ISLAMIC COMMERCIAL LAW: AN ANALYSIS OF OPTIONS

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This essay is presented in two sections. Section one is devoted to a market analysis of options, and section two to a Shari'ah perspective on options trading. There is no real shortage of information in the operational procedures of options and the various ways in which options are utilized as trading vehicles and hedging and risk-reduction devices. On the other hand, there is a shortage of in-depth information analyzing options trading from the perspective of the Shari'ah. The second part of this essay is tentative, in part because certain aspects of the issue need further development and research. The literature on the subject is in its early stages and has not reached a stage where consensus on issues can be identified. This is borne out perhaps by the divided opinion that we have at present over the basic question of the validity or nonvalidity of options from an Islamic legal perspective. I shall review these two opposing currents of opinion in due course. Suffice it here to note that this presentation does not seek to advocate the validity of those varieties of options which either directly or indirectly proceed on the charging of fixed interest to accounts. This may be said to be one of the distinctive features of the Shari'ah perspective on options—just as it is of all varieties of commercial transactions in Islamic law.

My review of the mechanics of options trading in the first section of this essay broadly indicates that options trading does not proceed on charging of fixed interest, nor does it involve unwarranted risk taking and uncertainty (*gharar*). Options trading has a logic of its own, which is dominated by the idea of risk reduction and hedging against excessively large positions in its underlying assets. From the perspective of Islamic law this aspect of options is attractive and hence, from this perspective I make the case for the legality of options. I may also add here in passing that options trading cannot be equated with gambling or overindulgence in financial speculation. as it is basically designed to mini-

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mize speculative risk taking and for the most part operates as an antidote to gambling.

Although the basic logic of options as a risk management tool extends to all areas of options trading, and there is support for the view that options in financial instruments and interest rate options tend to have a limiting effect on interest rates, research findings on this aspect of options are not presented here. I have excluded a discussion of the interest rate option from the scope of this presentation.

A Market Analysis of Options

Trading in futures emerged in the early 1970s and in options in the early 1980s, each in response to the growth of international trade and the increased volatility in financial markets. Futures and options manage and reduce risk by means of hedging. Futures markets for agricultural produce developed as a result of substantial price fluctuations faced by buyers and sellers. Agricultural futures allowed farmers to guarantee selling prices and merchants to guarantee buying prices so that both could avoid losses. Financial futures emerged in the early 1970s in response to fluctuation in currency prices, following the breakdown of the Bretton Woods fixed exchange rate system. These developments in the financial markets were followed by innovations in options markets. Options are versatile and can be used in a large number of ways. Strategies that can be applied to options are virtually limitless and new products are continually being introduced into the market. Options are sold (or written) largely by companies and institutions, such as banks, that hold inventories of commodities or financial instruments. By writing options against these inventories, profits can be realized with little assumption of risk. On the other hand, most individuals find option writing much less attractive than option purchasing, not least because the potential profit to the option writer is limited to the amount of the premium. The price in the options contract is known as the "exercise price" or the "strike price," and the date in the contract is known as the "expiration date," the "exercise date," or simply the "maturity."

Trading in options has become popular for a variety of reasons. Options can be bought for a fraction of the money required to buy the underlying assets. Investors who do not have enough funds or who do not want to tie up large sums of money in futures contracts can, by buying options, acquire control over large quantities of commodities and their related contracts. If the market prices move in their favor, they can exercise the options and buy the underlying assets and then sell them at a profit. In the event of an unfavorable move in the market prices, the option holder simply does not exercise it and forfeits the premium.

Options are also used by speculators as a hedging device against open positions in both the stock and futures markets.[1]

Although options are traded on a variety of underlying assets-stocks, currencies, treasury bills, and futures, the rudiments of options trading may be explained by reference to conventional stocks and securities. Trading strategies in other sectors are fundamentally the same as in conventional stocks. We may note at the outset that options are not securities in the true sense. Securities are issued by corporations, municipalities, and government treasuries, whereas options on a security, such as IBM stock, are issued not by IBM, but rather by an individual or a firm, known as *writer* (or *grantor*). It may be issued or written by anyone. An option is simply a contract entered into by two parties. The buyer of the contract is granted a privilege to buy or sell a security at a specific price; the seller (writer) of the contract assumes an obligation to accommodate the buyer should the buyer exercise his privilege. Since the value of the underlying security can fluctuate sharply during the life of the contract, the buyer pays the seller a fee, called a *premium,* for granting the privilege.

The logic of options can be applied to things other than securities. Suppose you own a valuable oil painting valued at 1 million ringgit (RM). You enter into a contract with another party allowing him to purchase the painting for 1 million ringgit at any time during the next 12 months. Since the painting could be worth RM1,100,000 within a year, you demand a fee of RM10,000 for granting the option. If the value of the artwork does rise to RM1,100,000 within the year, the owner of the contract will exercise the option and purchase it for RM1,000,000. You will have lost the picture but would have received a total of RMl,010,000. If on the other hand the value of the painting falls to RM900,000, the contract would not be exercised. You keep the RM10,000 fee and still own the painting.

Options on equity securities have been traded for many decades, but until 1973 the market was very informal. Someone who wished to purchase an option on IBM stocks would contact one of a handful of option dealers, which were generally small firms that specialized in the product. The option dealer would seek out another party willing to sell (write) the option. All of the terms of the contract, including the premium, were subject to negotiation and agreement.

A major change in the trading of equity options occurred in 1973 when the Chicago Board of Trade (CBT), which dealt in commodities, set up the Chicago Board of Options Exchange (OBOE) and for the first time equity options began to trade on an exchange. This centralization of the market led to an increased interest in options, leading many other bourses in the U.S to follow suit and establish similar facilities for options trading.[2]

Listing equity options eliminated the uncertainties found in earlier markets. Before 1973, the parties to an option contract would have to agree on three important aspects of the contract:

- *The exercise price.* The buyer might have wanted the contract exercised at $4.00 per share but the seller at $4.50 per share.
- *The length of the contract.* The buyer might have wanted the option to extend to nine months, the seller to only six months.
- *The premium.* All of these were subject to negotiation and agreement.

But with the listing and centralization of equity options, the need to negotiate the first two, namely the exercise price and the contract period, was eliminated as they were now determined by the exchange on which the contract was traded. Only the premium was left for the parties to determine.

Another important development was the creation of a clearinghouse, the Options Clearing Corporation, which clears all listed options transactions. One of the tangible advantages of this was that transactions were henceforth cleared through electronic computation and the debiting and crediting of accounts, thus marking a departure from the cumbersome practice of physically transferring securities. There are now no physical securities to deliver or receive and all accounts are cleared on the next business day after the trade. On that day the buyer is credited with the option and debited the amount of the premium. The seller is debited the option and credited the premium.

An option may be defined as the right, but not the obligation, to buy (in the case of a call option) a particular item at a predetermined price on or before a specific date.[3] It is basically a forward or futures contract that may be cancelled prior to maturity if one of the two parties involved so chooses. The party who has the cancellation privilege is the buyer of the option. Whereas a futures contract involves an obligation for both the buyer and seller to perform on the contract, options traders mainly buy a right to buy or sell the underlying asset without the need to make or accept delivery. An option is a suitable tool for the currency manager who has a view of the future exchange rate movements but is not absolutely certain that the direction of change will be as he anticipates and wishes to reduce the losses arising in the event of his forecast being incorrect.

Options are of three types: calls, puts, and doubles. A *call option* is a contract that confers on the buyer of the option the right to buy a specified asset from the clearinghouse at a predetermined price (exercise

price) during a specified period of time. Consequently, the clearinghouse is under obligation to sell the underlying asset to the option buyer. A *put option* confers on the option buyer the right to sell to the clearinghouse the underlying asset at a fixed price during a specified period of time. The buyer of the option (call and put) pays the price of the option, or the premium, to the seller, which entitles the buyer to buy or to sell, but the seller has an obligation to perform when the buyer exercises the option. The option buyer is not obliged to buy or sell the underlying commodity or the futures contract; he may let the option lapse, in which case he loses only the premium he paid. The option premium resembles the insurance premium that is paid as protection money against misfortune such as fire or flood.[4]

A distinction is made between "European-type" and "American type" options. The former can be exercised on one date only, the expiration date. The latter may be exercised on any business day up to the expiration date. American-type options provide greater flexibility—the choice of date increases the likelihood of a profit being made. Correspondingly, an American-type option involves a higher premium than a European-type option.[5]

The call option resembles a futures contract since both involve the future delivery of an item at an agreed upon price. This obvious similarity occasionally leads people to make the mistake of considering the futures contract as an option. It is not. While the seller in a futures contract is allowed some flexibility concerning the delivery date and grade, both parties are, nevertheless, obligated to complete the transaction either by a reversing trade or actual delivery. In the case of an option, there is no *obligation* of any kind on the part of the holder, only a *right* to buy or sell a specified amount of a real or financial asset at a specified price during a specified period. Whereas it costs nothing (except for margin requirements) to enter into a forward or futures contract, the purchase of an option requires an upfront payment.[6]

A third type of option, known as the *double option,* provides the taker with the right either to buy from or sell to the grantor a specified quantity of commodity or a specified futures contract during a fixed period at a predetermined price. In essence, the double option is no more than a put and call option combined. The expiration date in all options is predetermined and varies anywhere between one day and two years. By this date the purchaser of the option must declare his intention to exercise the option, that is sell the option or let the option lapse.

An option can be "in the money," "out of the money," or "at the money." An option is in the money if exercising the option results in a profit (disregarding premium). A call option is in the money if the market price of, say, the underlying stock is higher than the strike price of the option. An option is out of the money if exercising the option results

in a loss (disregarding premium). A call option on a certain stock would be "out of the money" if the market price of the stock is lower than the strike price of the option. An option is "at the money" when the market price of the stock and the option's strike price are the same: The option is neither in nor out of the money.[7]

Selling long and short in options is similar to those in other securities. Someone who has purchased a put or a call three weeks before selling it is selling long: He owns the option. If someone does not own the option and sells (or writes) one, he is selling short. If the option is exercised, the short seller would have to make arrangements to live up to the contract. The option writer thus writes (or sells) an option in one of two ways—covered and uncovered. A covered writer has access to the underlying security, whereas an uncovered writer has nothing but an open contract. Obviously, uncovered writing poses a greater risk than covered writing.[8]

Options on Futures

Trading options on futures is similar to trading options on other underlying assets. Just as there are options on actual commodities, there are options on the futures contracts concerning those commodities. There are a number of goods, besides stocks and currencies, for which options are traded. For many of these goods there are also futures contracts and options on the future contracts. The only difference to note here is that options on futures is a three-tiered instrument. The primary trading vehicle (the options contract) is a derivative instrument whose underlying interest is another derivative contract (the futures contract), whose value, in turn, can depend on anything from stocks or bonds to currencies and indices.[9]

Futures options represent listed puts and calls on a select but growing number of standardized futures contracts. They give the buyer the right to buy (calls) or sell (puts) a single standardized futures contract for a specified period of time at a predetermined striking price. They have the same standardized striking prices, expiration dates, and quotation system as other listed options. In other words, futures options are valued like any other listed puts and calls by reference to the differences in the option's striking price and the market price of the underlying futures contract. Traded options are particularly attractive instruments because they not only provide all the same rights to buy or sell the underlying commodity futures contract, they are also instruments which may be traded in their own right.

The prime rationale for the existence of options on futures is its price performance characteristics compared to futures contracts. Taking a position in the futures market means that one is immediately exposed to a theoretically unlimited risk of loss. For the option buyer, this is not the

case. Another reason for preferring options on futures to options on the physical commodity itself is the economy and ease of exercise. To exercise an option on the commodity itself, one must have the entire cash value of the striking price. To exercise an option over a futures contract, the amount of money involved is basically limited to the option premium. Another difference between futures and options is that futures attract margin requirements, whereas buying options requires no margin deposits.[10] Futures are symmetrical, that is, the seller (short) and the buyer (long) are subject to symmetrical gains and losses: The long gains by the amount that the short loses and vice versa; their rights and obligations regarding delivery and payment are also symmetrical. Options are asymmetrical, which means that buyers and sellers of options have unequal rights and obligations. The option buyer has the right to initiate the delivery process at any time, while the seller is under obligation to comply. Thus, the buyer is in a superior position because he has the right and the seller has the obligation. The buyer's potential losses are confined to the size of the purchase premium, while profits are potentially unlimited. This asymmetry also enables contingencies and unforeseen events to be more effectively hedged with options than with futures or forward contracts.[11]

The Option Clearance Corporation (OCC) performs much the same sort of function for options markets as the clearinghouse does for futures markets. It guarantees that the option writer will fulfill his or her obligations under the terms of the option contract and keeps a record of all long and short positions. All option trades must be cleared through a member. Members are required to have a certain minimum amount of capital and to contribute to a special fund that can be used if any member defaults on an option obligation.[12] Moreover, both the exchanges and the OCC as well as federal and state authorities have rules that regulate the behavior of traders. In general, options markets have demonstrated a willingness to regulate themselves. "There have been no major scandals or defaults by OCC members. Investors can have a high level of confidence in the way the market is run."[13]

Not all options are traded on exchanges. Some interest rate and foreign exchange options are traded over the counter between two financial institutions or between a financial institution and one of its corporate clients. Over-the-counter options have the advantage in that their expiration dates and strike prices do not have to correspond with the standards of an exchange.[14]

Trading futures is similar to futures options in that both are bought and sold, quantities and contract months must be designated, and each has a price associated with it. Contract months in options not only relate to the underlying futures contract but also determine the expiration date. Futures options expiration dates are usually in the month preceding the

underlying futures month. Option traders need to articulate two more modifiers than are articulated in futures trading: the strike price and whether the option is a put or a call.

When a trader buys a futures contract, he effectively owns the commodity. If exercised, the futures contract obliges the holder to take delivery of the commodity or instrument. If a futures options contract is exercised, the holder takes delivery of the futures contract, not the commodity. In other words, the options contract holder becomes the futures contract holder.

There are three ways to get out of option positions: Let them expire as worthless, offset them, or exercise them. Most often, options are offset. To offset an option means to trade it back to the market by taking an opposite position in which case the quantity, month, strike price, and option type must be the same.

A futures option buyer has the right to exercise at any time, which means converting the option into a futures position. Most of the time, an option is worth more by trading it back to the market. However, as the expiration day approaches and/or the option becomes deep in the money, exercising may be the most profitable method of disposing of the option. Once the option is exercised, the futures position is assumed and the option no longer exists.

An option is left to expire (i.e., become worthless) if it remains out of the money, in which case neither offsetting nor exercising it would be advisable. The option holder simply lets it expire, thereby limiting his loss to the cost of the premium.[15]

Options (*al-Ikhtiyarāt*) from the Viewpoint of the Shari'ah

Arab writers use different terms for options. The most common is the phrase, *'amalīyat al-shartīyah al-ajilah* (lit. deferred conditional transactions). Three types of options have been discussed: (simple) options, whether call or put, known as *'amalīyat shartīyah basīṭah;* double options, known as *'amalīyat shartīyah murakkabah,* which combine both call and put options and entitle the option holder to act in either or both capacities; and double quantity options (peculiar of the Egyptian futures), known as *'amalīyat shartīyah muḍa'afah,* in which the trader is granted the right to double the quantity of the underlying commodity so as to increase his profit, not merely through an option to execute the contract but by doubling the stipulated quantity of that contract at a predetermined price agreed upon at the time of contract.

Published material on options and futures in Arabic is still scant and without consistent verifiable terminology. I have preferred the term *al-ikhtiyarāt,* which was recently used by Abd al-Wahhab AbuSulayman,

simply because it is concise and strikes a note with a parallel term, *al-khiyārāt*, which is a familiar theme of fiqh and which is explored in the following pages. Yet for reasons that become apparent in his article, "*Al Ikhtiyarāt: Dirasah Fiqhīyah Tahlilīyah Muqaranah*" (Options: A Comparative Legal Analysis), AbuSulayman has not discussed the varieties of options and, therefore, no specific terms have been identified for any of the three types of options mentioned above. However, AbuSulayman has used three other related terms that merit recognition: *ikhtiyar al-ṭalab* (call option), *ikhtiyar al-daf'* (put option), and *fatrah al-ikhtiyar* (option period). By utilizing Abu Sulayman's terminology, one may designate *al-ikhtiyarāt al-basītah* (simple or just options), *al-iktiyarāt al-murakkabah* (double options), and *al-ikhtiyarāt al-muḍa'afah* (double quantity options), in preference, that is, to the longer phrases that have been used in earlier works.[16]

I have been able to consult the writings of only a handful of Arab writers on the subject of options, and they have all addressed the issue within the purview of the conventional fiqh doctrine of *al-ikhtiyar* (options). The origin of *al-ikhtiyarāt* is clearly traceable in the Sunnah, but the elaborate details and subdivisions of *al-ikhtiyarāt* into various types have all been developed, as a matter of initiative and *ijtihād*, in the juristic writings of the *'ulama*. The basic concept of an option which occurs in the Sunnah and in the juristic manuals of fiqh was intended, not so much to create a new trading formula or risk-management tool but to ensure propriety and fairness, as well as to protect the integrity of consent in the completion of contracts. The typical *al-khiyārāt* that the Sunnah validated is the option of stipulation (*khiyār al-sharṭ*), which granted to the buyer the option within a time frame (of three days or so following the conclusion of the contract) either to ratify the contract or revoke it. Evidently, the ruling of the Sunnah envisaged the eventuality in which the buyer does not possess sufficient knowledge of what he or she has agreed to buy. A sale of this type cannot be said to be reflective of the true intentions of the buyer, especially when what is bought turns out to be defective in a way that is not obvious to the naked eye.

Options that Islamic law has granted are of two types: those that are granted by the law itself, regardless of any contractual stipulation, and those that materialize only as a result of a clear provision in the contract. The former variety is basically confined to the option of defect (*khiyār al-'ayb*) and the option of viewing (*khiyār al-ru'yah*). Thus, the law grants the buyer the option of revoking the contract on account of material defect or seeing what is bought for the first time. The second variety of options, that is, contractual options, such as the option of stipulation (*khiyār al-sharṭ*) and the option of identification (*khiyār al-ta'in*), are of greater interest to our present purposes. All options, whether put, call, or double, that are practiced in conjunction with trading in stocks or futures

are, in fact, contractual options—created by virtue of an agreement. In the Islamic law of contract, *al-Khiyārāt* are generally seen to be anomalous, in the sense that they tend to interfere with the integrity of contractual obligation. Thus, it is stated that once a contract is properly concluded nothing should hinder its binding character and enforcement. This is one aspect of the juristic discourse of the *'ulama* on the subject of *al-khiyārāt (*which is, however, not of interest to us here). The main feature of the Islamic law concept of *al-khiyārāt* that concerns us is that while recognizing the basic freedom of contract and binding nature of contract, Islamic law has entitled the parties to stipulate that the contract so concluded will become effective only upon further ratification and approval. In essence, this is the basic rationale of the shari'ah concept of *al-khiyārāt,* which modern writers have utilized in their discourse on the validity or otherwise of trading in options. Evidently, this approach is based on the assumption that options are contractual stipulations that can be added and attached to an underlying contract.

However, there are issues of option trading that do not find ready answers in the works of the *'ulama*, and the theory of *al-khiyārāt* has fallen short of providing the needed solutions. Two such issues are whether it is lawful to charge a fee for granting an option and whether an option can be bought and sold as a valuable instrument in its own right. The conventional discourse in fiqh envisaged *al-khiyārāt* as an aspect of the contract of sale, an ancillary or incidental aspect of that contract, but not a contract in its own right that can be evaluated and traded separately from the main contract. The issue here is then addressed within the purview of the *fiqh* concept of *daman* (compensation) in conjunction with *al-khiyārāt:* One of the parties in a contract of sale (usually the seller) grants a privilege, or an option to the other, which might be disadvantageous to the former and, therefore, may either grant it free of charge or ask for compensation. The debate thus continues between those who consider such analogies to some of the rulings of fiqh relevant and valid and those who do not, which is partly why different responses have been recorded on the validity of charging a fee or a premium for options.[17]

An alternative approach has been taken by some writers who attempt to draw a parallel between options trading and the *fiqh* concept of *al-'urbūn* (also rendered as *al-'urban*). *'Urbūn* refers to the earnest money which the seller takes from the buyer with the understanding that it becomes a part of the price in the event that the sale is ratified, but that it will belong to the seller in the event the buyer fails to ratify his initial agreement. Among the leading schools of fiqh, only the Hanbali's have validated *al-'urbūn;* the majority have ruled against it on the basis that the seller has no right to keep the earnest money which is the property of the buyer and, therefore, must be returned to him. In addition, there is the question of whether drawing the parallel between *al-'urbūn,* even if its

validity is taken for granted, and options trading is accurate because the basic purpose behind the two transactions is so different that drawing an analogy between them becomes totally superfluous; therefore, in the final analysis, such an analogy will be no more than a discrepant analogy (*qiyās ma' al-fāriq*), which is invalid.[18]

Another issue that has arisen in discussing options is whether it is valid in a sale that one of the countervalues should consist merely of granting a right, or a privilege, as opposed to a tangible asset (*māl*) that is purchased in exchange for a price. Here some juristic details tend to emerge as to whether a nontangible asset, service, and usufruct, (*manfa'ah*), which has no concrete reality and existence at the time of the contract, can be bought or sold in the same way as a tangible asset, or *māl*. That options partake in the nature of *manfa'ah* and may therefore not qualify as *māl*. Whereas the Shafi'is and Hanbalis include usufruct under the definition of property, the Hanafis and Malikis do not. But the 'ulama of later periods (*al-muta'akhkhirūn*) have generally included usufruct in the definition of *māl*.

The basic validity of *khiyār* is proven by the authority of a hadith in which it is reported that when Habban Ibn Munqidh complained to the Prophet that he frequently was the victim of cheating in sales the Prophet responded that "when you conclude a sale you may say that there must be no fraud, reserving for yourself an option lasting three days." But the option of stipulation that is granted by this hadith is said to be valid only in regards to nonusurious sales. As for sales of usurable items such as currencies and barter sales of foodstuffs, they must be concluded without delay, and they are not amenable to any options. The option of stipulation is also valid with regard only to contracts that are open to the prospect of cancellation, thereby precluding from the purview of this hadith contracts such as marriage and divorce or contracts that can be unilaterally repealed by either party, such as a gift or a partnership.

There is also the hadith of 'Abd Allah Ibn 'Umar that says that the parties to a sale are free to revoke their agreement before they part company except in a sale that is subjected to option. This hadith confirms the substance of the previous hadith on the basic validity of *khiyār*, but it does so in conjunction with the meeting of contract: It grants to both the buyer and seller in an option sale the privilege to reserve for themselves the right either to revoke or to ratify their initial agreement. In other words, they may part company and leave the meeting of contract without breaking the conceptual continuity of that meeting if they have agreed on an option. The rationale for such an option may well be that the buyer may be uninformed and need time to consult another person, a relative or a business associate, to enable him to make a final decision.[19]

The leading *madhāhib* are in agreement on the validity of the option of stipulation (*khiyār al-sharṭ*) either by the buyer, the seller, or both. An

option may even be held in favor of a third party to approve the sale in order to make it effective and binding within a specified period of time. If both parties to the sale have stipulated options/conditions of their own, then the contract becomes effective if they both ratify it, and it naturally collapses if they both revoke it. Should there be a disagreement as to whether the sale has been ratified or revoked, the plea to revoke it shall prevail over the plea to ratify it.

There is general agreement that the option period begins the moment the contract is concluded, but the 'ulama have differed concerning the duration of a valid option of stipulation. The Hanafis and Shafi'is maintain that it should not exceed three days, which is what the hadith specifies, but also because *khiyār* is essentially *ultra vires* and, therefore, no liberal recourse to it should be encouraged. Imam Malik has taken a more flexible stance toward the understanding of the hadith by saying that the hadith mentions three days in a figurative sense merely to convey a concept in an illustrative manner. Thus, the actual duration of an option may be determined by what is being sold. In the case of the sale and purchase of animals and clothes, the option period may be limited to three days, but it may be extended to a month or even two months in the case of buying a house. On the other hand, Imam Ibn Hanbal has held that an option may be of any length of time and that it is a matter entirely up to the contracting parties. According to Imam Ibn Hanbal himself, even if the parties agree on an option of stipulation in principle without specifying a period for it, the agreement is still valid although the ruling of the Hanbali school, as Ibn Qudamah has stated, is that the period of the option should be specified so as to prevent conflict, uncertainty, and *gharar*. This is also the view of the two disciples of Abu Hanifah, Abu Yusuf and al-Shaybani. In validating an open-ended *khiyār*, Imam Ibn Hanbal has cited the hadith to the effect that Muslims are bound by their stipulations unless it be a stipulation which declares unlawful what is permissible or permits what is unlawful.

Ownership of the subject matter during the option period remains with the seller, who is responsible for loss or damage unless the buyer has actually taken possession of it, in which case responsibility for loss and damage will transfer to the buyer. However, according to Imam Abu Hanifah only the option holder is responsible for loss: If the buyer alone has stipulated the option, he is responsible. But the 'ulama have differed on this. Many tend to relate the question of responsibility for loss (*daman*) to ownership and generally maintain that *daman* transfers to the buyer upon transfer of ownership. Furthermore, in an option sale the buyer is normally not entitled to use the object for his benefit during the option period; however, he may use it for purposes of investigation and testing.[20]

The validity (or otherwise) of charging a fee or premium for options falls under the general subject of contractual stipulation, a subject that has invoked different responses from the *madhāhib*, notwithstanding the affirmative nature of the source evidence on it. The issue acquires a religious dimension when it is put in such terms as to saying that contractual stipulations by the parties should not be allowed to circumvent and override the given mandates of Shari'ah on contracts. The Shari'ah has determined the essential elements of a number of nominate contracts, and any options/stipulations that are inserted therein should not exceed the basic framework that the law has laid down, in conjunction with various contracts. In other words, the parties are not at total liberty to stipulate what they please. Yet the basic validity of *khiyār* is not in doubt: We have already stated that the Sunnah entitles the parties to insert stipulations in contracts so as to meet their legitimate needs and what may be deemed to 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 Shari'ah 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. The Sunnah has clearly granted this liberty in the interest of fairness and the overall integrity of transactions. The issue has invoked responses from the *madhāhib* that may vary in form but generally tend to uphold the view that stipulations should be appropriate and harmonious to the essence of contracts (*mulā'im li al-'aqd, muqtada al-'aqd*). This is the common Hanafi-Shafi'i perspective on contractual stipulations that are held to be valid when they are in harmony with the essence of a contract. Thus, it is valid when the seller asks the buyer in a deffered sale to provide a guarantor or a surety in the form of a mortgage or a pawn. Provided that this is clearly stipulated and the parties have both agreed on it, it would be binding on the parties.[21] The Malikis are even more explicit in validating these and other such stipulations that may have a financial value; for example, when the buyer stipulates that the goods must be transported to a certain locality, or that delivery or payment be postponed to a future date, and the like. Therefore, from the viewpoint of the Shari'ah, there is no objection to any of these and the parties are entitled to secure benefit through stipulations.

By laying emphasis on the basic freedom of contract and on the parties' liberty to make stipulations as they please, the Hanbalis are the most liberal of all the schools in validating contractual stipulations. The Hanbalis maintain that stipulations that fulfill a legitimate need, realize a benefit and convenience, help remove a hardship, or facilitate the easy flow of commercial transactions are generally valid as a matter of principle and not by way of concessions and what is contrary to the norm (*khilaf al-qiyās*), as the Hanafis and Shafi'is tend to believe. To Ibn

Taymiyyah and his disciple Ibn Qayyim al Jawziyyah, the basic validity of contractual stipulations is not a matter of concession or exception to the normal rules; on the contrary, they are valid by the same Qur'anic authority that validates contracts on the basis of mutual agreement.[22] In response to the question of whether certain types of stipulations might amount to a contract within a contract, and therefore that they fall within the purview of the hadith that prohibits this, Ibn Qayyim maintains that that hadith is unreliable. The hadith that simply declares that "the Prophet prohibited a sale and (an overriding) condition" is not only spurious and defective from the viewpoint of authenticity and transmission but also because it is in conflict with other and more reliable hadiths, as well as with general consensus (*ijmā'*) and the normal rules of the Shari'ah. For example, according to one hadith the Prophet bought a camel from someone named Jabir, and agreed to Jabir's stipulation that before the camel is delivered Jabir be permited to ride it to Madinah. In addition, there is the hadith in which the Prophet said, "One who sells a slave who owns property, the property shall belong to the seller unless the buyer stipulates otherwise." Clearly these hadiths validate stipulations that are additional and extraneous to the sale. According to yet another hadith, the Prophet said, "Whoever sells a palm tree that has borne fruit, the fruit belongs to the seller unless the buyer stipulates otherwise." Wrote Ibn Qayyim, "This is nothing other than sale combined with (an extraneous) stipulation [*bay' wa sharṭ*] which is explicitly validated by authentic Sunnah." As for the alleged hadith's conflict with *ijmā'*, the consensus of the Ummah is that stipulations are permissable in the contract of sale in respect of taking a security deposit or a pawn, providing a guarantor, deferment (*al-ta'jīl*), and option of stipulation. All of these combine sale with stipulation, and their validity is generally supported by *ijmā'*.[23]

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

The fact that options are sold for a premium which are paid at the time of contract also differentiates options from futures in that at least one of the countervalues in options is payable at the time of contract, which should, if anything, make the juristic hurdle somewhat easier. The option

price (premium) is normally specified and paid upfront; the option period which ends by the expiration date is also clearly specified, there remaining no uncertainty of the kind that might be equated with *gharar*. The option premium is paid in exchange for a right/privilege that is granted to the option holder, and there is nothing objectionable in this.

The substance of my analysis is sustained in the works of at least three commentators whose works I have consulted; although my research does not follow their approaches, we tend to concur in our conclusions. I have consulted the works of Shannat al-Jundi, Yusuf Sulayman, and 'Ali 'Abd al-Qadir, all of whom affirm the basic validity of options trading and concur that the option buyer pays for a right, or an advantage, and the seller who grants this is entitled to be paid for it. They have also drawn attention to the carefully regulated procedures of trading options which virtually eliminate uncertainty over the essential aspects of transactions, so much so that there is no likelihood of disputes arising between the parties. This analysis is then extended to all varieties of options, including double options and double quantity options, all of which may be seen as a manifestation of the valid exercise of the freedom of contract.[24]

Ahmad Muhayyuddin Hasan, on the other hand, has taken a negative view of options trading on two grounds, namely, that the basic notion of *khiyār al-sharṭ* (option of stipulation) is anomalous to the norm and is merely tolerated, which is why it is basically confined to three days. Therefore, the way in which options are designed and traded turns the restrictive terms of *khiyār al-sharṭ* into a basic permissibility, marking a departure from the stated guidelines of Shari'ah. This is, as earlier stated, essentially the argument that the Hanafi and Shafi'i jurists have advanced on the subject and has, in fact, been addressed and effectively refuted in the writings of Hanbali jurists, especially Ibn Qayyim al-Jawziyyah, who has departed from the earlier position and reached the conclusion that options and contractual stipulations are valid as a matter of principle, and not by way of exception or departure from the norm, as Hasan has asserted. Hasan has raised a second objection to options trading, namely that they are unfair and work to the distinct advantage of one party to the total detriment of the other. "One of the contracting parties is granted open opportunity to realize profit at the expense of the other." The option holder is granted the open choice whether or not to finalize the sale, that he may pose as buyer or seller, or both, thereby allowing him to maximize his profit. "There is no doubt," Hasan glibly adds, that "this is oppression and injustice [*zulm wa jawr*]."[25] This analysis is somewhat unfounded and superfluous as it is based on a wrong foundation. For one thing, it should be obvious that the option holder does not always make a profit, as suggested by Hasan; rather, he may take a loss and lose his premium as a result. The option holder has not locked himself in a no-loss situation. Hasan does not acknowledge this. The other point is that

the option holder may be acting as a hedger who wishes to protect himself against exorbitant losses; by buying options he merely minimizes the prospects of a bigger loss. In addition, Hasan exaggerates the issue of oppression and injustice: The parties enter an agreement in which the option buyer pays for the advantage he is granted. The price that the option buyer pays is determined, not by him or his agent, but by the exchange authorities making the question of manipulation and unfair advantage irrelevant.

'Abd al-Wahhab AbuSulayman, a member of the Fiqh Academy of Jiddah (note that there are two Fiqh Academies in Saudi Arabia; the other is based in Makkah) has also passed a prohibitive judgment on options trading. AbuSulayman's analysis of this transaction differs from the other commentators mentioned above in that he does not discuss options trading in the general *fiqhi* context of *khiyārāt* (options) but analyzes it as a contract in its own right, that is, independently of its underlying contract. The author neither explains why he chose not to relate his discussion to the option of stipulation (*khiyār al-sharṭ*), nor why he chose to disassociate options from the main contract or the underlying commodity over which they proceed. Options are derivative instruments that derive their rationale from associating with another transaction or contract. The notion of granting the trader a choice of ratifying or canceling an underlying contract is, therefore, essential to options. The advantage of relating option trading to *khiyār al-sharṭ* is that it covers an underlying transaction as well as the question of whether an option can have a financial value of its own. AbuSulayman has neither acknowledged nor discussed the other writers, including the ones mentioned earlier who have discussed option trading in conjunction with *khiyārāt*, nor has he discussed the approach that they have taken in their publications.

After stating that an option is essentially a contract of sale in its own right, AbuSulayman sets out to address the basic components of this contract: the role of the brokers and the clearinghouse, the countervalues involved, whether the subject matter of sale in options qualifies the juridical description of property (*māl*), the deferment period, and so forth. One of the key questions that has become the focus of AbuSulayman's discussion over the validity of options is whether it is lawful to attach a monetary value to an option and whether the grantor of an option is within his rights to charge a fee for writing or granting an option. It is interesting to note that AbuSulayman's response to this question is clearly affirmative. He arrives at his decision by drawing an analogy with the sale of *'urbūn*, which is valid in Hanbali law but which the majority have rejected. According to AbuSulayman,

> charging a price for a call option whereby the buyer may then decide to exercise the option and make it a part of the price (sic)

> does not affect the validity of this contract—provided that it is valid in other respects—but may be seen in the category of *'urbūn* sale (*min qabil bay' al-'urbūn*), which consists of paying a part of the price and the buyer then stipulates that the deposit money should become a part of the price if he ratified the sale but that it should belong to the seller otherwise.

When the buyer decides not to ratify the sale, then the deposit money in *'urbūn* becomes the property of the seller. In either case, according to the Hanbali *madhhab* the transaction is valid, that is, whether the deposit money is kept by the seller or not—and the Shari'ah validates this transaction.

AbuSulayman further adds that the fact that the price is specified and there is no ambiguity over its quantity and terms also means that the transaction in question fulfills other basic requirements of a valid price. But then he adds somewhat erroneously that neither the price (*al-thaman*) nor the subject matter (*muthman*) qualifies the juridical description of *mal* (property). For the basic purpose of sale is exchange of one commodity for another, and both must qualify as *mal*. He then observes that "the subject matter of option is a right (*haqq*) and a right pure and simple (*al-haqq al-mujarrad*) is neither a tangible commodity nor usufruct; it cannot therefore be a proper subject matter of contract."[26] This statement is debatable, but the more fundamental error in AbuSulayman's analysis is where he disqualifies both of the countervalues in options from being *māl* proper. On the contrary, there is no doubt that the price here is *māl* because the option price or premium is normally paid in cash. The author repeats the same factual error in the next line on the same page when he writes that options trading is unlawful because "neither the price nor the subject matter (*al-thaman wa al-muthman*) is taken into possession as they are both absent at the time of contract and this turns the contract into *bay' al-kali' bi al-kali'* (or sale of one debt for another). To validate a sale of this kind it is necessary that at least one of the countervalues is prompt and the other which is deferred is accurately described so as to prevent disputes." Once again, this statement is based on a wrong premise simply because one of the countervalues in options, namely the price or premium, is normally paid and taken into possession at the time of contract and the subject matter of options is accurately identified. Following the registration of contract, the OCC clears the relevant accounts of the parties to the transaction within twenty-four hours. AbuSulayman's statement here would be applicable to futures contracts but not to options. Perhaps the author has failed to notice the difference that in a futures contract nothing changes hands at the time of contract, which is not the case in an options contract where the premium is paid at the time of contract.

The rest of this article addresses *bay' al-'urbūn*, which closely resembles options, especially that aspect of options that relates to the payment of a nonreturnable premium. *'Urbūn* refers to a sale in which the buyer, in advance, deposits with the seller earnest money as partial payment of the price, but agrees that if he fails to ratify the contract he will forfeit the deposit, which the seller can then keep. The majority of the *'ulama* have held this to be invalid and considered it akin to misappropriating the property of others. On the other hand, Imam Ahmad ibn Hanbal held it to be permissible, saying that 'Umar ibn al-Khattab practiced it and that his son, 'Abd Allah Ibn 'Umar, confirmed it to be valid. Among the followers (*tābi'ūn*), certain prominent figures including Sa'īd ibn al-Musayyib, Ibn Sirin, Nafi' ibn al-Harith and Zayd ibn Aslam also held it to be lawful.[27] But the majority have relied on a hadith narrated by Ibn 'Abbas and recorded in the *Muwatta* of Imam Malik and the *Sunan* of Ibn Majah which simply declares that "the Prophet prohibited the sale of *'urbūn*." However, Imam Ibn Hanbal considered this hadith to be weak. In validating the *'urbūn,* he relied on the report of Nafi' ibn al-Harith, Caliph 'Umar's officer in Makkah, that states to the effect that he bought from Safwan ibn Umayyah a prison house for the Caliph 'Umar for four thousand dirham on the condition that if the caliph approved of it, the deal would be final; otherwise, he (Safwan) will be given four hundred dirham (that is about ten percent of the actual price as compensation). In a sale of this kind the buyer asks the seller to reserve the goods for him and agrees not to ask for the return of the deposit if he changes his mind. The Hanbali school has validated this sale as it is devoid of vitiating elements. On the other hand, the majority have not entitled the seller to take any money for waiting or withholding the sale.[28]

In his analysis and comparison of the evidence for and against the *'urbūn* sale, al-Qaradawi has stated that the opponents of *'urbūn* have relied on a hadith and an analysis that is premised on a condition which entails appropriation by the seller of the buyer's property without any exchange. As for the authenticity of this hadith, al-Qaradawi concludes that it is unreliable and that the evidence in it is contrary to another hadith, recorded in Nayl al-Awtar (vol. V, 162), which in effect states that "the Messenger of God was asked concerning the sale of *'urban* [a variation of *'urbūn*] and he declared it permissible." But then this is also said to be a *mursal* (disconnected) hadith; its chain of transmitters includes a weak narrator. Consequently, al-Qaradawi observes that the issue should be determined on rational grounds. Here we note that Imam Ahmad Ibn Hanbal relied on the precedent of 'Umar ibn al-Khattab and did not considered *'urbūn* to fall into the category of unlawful appropriation. This ruling, al-Qaradawi adds, is more suitable to our own times and in greater harmony with the spirit of the Shari'ah, which seeks to remove hardship and facilitate the people's convenience.[29]

Another prominent scholar, Mustafa al-Zarqa, highlighted the utility of *'urbūn* (and therefore of options) in modern commerce, receiving support in general custom and legislation. *'Urbūn* provides a useful formula to facilitate a credible commitment or surety that the buyer will not change his mind after finalizing a sale, and that if he does, the seller will be compensated for a possible loss. Today, the need for such an assurance is all the more evident because large orders frequently require elaborate preparations that involve a chain of subsidiary transactions that incur additional expenditures. It is quite likely that the seller must reserve his goods or manufacture them specifically for the sale and then wait for the buyer to ratify the sale. *'Urbūn* responds to the need to compensate the seller when he may lose the opportunity of selling his goods or selling them for a good price.[30]

As already pointed out, the basic rationale of options resembles that of *'urbūn,* especially in the sense that both can be used as risk reduction strategies, or methods by which traders might wish to give themselves flexibility before committing to large contracts. Suppose, for example, that a bakery owner wishes to expand his business and thinks that the current market price of $2.50 per bushel of wheat is reasonable. He may want to lock-in the current market price for the next six to nine months, and yet, because of the uncertain success of his expansion plan, he may choose to tread cautiously and decide to limit his possible loss. This he can do by means of buying a call option on, say, ten wheat contracts of 5,000 bushels each; however, instead of committing himself to the full price of such a large contract (i.e, $12,500 x 10 = $125,000), he may decide to pay an option premium of $100 per contract. This would mean that he would have limited his possible loss to only $1,000. The basic notion of *'urbūn* also operates along similar lines: The buyer risks a small amount of money to give himself flexibility and also to limit his possible losses.

In conclusion, whichever formula one chooses, options (*al-khiyārāt*) or the *'urbūn,* options trading provides a benefit both as a risk reduction strategy and as a means by which the seller can be compensated for the privilege he grants to the buyer. Although *khiyārāt* and *'urbūn* share the same rationale and provide the necessary juristic support for options trading, they are not identical and can be utilized for different purposes. I still prefer to utilize the theory of *khiyārāt* as a juridical premise for validating options. I say this not only because of the unequivocal support for *khiyārāt* found in the Sunnah, but also because the basic concept involved in the option of stipulation strikes a closer note with options as a trading formula and a derivative instrument that is associated with an underlying contract. *Khiyārāt* are essentially predicated on the basic freedom of the individual in respect to legitimate contractual stipulations that

are deemed to be of benefit. This I believe offers a sound juridical foundation for validating options.

Conclusion

This presentation has highlighted the different approaches that Muslim scholars have taken in order to verify the validity of options trading in Islamic law. While some have preferred to subsume trading in options under the Islamic law concept of contractual stipulations (*khiyārāt*), others have drawn an analogy with *'urbūn* in which an intending purchaser lays down with the seller a deposit as good faith money, which is, however, nonrefundable in the event he does not proceed with the purchase. In yet a third approach, which to the best of my knowledge is taken by only one writer, AbuSulayman, options trading is considered as an independent transaction, that is, independent of its underlying assets. Some of the crucial legal issues, such as the validity of charging a fee for granting an option and whether or not an option can be considered a saleable asset (*māl*), have generally received affirmative response. Basically, there is no issue to speak of over the period for which an option is written, simply because deferment of a purchase to a future date underscores the very essence of a contractual option (*khiyār)*.

Regarding the length of the option period, the Maliki and Hanbali schools take a fairly liberal position on the time frame of the *khiyār*. Of course, charging interest is not involved here because the option premium is payable up-front, that is, at the time of contract. The Hanbali scholars, Ibn Taymiyyah and Ibn Qayyim al-Jawziyyah, evidently vindicated the normative validity of the option of stipulation (*khiyār al-sharṭ*) that others had considered to be *ultra vires*. This analysis concludes that there is nothing inherently objectionable in granting an option, exercising it over a period of time, or charging a fee for it; and that options trading, like other varieties of trade, is permissible (*mubah*) and as such, is simply an extension of the basic liberty that the Qur'an grants to the individual in respect of trading, civil transactions, and contracts (2:275; 5:1). Needless to say, options trading, like all other varieties of commerce, can be distorted by malpractice and abuse; and the likelihood of this is perhaps much greater in options on futures, and indeed all options over assets that involve a high level of speculative risk taking. Therefore, it is essential that we, with vigilance, refine our safeguards against malpractice at all levels through legislation and in-house regulatory procedures, placing quantitative position limits on traded options as well as the underlying assets and instruments over which they proceed.

Notes

1. Daniel Kane, *Principles of International Finance* (London: Croom Helm, 1988), p. 281; David Courtney et al., *An Investor's Guide to the Commodity Futures Market* (London: Butterworths, 1986), pp. 98, 101.
2. James T. Colburn, *Trading in Options and Futures* (New York: New York Institute of Finance, 1990), pp. 3–5.
3. Robert E. Fink et al., *Futures Trading: Conceptions and Strategies* (New York: New York Institute of Finance, 1988), p. 618; Colburn, *Trading Options*, p. 5.
4. Frank K. Relly, *Investment Analysis and Portfolio Management*, 2nd edition (Chicago: The Dryden Press, 1985), p. 761 ff; John Hull, *Introduction to Futures and Options Markets* (Englewood Cliffs, New Jersey: Prentice Hall, 1991), p. 4; Fink, *Futures Trading*, p. 619.
5. Keith Redhead, *Introduction to Financial Futures and Option* (Cambridge, England: Woodhead Faulkner, 1990), p. 82.
6. Lawrence J.Gitman et al., *Fundamentals of Investing*, 3rd edition (New York: Harper & Row, 1988), p. 212.
7. Fink, *Futures Trading*, p. 630; Colburn, *Trading in Options*, pp. 14–17.
8. Colburn, *Trading in Options*, p. 8.
9. Ibid, p. VIII.
10. Gitman, *Fundamentals*, pp. 545–46; Courtney, *Investor's Guide*, p. 108.
11. Teweles, *Commodity Futures*, p. 212ff; Kane, *Principles*, p. 288.
12. Hull, *Introduction*, p. 181.
13. Ibid., p. 182.
14. Ibid., p. 185.
15. Colburn, *Trading in Options*, pp. 78–81.
16. Cf. Abd al-Wahhab Ibrahim AbuSulayman, "*Al Ikhtiyarat: Dirasah Fiqhīyah Tahlilīyah Muqaranah*," *Majallah al-Buhuth al-Fiqhiyyah al-Mu'asarah*, n. 15 Jamadi al-Awwal 1413 A.H./October 1992, pp. 6–38. For earlier terminology on options see also Al-Jundi, *Mu'amalat al-Bursah*, pp. 133 ff.
17. Cf. Al-Jundi, *Mu'amalat*, pp. 162–163.
18. Cf AbuSulayman, "*Al Ikhtiyarat*," pp. 32.
19. Ibn Rushd, *Bidayah*, II, 157 ff; Al-Shirazi, *Muhadhdhab*, I, 343; Al-Jundi, *Mu'amalat*, p. 141 ff; Hasanayn, *Nazariyyah Butlan al-'Aqd*, pp. 55–56.
20. Ibn Juzay, *Qawanin*, pp. 286–287; Ibn Qudamah, *Al-Mughni*, III, 585; Ibn Rushd, *Bidayah al-Mujtahid*, II, 159; Hasanayn, *Nazariyyah Butlan al-'Aqd*, pp. 59–60.
21. Al-Sarakhsi, Al-Mabsut, XIII, 19; *Al-Kasani, Bada'i'*, V, 171; Al-Shirazi, *al-Muhadhdhab*, I, 356.
22. Al-Hattab, *Mawahib*, IV, 375; Ibn Qudamah, *Al-Mughni*, IV, 217; Ibn Taymiyyah, *Nazariyyah*, pp. 16, 152.
23. Ibn Qayyim al-Jawziyyah, *I'lam*, II, 327.
24. Al-Jundi, *Mu'amalat al-Bursah* p. 151 ff; Yusuf Sulayman, "*Ra'y al-Tashri' fi Masa'il al-Bursah*," *Al-Mawsu'ah*, V, 425; Ali Abd al-Qadir, "*Ta'qib 'ala Ra'y al-Tashri' fi Masa'il al-Bursah*," *Al-Mawsu'ah*, V, 441.
25. Hasan, *'Amal Sharikat al-Istithmar*, pp. 268–271.
26. AbuSulayman "*Al Ikhtiyarat*," *Mujallah al-Buhuth*, pp. 32–33.
27. Ibid., p. 33.
28. Ibid.
29. Ibn Rushd, *Bidayah*, II, 162; Ibn Qudamah, *Al-Mughni*, IV, 256.
30. Ibn Qudamah, *Al-Mughni*, IV, 258; Al-Qaradawi, *Shari'ah al-Islam*, p. 114.