Shari'ah Standard No. (20)

Sale of Commodities in Organized Markets

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This Standard aims to elaborate the foundations on which international commodity sales, between parties from different countries, are based whether the contracts have been concluded for spot or deferred commodities or through derivatives (futures, options, indexes and swaps). The Standard also explains what is permissible out of these according to the Shari'ah and what is not, along with an explanation of the Shari'ah substitutes for them within the Islamic financial institutions (Institution/Institutions).[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This Standard covers international sales contracts whose subject-matter are commodities and to derivatives of various kinds: Swaps, Indexes, Futures and Options.

The Standard does not cover financial and commercial paper or currencies, because these have their own specific standards, just as it does not cover sales that are concluded outside the organized markets.

2. Definition of International Sales and Their Kinds

2/1 Definition of international commodity sales

2/1/1 International commodity sales are contracts that are concluded in organized commodity markets under the supervision of specialised Organizations and through intermediaries who coordinate the demand for sales and the demand for purchases by employing standard contracts that contain various conditions and specifications along with a statement of the period and place of delivery. The contract may also stipulate the deposit of a portion of the price as a security for the execution of the contract and opening of an account with the intermediary.

2/2 Types of international commodity sales

International commodity sales are divided into three types:

2/2/1 Spot contracts

These are contracts that require immediate delivery and acceptance of delivery, however, delivery and possession may take place within the limit of a day or two days in accordance with the regulations of the market.

2/2/2 Forward contracts

These are contracts in which both counter-values are deferred with the legal effects of the contracts taking place at a determined future date, and delivery and possession take place at that time.

2/2/3 Futures commodity contracts

These are contracts whose legal effects take place at a determined future date either through liquidation between the parties, or cash settlement or through counter-contracts, but they rarely end in actual delivery and possession.

2/3 Termination of international commodity sales

International commodity sales end in one of the following ways:

2/3/1 Contracts in which actual delivery takes place for both counter-values or in one of them;

2/3/2 Contracts that end through the operation of liquidation between the two parties;

2/3/3 Contracts that end in cash settlement by agreement; and

2/3/4 Contracts that end in counter-contracts.

3. Shari'ah Basis for International Commodity Sales

3/1 Spot contracts

Conclusion of spot contracts in the commodity markets is permitted with the following conditions:

3/1/1 That the commodity sold must be in existence and owned by the seller;

3/1/2 That the commodity sold must be ascertained in a manner that distinguishes it from others;

The documents that establish the existence of the commodity, its ownership and distinguish it from others are sufficient proof of the realisation of the two previous conditions.

3/1/3 That the contract should not include a condition that prevents the buyer from taking delivery of the commodity sold and obliges him to accept a set-off for value;

3/1/4 That the price be paid on a spot basis. Delay, without the stipulation of delay, in the delivery of an existing and ascertained commodity, or delay in the acceptance of spot price, does not affect the validity of the contract.

3/2 Forward contracts (both counter-values delayed)

3/2/1 These are the selling and buying of commodities with the stipulation of delivery in the near future. They differ from futures transactions insofar as they are not organized in an exchange and they are instruments of hedging that do not submit to financial supervision.

3/2/2 There are two forms for contracts with both counter-values delayed:

3/2/2/1 That the commodity is a liability through description, while the price is deferred, irrespective of the contract being concluded with the word sale or with the word Salam. These contracts are not permitted, because they amount to a Salam contract in which the capital of Salam (Ras al-Mal) is not paid promptly. [see Shari'ah Standard No. (10) on Salam and Parallel Salam]

3/2/2/2 That the commodity is ascertained, but a delay in its delivery is stipulated along with a delay in the price. Such contracts are not permitted.

3/2/3 When the contract is that of Istisna'a, such a contract is valid even when the price is delayed. [see Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a, item 3/1/5]

3/2/4 There is no restriction in delaying one of the counter-values: the price, while observing Accounting Standard No. (20) on Deferred Sale; and the commodity sold, while observing Shari'ah Standard No. (10) on Salam and Parallel Salam.

3/3 Futures transactions in commodities

It is not permitted to undertake futures transactions according to the Shari'ah, either through their formation or by trading in them. [see items 2/2/3, 5/1]

4. Key Applications of International Commodity Sales

4/1 Permissible applications of international commodity sales:

4/1/1 Appointing another person as an agent for the purchase of a commodity at a spot price, and the sale of the commodity by the agent to a third person for a deferred price on behalf of the principal along with the determination of compensation for the agent as part amount or percentage of the purchase price of the commodity. These are the operations of the "Investment Agency."

4/1/2 Appointing another person for the management of purchase operations with a spot price and sale on a deferred basis with the manager being entitled to a known undivided share in the profit. These are "Mudarabah" operations. [see Shari'ah Standard No. (13) on Mudarabah]

4/1/3 The agent undertaking -after the purchase of the commodity on account of the principal- to buy it for himself from the principal with the stipulation of distinguishing between the liability of the agent and the liability of the principal for the commodity and this by ensuring two independent offers and acceptances between the principal and the agent. It is possible that this be accomplished through the exchange of two advices, one for notifying ownership by means of agency and the proposal of purchase (offer), and the other for agreement to sell (acceptance). [see Shari'ah Standard No. (8) on Murabahah (appendices A and B)]

4/1/4 Purchase by the institution of a commodity on a spot basis and the subsequent sale of this commodity by the institution to another on a deferred payment basis. In this application the avoidance of buy-back is stipulated, like the buyer selling what he purchased with a deferred price to one from whom it was initially bought on a spot basis at a price lesser than this (deferred price).

4/2 International commodity sales prohibited by the Shari’ah

4/2/1 Transactions in commodities that are not permissible.

4/2/2 Sale of the purchased commodity prior to its ascertainment in a manner that distinguishes the commodity sold from other commodities leading to the overlapping of the liability of the buyer and the liability of the seller due to the mixing up of what is owned by the buyer with what remains with the seller.

4/2/3 Purchase by the agent of a commodity for the institution’s account and its sale thereafter to himself without the exchange of two advices of offer and acceptance between the agent-buyer and the institution that owns the commodity so that the liability of the principal (seller) and the liability of the agent selling the commodity to himself come to overlap.

4/2/4 Sale by the agent of the purchased commodity before actually or legally taking delivery. Legal delivery includes the transfer of liability to the buyer (agent) by ascertaining the commodity in a manner that distinguishes it from things other than the commodity sold.

4/2/5 Commodity purchase operations of the institution through agency and purchase thereafter by the agent for his own account on a deferred basis by confining the transaction to an offer by the agent to the institution to enter into the transaction and acceptance by the institution thereof prior to taking possession of the commodity by the institution or without the exchange of the two advices of offer and acceptance.

4/2/6 Purchase of a commodity by an institution on the basis of a spot price and thereafter its sale to the (same) institution it-self on a deferred basis, or its sale to a holding institution of the seller institution with complete or majority ownership, or with effective control, amounts to a buy-back ('Inah) sale. [see Shari'ah Standard No. (8) on Murabahah and item 2/2/4 of Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a]

4/2/7 Sale by an agent of a commodity for his client, prior to the transfer of ownership to him through purchase, to an institution that is his principal.

4/2/8 Sale of ascertained specified commodity, without its passing into the ownership of the seller, through fictitious documents or the sale of the same commodity at the same time to more than one institution dealing with the commodity. It is necessary to be precise about the numbers of the title documents of the commodity along with the fixing of liability for the person causing a discrepancy.

4/2/9 The lack of detail about compensation for agency (brokerage) and merging it with the determined purchase price, which is stated as an amount that includes it. The substitute for this is the mentioning of the compensation and then deducting it from the inclusive price, or the addition of the compensation to the purchase price or the determination of the sale price with the specification that what is in excess is the compensation of the agent.

4/2/10 A statement within the general memorandum of agency for purchase and sale of commodities that denies the right of the buyer (principal) to take delivery of the commodity.

4/2/11 The institution making the payment of the purchase price of the commodity contingent upon the agent providing a guarantee for the payment of the sale price by the agent himself or by another person.

4/2/12 Stipulation of a guarantee by the seller for the sale price under all circumstances. He is obliged to provide a guarantee in case of tort, negligence or breach of the provisions of agency like the stipulation that he obtain sureties from the buyers of the commodities with respect to the deferred period. [see Shari'ah Standard No. (5) on Guarantees]

5. Derivatives

Derivatives have a large number of kinds, the most important of which are: Futures, Options, Indexes and Swaps. The Shari'ah rule for derivatives is based on the rule for the contracts employed within their framework, as stated in paragraphs that follow:

5/1 Futures

5/1/1 A contract that is binding under law. It is concluded on the trading floor of the exchange for the sale and purchase of commodities or financial instruments for a period linked to the near future. The transaction is arranged with the mentioning of the quantity, type and category along with the statement of the date and place of delivery. As for the price, it is the sole element that varies, and it is ascertained in the trading hall.

5/1/2 The Shari'ah rule for futures contracts

It is not permitted according to the Shari'ah to undertake futures contracts either through their formation or trading. [see para. 4]

5/2 Options

5/2/1 A contract by means of which a right is bestowed -but not an obligation- for the purchase or sale of an identified item (like shares, commodities, currencies, indexes or debts) at a etermined price and for a determined period. There is no obligation in this contract except on the person selling this right.

5/2/2 The Shari'ah rule for options

Options indicated above are not permitted neither with respect to their formation nor trading.

5/2/3 Shari'ah substitutes for options

5/2/3/1 The conclusion of a contract pertaining to ascertained assets is permitted according to the Shari'ah, along with the payment of part of the price as 'Arboun (Earnest Money) with the stipulation that the buyer has the right to revoke the contract within a specified period in lieu of the entitlement of the seller to the amount of earnest money in case the buyer exercises his right of revocation. It is not permitted to trade the right established with respect to the earnest money.

5/2/3/2 The conclusion of a contract for commodities in themselves along with the stipulation of an option for establishing the right of revocation for one of the parties, or for both, during a known period. This option is not eligible for trading.

5/2/3/3 The issuance of a binding promise by the owner of assets to sell them, or a binding promise by one desiring to buy them, without specifying a counter-value for the promise. This promise is not eligible for trading.

5/3 Swaps

5/3/1 Swaps are agreements between two parties for the temporary exchange of determined financial assets, material assets or interest rates. In some cases the sale of a commodity or deferred currency takes place without the transaction resulting in any exchange of the commodity, while in other cases there may be an option, in return for a counter-value, that gives the owner the right to execute or not to execute the contract.

5/3/2 The Shari'ah rule for swaps

Swaps are not permitted in the forms in which they are practised in commodity exchanges.

6. Date of Issuance of the Standard

This Standard was issued on 30 Rabi' I, 1425 A.H., corresponding to 20 May 2004 A.D.

Adoption of the Standard

The Shari'ah Standard on International Commodity Sales in Organized Markets was adopted by the Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D.

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (8) held in Al-Madinah Al-Munawwarah during the period of 28 Safar to 3 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board decided to issue the Standard on International Commodity Sales in Organized Markets.

On 25 Rajab 1423 A.H., corresponding to 2 October 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare an exposure draft on international commodity sales in organized markets.

The Shari'ah Standards Committee (2) in its meeting held in the Kingdom of Bahrain on 13 Safar 1424 A.H., corresponding to 15 April 2003 A.D., discussed the juristic study and required the consultant to incorporate necessary amendments in the light of the discussion and the observations of the members. The Committee also discussed the exposure draft in its meeting held on Monday 23 Rabi' II, 1424 A.H., corresponding to 23 June 2003 A.D., and made necessary amendments in the light of the discussion and the observations of the members.

The revised exposure draft of the standard was presented to the Shari'ah Board in its 11th meeting held in Makkah Al-Mukarramah during the period of 2-8 Ramadan 1424 A.H., corresponding to 27 October - 2 November 2003 A.D. The Shari'ah Board made amendments to the exposure draft of the standard and decided that it be sent to specialists and interested parties in order to obtain their comments in preparation for its discussion in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 29 Dhul-Qa'dah 1424 A.H., corresponding to 21 January 2004 A.D. The public hearing was attended by more than fifteen participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2), responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) in a joint meeting in the Kingdom of Bahrain on 30 Dhul-Qa'dah 1424 A.H., corresponding to 22 January 2004 A.D., discussed the comments that were made during the public hearing as well as the observations received in writing. The Committees made amendments that were deemed suitable.

The amended exposure draft was presented to the Drafting Committee in its meeting held in the Kingdom of Bahrain on 25 Safar 1425 A.H., corresponding to 15 April 2004 A.D.

The Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D., discussed the amendments suggested by the Shari'ah Standards Committee and the Drafting Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

Appendix (B)
The Shari'ah Basis for the Standard

- The basis for the permissibility of international sales transactions that fulfil the required Shari'ah elements and conditions of the validity of sales is their inclusion within the fold of the sale with respect to which the Words of Allah, the Exalted, were laid down: ***{"...Where Allah has permitted trading..."}***,[(2)] as well as His Words: ***{"...Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent..."}***.[(3)] The implementation of the international conventions on sales or the implementation of the laws of some countries does not require prohibition of these sales if they do not contain what conflicts with the rules and principles of the Shari'ah, and this is due to the Words of Allah the Exalted: ***{"O you who believe! fulfil (your) obligations..."}***,[(4)] with the proviso *"except what legalizes the prohibited and prohibits what is legal"*, due to the words of the Prophet (peace be upon him): *"Muslims shall abide by their conditions, except for a condition that legalises the prohibited or prohibits the lawful"*.[(5)]
- The basis for the prohibition of delaying of both counter-values is that in this there is the creation of two liabilities, along with what the jurists have mentioned with respect to the impermissibility of delaying the capital of Salam. Further, there is opposition to the conditions required by the contract. The basis for the conditions of spot contracts in the commodity

(2) [Al-Bqarah (The Cow): 275].
(3) [Al-Nisa` (Women): 29].
(4) [Al-Ma`idah (The Table): 1].
(5) This Hadith has been narrated by a number of Companions. It has been related by Ahmad [1: 312]; Ibn Majah with a hasan chain of transmission [2: 784], Mustafa Al-Babi Al-Halabi edition, Cairo (1372 A.H./1952A.D.); Al-Hakim (Hyderabad, India edition, 1355 A.H.); Al-Bayhaqi [6: 70, 156], [10: 133], Hyderabad, India edition, 1355 A.H.); Al-Daraqutni [4: 228], [3: 77], Dar Al-Mahasin Lil-Tiba'ah, Cairo (1372 A.H./1952 A.D.).

markets is that these are general conditions of sale and are permitted according to the Shari'ah.

- The basis for the permissibility of contracts in which one of the counter-values is deferred is the validity of *Bay' Mu'ajjal* and Salam.
- The basis for the permissibility of forms of transactions mentioned in the Standard related to international commodity sales is that they are concluded in accordance with the principles of Wakalah (agency), sale with a deferred period, Murabahah sale, and all these are valid contracts.
- The basis for the obligation of issuing an offer by the agent for seeking a sale on his own account and its acceptance by the principal as a seller is the distinction between the liability of the seller (the principal) and the liability of the buyer (the agent).
- The basis for the obligation of specifying the wages of the agent, and not merging it with the price is the Hadith: *"He who hires a hired worker must make known to him his wages"*.(6) This rule of the contract of Ijarah is applicable to agency for wages.
- The basis for the prohibition of stipulating the lack of delivery in commodity sales is that this negates the requirements of sale, which are the transfer of ownership to the buyer and his right to undertake transactions in the sold commodity.
- The basis for prohibiting the stipulation of a guarantee by the agent is that the agent is a trustee and does not provide a guarantee except for cases of transgression, negligence or going against the constraints of agency.
- The bases for the prohibition of deferred transactions in currencies are the Hadiths prescribing the obligation of possession in their sale. This has received support from a resolution of the International Islamic Fiqh Academy emphasising this.(7)
- The basis for the prohibition of derivatives is that these are binding promises that are converted to sale contracts pertaining to the future without an offer and acceptance. The Shari'ah substitutes mentioned in the Standard for derivatives are stated in a resolution of the International Islamic Fiqh Academy.(8)

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(6) Related by Ibn Majah in his *"Sunan"* [2: 817]; See also *"Majma' Al-Zawa`id"* by Al-Haythami [4: 98], Dar Al-Rayyan Lil-Turath and Dar Al-Kitab Al-'Arabi.

(7) The International Islamic Fiqh Academy Resolution No. (63) 1/7.

(8) The International Islamic Fiqh Academy Resolution No. (63) 1/7.

- The basis for the impermissibility of options is that the subject-matter of the contract in them is not wealth that can be deemed compensation according to the Shari'ah.[9]
- The basis for the impermissibility of swaps is that no actual exchange of counter-values takes place thereby. Such swaps, as well, usually constitutes interest payment, 'Inah, and deferment of one of the counter-values.

(9) The International Islamic Fiqh Academy Resolution No. (63) 1/7.