 2005).

Istisna **-** is another deferred sale contract, where the price is paid in installments as the work progresses in manufacturing or building an object. The *istisna* contract will provide specifications about the manufacturing which the manufacturer will undertake to manufacture (Thani, Mohamed Abdullah & Hassan 2003). Typically in an *istisna* the Islamic financial institution funds the manufacturer during the construction of the asset, acquires title to that asset on completion and either immediately passes title to the developer on agreed deferred payment terms or, possibly, leases the asset to the developer (Rosly 2005).

Istijrar - *Istijrar* contracts involves two parties the buyer which is usually a company seeking financing to purchase an underlying asset and a financial institution. The Financial institution buys the commodity at the prevailing price and resells it to the company at a price to be paid at a specified date in the future. The actual price at that date depends on the underlying assets' price movement from the day of the contract initiation to the day of maturity. There is also embedded an upper bound option and a lower bound option for the parties to choose to fix the price at which settlement will occur at any time before contract maturity (Bacha 1999)**.**

Ja'alah **-** The *ja'alah* contract can be defined as an open promise by one party to pay whoever performs a particular task a named reward (the *jul*). The party who undertakes to pay a reward or the principal is called the *ja' eel* whereas the party who is required to perform the act or agent is called the *maj'uul* (Kunhibava 2006).

Urbun **-** The legality of *Bai al-urbun* is still unsettled. The *Hanbali* School considers *Bai al-urbun* as a legal contract, but the other schools object to it and find it an invalid contract, firstly because it is considered to be akin to misappropriating the property of others and secondly it involves an unknown option or condition, which amount to *gharar* (Al-Amine 2000)[138]. But a number of contemporary scholars have proposed its use as an Islamic derivative. For example (Al-Amine 2000), and (Kamali 2002).

138 The source of the difference lies in the authenticity of two *hadiths*. The majority rely on a *hadith* reported by Imam Malik in al-Muwatta as well as by Imam Ahmad, al-Nasai Abu Dawud and Ibn Maja to the

Bai al-urbun is a sale in which the buyer deposits earnest money with the seller as part payment of the price in advance and agrees that if he does not continue with the contract he will forfeit the deposit money which the seller can keep. If the buyer, after some time, decides to go ahead with the transaction, the payment is adjusted for the initial deposit. As can be seen *bai al-urbun* is similar to a call option. Except that in the call option the down payment is not subtracted from the contract price and secondly in the case of the *bai al-urbun* the future price is known at the day of the contract agreement (Obaidullah 2001).

effect that the Prophet (PBUH) prohibited the sale of urbun. However the *hadith* is considered to be weak. The Hanbali school relied on a *hadith* reported by Abd al-Razak to the effect that the Prophet was asked about urbun sale and he declared it permissible. But this *hadith* is also declared to be weak (Al-Amine 2000).