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Forward Contracts—Prohibitions on Risk and Speculation Under Islamic Law

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ABSTRACT

Forward contracts allow buyers and sellers of goods to reduce risk by contracting for sale at a predetermined price and quantity prior to the actual exchange of goods and payment. While forward contracts are extensively used in the Western world without restriction, those who adhere to Islamic law are often constrained by principles intended to reduce risk, gambling, and usury. These principles can prove overly restrictive; however, Islamic law restrictions also illuminate the problems associated with the overly permissive Western system in which speculators contract in a manner tantamount to gambling—a problem associated with the recent financial crisis. This Note discusses forward contracts representing risk-hedging and pure speculation and then addresses the principles of Islamic law that affect these financial instruments. The Note next explains the forward contracts that are permissible under Islamic law and poses two questions: (1) How important are the motives of the parties involved in the contract? (2) Is there something that the requirements of Islamic law can teach those who do not subscribe to the religion? These questions are answered and conclusions are drawn concerning the permissibility of hedger-hedger forward contracts under Islamic law and whether Islamic law is overly restrictive in its treatment of these, concluding that no reasonable interpretation of Islamic law could deem a purely speculative forward contract as permissible.
Do not buy fish in the sea, for it is gharar. The Prophet forbade sale of what is in the wombs, sale of the contents of the udders, sale of a slave when he is runaway . . . . The Messenger of God forbade the sale of the copulation of the stallion . . . . He who purchases food shall not sell it until he [measures] it.

Frank E. Vogel & Samuel L. Hayes, III, Islamic Law and Finance: Religion, Risk, and Return

INTRODUCTION

Contracts for the sale of goods that do not exist or are not deliverable at the time of contract are an important part of the world economy. These types of sales, known as forward contracts, happen every day, in every corner of the world, and have served an important economic function since ancient times. Despite the somewhat counterintuitive nature of purchasing goods that one cannot immediately take possession of—an action that seems inherently risky—the sale of goods that do not yet exist can actually decrease risk for the buyer and producer by allowing both parties to “hedge their bets” through mutual agreement.

At first glance, hadiths, like those above, give the impression that forward contracts are banned completely under Islamic law. Although an oversimplification, the fundamental problem with the forward contract is the inherent gharar (risk or uncertainty) that is involved in the transaction. In more extreme cases a contract might be determined to be maysir (gambling) and is certainly forbidden by Islamic law.

Although the principles of gharar and maysir heavily influence Islamic financial instruments and transactions, Islam does not mandate a universal ban on all forward contracts. Indeed, it would pose enormous difficulties for the world economy if a financial system that includes 275 institutions operating in over 50 countries refused to deal at all in forward contracts. Even more significant for the global economy is the fact that there are 1.57 billion Muslims, 23% of the world’s population, who presumably adhere to Islamic legal principles while conducting their financial transactions.

This Note will explore Islamic legal principles that either prohibit or modify many forward contracts that the Western world takes for

FORWARD CONTRACTS

It will explore the different elements that make a forward contract either permissible or forbidden, and how these elements depend on one another for a structure that allows transactions that, on their face, should theoretically be forbidden.

In exploring these issues, this Note will explain how those who follow Islamic law function in a world economy that relies on forward contracts of all varieties, and how individuals and institutions compliant with Islamic law function within such restrictions. This Note will also address the limits of Islamic law in allowing certain forward contracts where the parties' motivation is not the traditional purpose of a forward contract.

It is also the goal of this Note to answer two questions. First, just how important are the motives of the parties involved in the contract? Second, is there something that the requirements of Islamic law can teach those who do not subscribe to the religion? This latter question will be explored in the context of purely speculative derivatives (PSDs), a type of contract where neither party is hedging a pre-existing risk and a contract that, in many ways, is tantamount to gambling—a practice that, arguably, made a significant contribution to the recent financial crisis.6

This Note will begin with a brief discussion of a standard, “Western-style” forward contract, followed by an example and explanation of a purely speculative forward contract. It will then address the principles of Islamic law that affect these financial instruments, namely gharar (risk or uncertainty); maysir (gambling or games of chance); and riba (usury). Following the examination of these three principles, this Note will explain the two types of permissible Islamic forward contracts and the ways in which Muslims and Islamic financial institutions navigate the principles of gharar, maysir, and riba to ensure that an instrument or transaction is not forbidden. Finally, this Note will provide answers

2. Hadiths are stories or lessons attributed to Mohammed. They form an important part of Islamic law; one that is subject to interpretation and can be questioned as to its legitimacy but only on the grounds that the chain of those transmitting the hadith is suspect. See, e.g., S. E. Rayner, THE THEORY OF CONTRACTS IN ISLAMIC LAW 1-15 (1991).

3. Contracts like these are not forbidden or subject to gambling laws in America or many other countries. For an analysis of purely speculative contracts and an argument for why they should be subject to gambling law, see Timothy E. Lynch, Gambling by Another Name? The Challenge of Purely Speculative Derivatives, 17 STAN. J.L. BUS. & FIN. 69 [hereinafter Gambling by Another Name?].


6. See generally Gambling by Another Name?, supra note 3.
to the two questions posed above and draw the following conclusions: (1) although Islamic law allows hedger-hedger\textsuperscript{7} forward contracts, the law is overly restrictive in its treatment; and (2) no reasonable interpretation of Islamic law could conclude that a purely speculative forward contract is permissible.

I. THE FORWARD CONTRACT

A basic forward contract might take the following form:

[A] wheat farmer has the risk that the spot price of wheat will decrease by the time [his] wheat is ready to be harvested and sold. Correspondingly, a flour mill owner has the risk that the spot price of wheat will increase by the time he is ready to purchase and consume the wheat. By entering into a forward contract at a pre-determined price on an amount of wheat the farmer is certain to harvest and the mill owner is certain to want to purchase, both the wheat farmer and the flour mill have effectively hedged against the possibility that the wheat spot price will move against them.\textsuperscript{8}

This is an excellent example because wheat is a fungible commodity—an essential element in an Islamic forward contract—and if certain other criteria were met, the above example would be allowed under Islamic law.\textsuperscript{9} Furthermore, this is a “hedger-hedger” contract in which both parties are attempting to hedge risks, thus serving a purpose beyond simple profit.\textsuperscript{10} This additional utility of risk hedging is important, and the recognition of this utility is presumably one of the reasons Islamic jurisprudence allows for certain forward contracts.\textsuperscript{11}

\textsuperscript{7} See Gambling by Another Name?, supra note 3, at 77 (“Hedger-hedger derivatives contracts are contracts in which the counterparties each have an equal and opposite risk to the other’s and they hedge their respective risks by contracting, each eliminating his own pre-existing risk without incurring additional, or speculative, risk in the process.”).

\textsuperscript{8} Id. at 11.

\textsuperscript{9} See RAYNER, supra note 2, at 134-35 (discussing the fact that unique, i.e. non-fungible, items do not comply with the specificity requirement of salam (forward contract) sales).

\textsuperscript{10} See generally Gambling by Another Name?, supra note 3, at 77 for a discussion of hedger-hedger contracts.

\textsuperscript{11} See, e.g., RAYNER, supra note 2, at 74 (discussing the retention and Islamization of pre-Islamic contract models and the application of Ijmâ‘, Qiyaṣ, and Istisâdāb); NABIL A. SALEH, UNLAWFUL GAIN AND LEGITIMATE PROFIT IN ISLAMIC LAW: RIBA, GHARAR, AND
These considerations will be addressed in greater detail in the following sections dealing with the forms of forward contracts allowed under Islamic law.

In a broader sense, a forward contract is a derivative: a family of "financial instrument[s] whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity ...." The world of derivatives is diverse and complicated; it includes financial instruments and transactions such as options, swaps, futures, and a myriad of other transactions. This Note, however, will only be exploring forward contracts, or futures and PSDs of the forward contract variety—a set of circumstances surrounding forward contracts that will be discussed in the next section.

A forward contract can be an excellent tool for hedging risks. Although there is a potential for unexpected loss or gain (the gharar aspect of the transaction), forward contracts are useful and generally serve both parties by guaranteeing that the producer receives a certain amount of payment for what he is supplying and that the buyer receives the goods he desires at a price he is willing to pay.

This Note focuses on two types of forward contracts: (1) a forward contract involving commodities where the two parties are hedging a risk; and (2) a PSD forward contract involving commodities where both parties are not hedging a risk but are simply speculators. This is a useful comparison, as these two scenarios, despite the fact that they are the same instrument, ostensibly represent the extreme ends of a spectrum of reasons for using forward contracts.

II. THE PURELY SPECULATIVE DERIVATIVE

A purely speculative derivative (PSD) can take many forms; it could be a forward contract or any other type of derivative. The bottom line with a PSD is that it is purely speculative, and the parties to the

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12. BLACK'S LAW DICTIONARY 475 (9th ed. 2004).
14. This Note will use the term "forward contract" as a reference to both forward contracts and futures contracts. A futures contract is simply a type of forward contract that is traded on an organized exchange and is subject to exchange rules and clearing procedures. See DON M. CHANCE & ROBERT BROOKS, AN INTRODUCTION TO DERIVATIVES AND RISK MANAGEMENT 252 (7th ed. 2007).
15. See generally Gambling by Another Name?, supra note 3.
16. See generally id.
contract are not hedging a pre-existing risk, but are instead simply engaging in the PSD for financial gain.17

PSDs go well beyond the typical forward contract in that they contain enough gharar (risk or uncertainty) to essentially amount to maysir (gambling). The unavoidable risk that is inherent in any forward contract between two parties hedging their bets is actually actively sought by the parties to a PSD. The gharar in a PSD is not an unfortunate consequence of the transaction, it is the focus of the transaction.

The following is an example of a PSD contract concerning the price of oil:

We can easily illustrate the development of a purely speculative derivatives contract using the price of oil, a commodity commonly traded on contemporary derivatives exchanges. One speculator may predict that brewing tension in the Middle East will escalate, limiting oil production and forcing a steep increase in world oil prices. Seeking to invest in oil without having to actually own (and store) oil, this speculator can invest in oil futures in which he buys future oil at a fixed price, a price which—based on his prediction—will be lower than the market price of oil at the expiration date of the futures contract. This speculator would get the most favorable contract terms from a speculator who predicts that the tension in the Middle East has not only artificially increased the price of oil but will soon de-escalate resulting in lower prices. These two parties, because they have heterogeneous expectations, should be able to negotiate an oil futures contract on terms acceptable to both.18

In this example, it is not true that one party is producing the oil while the other party is depending on receiving the oil for sale or use; instead, neither party ever intends on actually possessing the oil at all. The two parties will benefit based on their speculation (the accuracy of their predictions), with one party winning and the other party losing. The profit to be gained will simply be derived from the final price of the commodity, which determines the value of the contract.

17. See generally id.
18. Id. at 83.
The first speculator will win if his predictions are correct because he purchased the futures contract at a lower price than what it will be worth once violence in the Middle East escalates and the price of oil increases. In contrast, the second speculator will win if his predictions are true, because he sold at a higher price than what the futures contract will be worth once the violence in the Middle East de-escalates and the price of oil drops.

At this point, similarities between such purely speculative forward contracts and gambling are already apparent. Much like betting on a sports team, those involved in the transaction may have reasons to believe that one team will prevail over another, but an outcome cannot be guaranteed. Therefore, when relying on a factor such as "violence in the Middle East," the outcome is arguably even more difficult to speculate on.

III. ISLAMIC LEGAL PRINCIPLES

The principles of gharar, maysir, and riba have a significant impact on Islamic finance. Gharar (risk or uncertainty) affects contracts of all kinds, from sales contracts to life insurance policies. Similarly, the prohibition on maysir (gambling and games of chance) can prevent certain financial activity that is deemed too similar to gambling to be considered a legitimate transaction. Finally, riba (usury) provides the basis for Islam's ban on interest on loans and for its ban on any illegitimate or exploitive gain that a party might derive from a transaction. These three principles are complex and the extent of their application is often disputed. This Note will outline these principles to the extent that they pertain to forward contracts.

A. Gharar (risk or uncertainty)

The Qur'an never mentions gharar specifically. However, maysir (gambling and games of chance) is banned in the Qur'an, which would lead one to automatically deem gharar suspect. Gharar is mentioned numerous times in hadiths in the form of various hypotheticals and

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19. Recall that a futures contract is simply a type of forward contract.
20. See generally Vogel & Hayes, supra note 1
22. Saleh, supra note 11, at 121.
examples from Mohammed's life.\textsuperscript{23} There have been numerous attempts to give a concise definition of the term gharar.\textsuperscript{24} One Islamic law scholar recommends the observance of three rules when attempting to understand and avoid gharar in a transaction:

1. There should be no want of knowledge . . . regarding the existence of the exchanged countervalues.

2. There should be no want of knowledge . . . regarding the characteristics of the exchanged countervalues or the identification of their species or knowledge of their quantities or of the date of future performance, if any.

3. Control of the parties over the exchanged countervalues should be effective.\textsuperscript{25}

The aversion to risk that is attributed to Mohammed makes sense. Because Mohammed was a merchant and experienced in trade, it would have been quite evident to him the various ways one party to a transaction could take advantage of another party with less knowledge or bargaining power.\textsuperscript{26} The goal of preventing the exploitation of one party by another "led to the elaboration of a rule of general application, commanding that any transaction should be devoid of uncertainty and speculation . . ."\textsuperscript{27}

Despite this prohibition against uncertainty, there is an inherent, unavoidable amount of risk or uncertainty present in every sale or transaction.\textsuperscript{28} As a result, over the centuries, Islamic law has adapted to the demands of the marketplace, attempting both to facilitate trade and to simultaneously subject transactions to tests that demand certain criteria be met.\textsuperscript{29}

\begin{itemize}
    \item \textsuperscript{23} See, \textit{e.g.}, \textit{id.} at 49 (relating a story from Mohammed's time about a Bedouin tribesman being taken advantage of by a townsman who purchased the tribesman's goods at a lower than market price).
    \item \textsuperscript{24} See \textit{id.} at 50-52.
    \item \textsuperscript{25} \textit{Id.} at 52. This definition is Nabil A. Saleh's creation based on his analysis of a number of Islamic scholars' attempts to define \textit{gharar}. Also, please note that Saleh's use of the term \textit{jahl} (want of knowledge) in his definition has been omitted, as including the Arabic term for this concept is not important for the purposes of this Note.
    \item \textsuperscript{26} See \textit{id.} at 49.
    \item \textsuperscript{27} \textit{Id.}
    \item \textsuperscript{28} See, \textit{e.g.}, \textit{id.} at 50.
    \item \textsuperscript{29} See, \textit{e.g.}, \textit{id.}
\end{itemize}
B. Maysir (gambling and games of chance)

The Qu'ran explicitly forbids gambling: "O you who believe, intoxicants, and gambling, and the altars of idols, and the games of chance are abominations of the devil; you shall avoid them, that you may succeed." Similarly, the Qur'an also states, "[t]he devil wants to provoke animosity and hatred among you through intoxicants and gambling, and to distract you from remembering God, and from observing the Contact Prayers (Salat). Will you then refrain?"

In relation to the sale of goods, hadiths have been variously interpreted to refer both to maysir and to gharar because they forbid the sale of "the stroke of the diver" (i.e. anything a diver may return with after a dive), of unexamined goods a buyer touches (a game played by merchants in Mohammed's time), and of the sale of goods determined by the throwing of a rock (another game). The similarities between gambling and these pre-Islamic game-sales are clear; the buyer will be forced to purchase, and the seller forced to sell, something of an unknown value.

C. Riba (Usury)

Riba is not simply "the prohibition of interest on credit . . . in Islamic law it is much more far-reaching." For the purposes of this Note, only a brief discussion of riba is necessary, but this brief look at riba and its relation to the sale of goods is important for understanding the role gharar (risk or uncertainty) plays in Islamic contract.

It is reported in a hadith that Mohammed said, "[p]rofit accompanies liability for loss (al-kharaj bi-l-daman)." Thus, "one may reap the profits (al-kharaj) from possession of property only if one also bears the risks of its loss (al-daman)." Clearly there exists an essential link between risk and lawful gain under Islamic law. Interest on loans is forbidden because the lender is guaranteed his principal in return, plus additional guaranteed profit. Theoretically, there is no risk

30. Qur'an 5:90.
32. See, e.g., Vogel & Hayes, supra note 1, at 88-89.
33. Id.
35. See id. at 48 (citing to Abu Dawud, Tirmidhi, Nasa'I, and Ibn Maja for this hadith).
36. Id.
involved here, and this lack of risk makes any profit the lender will gain unlawful—he is only entitled to the repayment of his principal.\textsuperscript{37}

Similarly, the sale of a fungible good for another fungible good is prohibited under Islamic law; there is a perceived lack of risk, and the main concern is with the chance that \textit{riba} (usury) may be present. The use of wheat to purchase an equal amount of wheat in the future is prohibited under Islamic law because the seller is guaranteed the same amount of wheat back on the future date set in the contract.\textsuperscript{38} This is why Islamic law requires money to be used when purchasing fungible items. The idea here is to avoid \textit{riba} and actually \textit{create} risk to justify potential profit—the risk being that the spot price of wheat will increase or decrease.\textsuperscript{39} This brings us back to the original example of a forward contract involving the wheat farmer and flour mill owner. The farmer bears the risk that the spot price of wheat will go up and he will have sold too low, and the mill owner bears the risk that the spot price of wheat will decrease and he will have purchased too high.

IV. THE ISLAMIC FORWARD CONTRACT—GENERAL PRINCIPLES

"A man asked me to sell him something that I did not have; Should I go and buy it from the market?" The Prophet replied: "Do not sell what you do not have."

S. E. Rayner, \textit{The Theory of Contracts in Islamic Law}\textsuperscript{40}

On its face, it appears from the hadith above that Islamic law would prohibit the forward sale of goods, because the seller is dealing in goods that he does not immediately possess.\textsuperscript{41} However, "\textit{salam} was admitted by [Islamic law] on the ground of a tradition attributed to the Prophet

\textsuperscript{37} Vogel & Hayes, supra note 1, at 84.
\textsuperscript{38} Id. at 85. Careful readers might notice that the wheat in this scenario seems like a "loan" of wheat. If there is no extra "interest" wheat provided, why would this transaction not be a valid transaction? The answer appears to lie in the distinction made by Islamic law between fungible goods and currency. The logic is that money should not be treated as if it were a commodity. Things like wheat are essential to human existence and will be consumed, whereas money may be saved or spent and still retain value. Based on this reasoning, wheat for wheat gives the seller an unfair guarantee of a consumable commodity in the future; whereas, the guarantee of repayment to a lender simply puts him back in his original position as if he had never lent the money—a position that is not considered advantaged. See \textit{id.} at 82-86, for commentary on this and the logic behind this conclusion.
\textsuperscript{39} Id. at 85.
\textsuperscript{40} Rayner, \textit{supra} note 2, at 133 (citing Abū Dāwūd al-Sijistānī, \textit{al-Sunan}, (Cairo n.d.) 4 Vols; III, no. 3503).
himself and on the ground of consensus . . . and because it responds to public needs." Yet, this exception is by no means a green light for any type of forward contract.

One of the key elements of a permissible forward contract under Islamic law is specificity. When a forward contract is made for goods, the goods must exist or be guaranteed to exist. However, if the object of the contract is the promise that an item will be delivered or manufactured, then it is not necessary that the item exist at the time the contract is made. Regardless, the goods being sold must be fungible (unless it is an *istiṣnā* contract, described below); and the quality, quantity, and other defining characteristics of the goods must be described in detail. Furthermore, payment must be made by the buyer immediately at the closing of the contract and the delivery of the goods must be specified for a certain future date and location.

While there are differences among Islamic religious schools about the various requirements of an Islamic forward contract—some differences are significant, while others are minute—there are also common, consistent rules among the schools. Before addressing the common rules necessary for the purpose of this Note, it is important to explain the basics of the two types of forward contracts that are permissible under classical Islamic law.

A. *Bay' salam*

The salam contract provides for the promise of future delivery of fungible goods; it is "the sale of a thing which will be delivered to the purchaser on a future date. That future date must be set at the time of the contract." Furthermore, payment must occur at the execution of the contract for delivery of the fungible goods. This stipulation is in direct contrast with most forward contracts where payment is due at the

42. *Id.* *See also* Rayner, *supra* note 2, at 133 (explaining that salam is a type of forward sale under Islamic law).  
43. *See* Rayner, *supra* note 2, at 133.  
44. *See, e.g., id.* at 134.  
45. *See, e.g., id.* at 71-76; *see also* Vogel & Hayes, *supra* note 1, at 122 (one of many sources to discuss the al-kali' maxim forbidding the sale of "delay for delay," something that is universally banned by Islamic law, hence the requirement of immediate payment by the buyer).  
46. For a detailed look at the Hanafi, Shafii, Maliki, Hanbali and Ibadi schools and their criteria for a valid forward contract, *see* Sālēh, *supra* note 11, at 71-76.  
47. *See* Rayner, *supra* note 2, at 133.  
48. *Id.* at 134.  
49. *See, e.g.,* Vogel & Hayes, *supra* note 1, at 220.
end of the fixed period stipulated by the contract—not immediately.\textsuperscript{50} Indeed, it is a fundamental element of any Islamic contract that the price of a good be fixed and not subject to any market fluctuation that could alter the value of the contract.\textsuperscript{51}

This requirement of immediate payment has several negative consequences for the buyer. By requiring immediate payment, the salam contract exposes the buyer to the risk that the seller will not perform by delivering the goods.\textsuperscript{52} Despite the fact that the goods being sold are subject to a strict level of specificity, the seller has some control over what he actually delivers. For instance, if the contract is for one hundred bushels of Red Fife wheat and the seller has two hundred bushels, one hundred of which have been sitting in a barn and the other one hundred freshly harvested, he could choose to deliver the older of the two.\textsuperscript{53} This slight variation would not, on its face, violate the specificity requirements. Additionally under Islamic law, the seller has a certain amount of leeway as to when he actually delivers.\textsuperscript{54} This creates additional uncertainty for the buyer. Depending on the rules of the Islamic school being followed, the buyer will generally be required to accept an early or late delivery.\textsuperscript{55} Despite the specificity requirements of Islamic law, there is a certain amount of “good will” flexibility that is demanded when executing a salam contract.

With regard to the necessary level of specificity of the goods being sold, we return to the sale of crops to elucidate the standard under Islamic law. As stated previously, the goods being sold must be fungible, and the quality, quantity, and other defining characteristics of the goods must be described in detail. Specificity is required, but there is a point at which a salam contract might be too specific. It is important to note that while hadiths allow salam contracts in which one pays in advance for a specified amount of crop, they “also forbid a salam contract tied to the crop of a particular field.”\textsuperscript{56} The key distinction here is the linkage to a particular field. Logically, there is more risk in a promise that a certain field may provide the crop than the promise that the crop is simply provided. This rule must be applied to any particular source, such as a specific tree, mine, or oil well.

\textsuperscript{50} See, e.g., id. at 223.
\textsuperscript{51} Id. at 225-26.
\textsuperscript{52} Id. at 223.
\textsuperscript{53} See id.
\textsuperscript{54} See, e.g., id.
\textsuperscript{55} See, e.g., id. at 146, 223. For examples of the requirement of acceptance of early delivery, see SALEH, supra note 11, at 72-76.
\textsuperscript{56} VOGEL & HAYES, supra note 1, at 89.
The last important aspect of a salam contract is the “parallel” or “back-to-back” salam.\textsuperscript{57} Although not always required in conjunction with a salam contract, a parallel salam contract is often used to ensure that there is no riba present in the transaction (from fluctuation in spot price), and to prevent hoarding—a practice also prohibited by Islamic law.\textsuperscript{58}

The parallel salam contract is also used because the buyer in the salam contract cannot sell the expected goods before actually taking possession of them—he cannot sell the contract (i.e., the rights to the goods). What the original buyer can do, however, is find an Islamic financial institution, generally a bank, that will enter into a parallel salam contract with a third-party buyer. This contract must be identical to the original salam contract and must be made before the seller is due to deliver the goods.\textsuperscript{59}

The parallel salam contract serves some of the risk-hedging purposes that a typical Western forward contract serves; however, its usefulness in this regard is limited.\textsuperscript{60} By arranging a parallel salam contract, if original buyer expects the price of the goods he is purchasing to drop, if the price is already decreasing, or if he decides that he does not need as much of the commodity as previously thought he can prevent further loss by selling the goods to a third party through an Islamic financial institution. The original buyer will still lose money, but he will “have executed a stop-loss ‘short’ transaction to prevent any further loss.”\textsuperscript{61}

B. \textit{Istīṣnā}

\textit{Istīṣnā} contracts are for the manufacture of goods and therefore not bound by the fungibility requirement to which salam contracts must conform.\textsuperscript{62} These contracts can be formed to sell different types of goods, from t-shirts to airplanes—items that, although mass produced, are unique with respect to size, brand, material, color, or some other attribute. The key element is that the goods to be delivered may vary in

\textsuperscript{57} For an overview of the mechanics of the parallel salam and parallel istīṣnā contracts, and two helpful diagrams, see ELISABETH JACKSON-MOORE, THE INTERNATIONAL HANDBOOK OF ISLAMIC BANKING AND FINANCE 41-46 (2009) (taking standards from the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), specifically: AAOIFI Shari'a Standard No. 10 and AAOIFI Shari'a Standard No. 11).

\textsuperscript{58} See QUR’AN 104:1-4.

\textsuperscript{59} VOGEL & HAYES, supra note 1, at 146.

\textsuperscript{60} See generally id. at 246-52.

\textsuperscript{61} Id. at 249-50 (emphasis added).

\textsuperscript{62} See, e.g., id. at 220.
some respect from a comparable item. A producer growing Red Fife wheat will presumably provide the same wheat as another producer growing Red Fife wheat, however, one blue jeans manufacturer will not manufacture the exact same pair of blue jeans as another manufacturer.

The main function of an istisnā contract is to finance manufacturing or production. Aside from the lack of a requirement that the goods be fungible, an istisnā contract is essentially identical to a salam contract in its requirements, in its restrictions, and in the obligations it imposes on the two parties. Parallel istisnā contracts exist and are used in the same manner as parallel salam contracts.

V. WHAT IS PERMISSIBLE IN ISLAMIC LAW—RESTRICTION AND MOTIVATION IN HEDGER-HEDGER FORWARD CONTRACTS

The Messenger of God forbade the "sale of the pebble" [hasah], sale of an object chosen or determined by the throwing of a pebble, and the sale of gharar.

Frank E. Vogel & Samuel L. Hayes, III, Islamic Law and Finance: Religion, Risk, and Return

This Section will explain the reasoning behind the first conclusion mentioned in the Introduction: that Islamic law allows hedger-hedger contracts but is overly restrictive. It will also answer the first question posed in the Introduction, which asks just how important are the motives of the parties involved in the contract. It appears, at least in terms of forward contracts for goods, that Islamic law has found a way to meet most of the goals of such transactions. Through the mechanisms of the salam and istisnā contracts, the risk between the two parties is created at, or reduced to, a level that is considered acceptable under Islamic law.

As previously mentioned, there is a spectrum of risk within derivatives, with a hedger-hedger forward contract being at the safest end and a speculator-speculator forward contract, or PSD, being at the riskiest end. Hadiths dealing with gharar create certain restrictions,
not to avoid risk per se, but to ensure: (1) knowledge of all aspects of the sale, and (2) the existence of a concrete, saleable object.\textsuperscript{67} The risk related to a contract cannot be considered as "merely one factor affecting price,"\textsuperscript{68} which is the way risk is treated in the "modern custom."\textsuperscript{69}

When evaluating whether a forward contract is valid under Islamic law in terms of gharar, two questions that must be considered are: (1) does the object of sale exist concretely?; and (2) is there a lack of knowledge of any "material aspect of the transaction"?\textsuperscript{70} Furthermore, as demonstrated in the section on Islamic forward contracts, payment must be made immediately, and a time and place for delivery must be specified in the contract. As opposed to Western forward contracts that allow people to engage in risky and uncertain contracts, Islamic law takes a more paternalistic approach and proscribes safer contracts. This has the effect of both protecting followers of Islam but also restricting their freedom to contract.\textsuperscript{71} This limitation on the freedom to contract is the overly restrictive aspect of Islamic law; there may be a better way of approaching forward contracts.

In determining when an unacceptable level of gharar has been reached, it is probably more useful to approach the question not in terms of small details (such as, whether a nut is inside or outside of its shell),\textsuperscript{72} but also in terms of drawing a line between reasonable gharar and prohibited maysir. In other words, in the context of contracts—when does risk taking become gambling?

According to Ibn Taymiyya of the Hanbali school, the most common interpretations of gharar are overly restrictive.\textsuperscript{73} The focus of other scholars in associating gharar with a test of ignorance and nonexistence as the defining criteria for allowing or disallowing a contract takes

\begin{footnotes}
67. \textit{Id.} at 89-90 (noting that in certain hadiths "incurring commercial risks—those of the market or supply and demand—is ... approved and even encouraged").

68. \textit{Id.} at 90.

69. \textit{Id.} (citing \textsc{Richard A. Posner, The Economic Analysis of Law} 12, 102-109 (1992)). In this context the authors' reference to "modern custom" within Islam is synonymous with "Western custom."

70. \textit{Id.} at 91; SALEH, supra note 11, at 52. Saleh lists a third element to consider when determining whether gharar will potentially invalidate a transaction. His first two items correspond to the two given above, his third is mentioned under the section of this Note dealing with gharar and involves effective control over the exchanged countervalues; something that, depending on the Islamic school, is not always considered, but could invalidate a contract depending on one's interpretation of the relevant hadith.

71. \textit{See Vogel & Hayes, supra note 1, at 92.}

72. \textsc{Saleh, supra note 11, at 60} (discussing different schools' limitations on contracts, including the extreme Shafi'i ban on the "sale of fruits or other agricultural products still in their natural external envelope such as nuts in the shell").

73. \textit{Vogel & Hayes, supra note 1, at 92-93. Ibn Taymiyya lived during the thirteenth and fourteenth Centuries CE. See id.}
\end{footnotes}
gharar away from its original meaning of risk or uncertainty. Ibn Taymiyya advocated the approach that gharar should be viewed on a spectrum, and those who know what they are committing to should be allowed to do so. Taymiyya defined gharar as that which "hesitates between soundness and destruction." The emphasis here is on the distinction between a sound decision, which recognizes risk and factors it into the decision-making process, and reckless or destructive behavior.

If one combines the hadiths dealing with gharar with the Qur'an's ban on maysir as a starting point, then one can easily connect Islamic law restrictions to the restrictions on gambling in most modern societies. The immorality and social harms that many societies feel stem from gambling create a starting point that allows for a more permissive stance on informed risk taking. If these social harms can be avoided, why not allow a certain degree of risk taking, and avoid focusing so heavily on black and white criteria that can invalidate an otherwise useful contract? Indeed, Taymiyya's views are more conducive to facilitating many modern financial transactions and are "frequently relied on by modern scholars of Islamic banking and finance." Taymiyya represents "Position B" on the following table; however, many classical scholars adopt "Position A."

Table 1. Classical and Suggested Approaches to Gharar in Forward Contracts

<table>
<thead>
<tr>
<th>Scope for valid consent (taradin)?</th>
<th>Gharar vs. Maysir</th>
<th>Evils to avoid?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Position A</td>
<td>Restrictive</td>
<td>Gharar dominant</td>
</tr>
<tr>
<td>Position B</td>
<td>Broad</td>
<td>Maysir dominant</td>
</tr>
</tbody>
</table>


74. See id.
75. See id.
76. Id. at 92-93.
77. Id. at 90.
78. See id. at 90-91.
79. Id. at 93.
80. Id. at 90-93.
This suggested approach to gharar and forward contracts moves away from small technicalities built within other approaches, and focuses more on the motivation of the parties and the social harm that may or may not be caused by the transaction. Applying Islamic law in this fashion would allow more flexible forward contracts and would allow risk to be factored into the price. Indeed, if a certain amount of risk is required in order to avoid riba and produce lawful gain, then why not reward parties by allowing them, for instance, to trade in fungibles? Furthermore, the negative consequences for the buyer, produced by requiring him to tender immediate payment, can be eliminated if the criteria for a valid contract turned on the soundness of the parties' reasoning and not on simple black-and-white distinctions.

The overly restrictive nature of Islamic law has further ramifications for those who may want to hedge risks. Based on the rules discussed in this Note, Islamic law would clearly prohibit the sale of other derivatives that might be beneficially used to mitigate economic damage to an individual. Although beyond the scope of this Note, weather derivatives, for example, would not be allowed under standard Islamic law rules dealing with contract. By returning to the example of a wheat farmer looking to hedge risk, we can evaluate the risks involved in weather derivatives. For example, a farmer may purchase weather derivatives that provide him payment if the amount of rainfall is below a certain point during the year, where the hedging counterparty to this derivative would be an individual who decides he has an economic interest in dry weather. Clearly, Islamic law would prohibit this type of contract based on the amount of gharar involved; but, what if this was economically rational and actually reduced the risk for both hedging parties involved? It is possible that a more relaxed interpretation of Islamic law based on the parties' motives might allow such a contract. However, this conclusion would require an extremely liberal view of hundreds of years of Islamic law.

Of course, reinterpretting Islamic law in a more liberal way brings with it the danger of eliminating the very purpose of the restrictions. Islamic law seeks to avoid the exploitation of individuals, to reduce risk, and to prevent people and financial institutions from making poor decisions and using their money in an unproductive manner.

81. See Lynch, Derivatives, supra note 13, for more information on weather derivatives.
82. One can use their imagination as to who might have an interest in this; a construction contractor or a farmer growing crops that depend on dry weather and little rainfall are possible examples.
83. See VOGEL & HAYES, supra note 1, at 77-83 (providing an overview of the goals of Islamic law in imposing restrictions on the freedom to contract).
The classical law and the hadiths are the obvious counterargument to a less restrictive approach. Despite its anachronistic nature, the story of the Bedouin herder, whose lack of knowledge allowed him to be taken advantage of by townspeople doing business with him outside of the city market, is still relevant in today's world. Uncertainty is something that has never left and will never leave financial transactions; it merely changes shape as society and technology advance. The freedom to contract is something that is prized by Western society, but there is a legitimate argument to be made that the social harm caused by the lack of knowledge present in many contracts warrants restriction.

VI. PURELY SPECULATIVE FORWARD CONTRACTS ARE FORBIDDEN UNDER ISLAMIC LAW—WHAT CAN BE LEARNED FROM THIS?

This Section will address the second conclusion in the introduction: that no reasonable interpretation of Islamic law could conclude that a purely speculative forward contract is permissible. It will also answer the question of whether there is something to be learned from Islamic law by those who do not follow Islam.

A forward contract of a purely speculative nature, such as a PSD, would be banned under classical Islamic law for two reasons. First, it would simply not meet the requirements of a permissible forward sale, which are outlined in salam and istisna contracts. Regardless of the details and disputes among the schools, the bottom line is that payment in a purely speculative forward contract cannot be tendered at the closing of the contract, and this violates the clear rule that payment must be made for the goods immediately. Second, neither party to the contract has the intention of ever possessing or delivering the goods. The buyer does not intend to receive the goods, the seller does not possess the goods—now or in the future, and the seller has no intention of delivering the goods.

The fact that Islamic law mandates that a delivery date be specified makes it clear that forward contracts under Islamic law were never intended to be of a purely speculative nature. The ability of speculators to turn a profit depends upon the aleatory nature of their contracts, and upon the ease of buying and selling these contracts quickly, without possessing the actual goods, to turn a profit. That is, "the condition that the object be capable of delivery or execution in Islamic law is also a judicial condition that the object must be in the ownership of the person

84. See SALEH, supra note 11, at 49.
intending to dispose of it, or that it must be capable of being performed.\textsuperscript{85}

It is clear that Islamic law allows forward contracts where actual delivery is intended. Often, as with a parallel salam or istiṣnā contract, an immediate buyer is required, thus eliminating the chance that a party to a forward contract might benefit from a hike in the price of the commodity and ensuring that there is a real beneficiary who receives the goods. Although the criteria for executing a legitimate forward contract varies among the schools, the universal deliverability requirement guarantees that PSD forward contracts are not present in transactions compliant with Islamic law.

Even with a more liberal interpretation of the restrictions on Islamic forward contracts, such as the approach advocated by Ibn Taymiyya, the motives of pure speculators would not pass muster. Islamic law’s prohibition on maysir would prevent pure speculators with no intention of hedging a risk from, essentially, gambling with their money.\textsuperscript{86}

In this respect, Islamic law allows parties to benefit from the forward sale of goods but denies them the opportunity to engage in activity that is ostensibly gambling. In the wake of the recent financial crisis and the numerous PSDs that contributed to or accelerated the process, some of Islamic law’s restrictions on pure speculation may not be a negative approach for others to consider.

It is not the intention of this Note to advocate a complete overhaul of the Western forward contract tradition—as mentioned previously, Islamic law often goes too far and is burdensome. It is noteworthy, however, that one of the major religions of the world has banned risky PSDs, both in the technical aspects of the transaction and also in relation to the motives of the contracting parties.

There is a convincing argument to be made that PSDs—in the context of this Note purely speculative forward contracts—are in fact gambling and should be governed by gambling law.\textsuperscript{87} Islamic law has already taken this step, and despite the temporally distant origins of its approach, may be well ahead of Western society’s treatment of such contracts. All societies impose restrictions on behavior that results in social harm, especially if that harm has a wide reaching effect, but the justification for those restrictions vary. The fact that religion is the

\textsuperscript{85} Rayner, supra note 2, at 139.

\textsuperscript{86} See generally Gambling by Another Name?, supra note 3, for an in depth look at how pure speculators are often banks, hedge funds, or municipalities that are gambling with the money of others who are not aware how their money is being used. This activity can cause great social harm, something that Islamic law seeks to prevent.

\textsuperscript{87} See id. for an argument that gambling law should be applied to PSDs.
source for Islamic law does not preclude the ability of secular law reaching the same conclusions; it simply must have a different rationale to justify the restrictions.

CONCLUSION

There is a debate among Muslims about whether engaging in modern financial practices is a harmless adaptation to a changing world, or if adaptation is foregoing morality under "compulsion exerted by life in a system shaped by alien values." There are certainly Muslims who consider a reinterpretation of Islamic law to be appropriate and realistic; however, these Muslims are in the minority. A majority of Muslims adhere to classical Islamic law—as evidenced simply by the fact that Islamic banking and Islamic financial instruments have been developed, currently exist, and are still in use. The fact that "Islamic finance" exists proves that the classical Islamic law "still command[s] overwhelming authority and prestige." The goal is "not to replace the classical law but to apply it."

However, it would not be unreasonable for Islamic law to take a more motive-based approach when applying its doctrine; nor would it be unreasonable for Western society to apply a more morality-based approach to financial transactions—even though these risky transactions may not actually be the type of gambling that takes place in a casino. Although it might be simpler to apply an objective test based upon immediate payment, delivery details, and strict requirements for description of the goods, it would not be impossible for Islamic law to maintain its emphasis on morality, and to evaluate parties' intentions and motives in court—enforcing contracts that avoided gharar, maysir, and riba, and invalidating contracts too similar to gambling. Indeed, that was the way the common law was applied in the nineteenth century in the United States. It was not until later, shortly before the Great Depression, that courts in the United States began upholding speculator-speculator contracts.

88. Vogel & Hayes, supra note 1, at 25.
89. See id.
90. Id. at 25-26. Vogel argues that "[i]f a drastic liberalizing reinterpretation of the Qur'anic ban on interest and other strictures were broadly accepted by religious Muslims, Islamic banking and finance would have little purpose. Advocates do not dream of a future alignment with conventional practice, but of successfully asserting their difference with it. If necessary, they will create a permanently distinct sphere of finance."
91. Id.
92. See Gambling by Another Name?, supra note 3.
It is clear that there have been shifts in both Islamic jurisprudence and Western jurisprudence as to the treatment of forward contracts—neither system is impervious to reinterpretation and adjustment. In terms of possible derivatives, if a hedger-hedger forward contract is on the most economically responsible, restrictive end of a spectrum, and a speculator-speculator forward contract is on the most irresponsible, permissive end, then Islamic law goes too far in constraining the restrictive side and Western tradition allows too much leeway on the permissive side. Perhaps the right balance is somewhere in the middle.

93. Recall the increased use of Ibn Taymiyya’s position among modern Islamic financial institutions. Further, the salam and istisna contracts are evidence of Islamic law’s flexibility in adapting to the needs of businesses and individuals. Scholars since the classical period have noted that these well-established contracts are reasonable and helpful exceptions to overly restrictive rules.