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**Futures and Forwards Contracts from Perspective of
Islamic Law**

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Abstract. Futures and forwards contracts are considered of the main derivatives contracts, which offer many services and benefits, namely risk management (hedging), and speculation. However, these contracts from the perspective of Islamic experts are varying and non-uniformed, where there are those who see futures and forwards contracts as unacceptable and forbidden by Islamic *law*, and there are also those who see futures and forward contracts as acceptable and compatible with Islamic law. This paper attempts to clarify the Islamic law perspective of futures and forwards contracts, to give a clearer picture about the legitimacy of these contracts, in order to examine whether the using of futures and forwards contracts are permissible or prohibited. The study follows the inductive method and descriptive research by displaying texts, previous literature, opinions of futures and forwards contracts from Islamic law perspective and comparisons between them, including the balancing and elicitation in light of Islamic law standards, strength of the arguments relied upon by each party and commitment to offer the presentation matter scientifically. The study's conclusion the current application of futures and forwards contracts in the financial markets are impermissible and are considered prohibited contracts. The study find futures and forwards contracts contain a number of forbidden elements in Islamic law, especially gambling and harm speculation additions to a number of pictures of some forbidden elements such as *gharar* (ambiguity), *riba* (usury) that are still in the circle of debate among Muslim scholars. However, the availability of a some terms and conditions that can dispose the prohibited elements in these contracts may make them compatible and consistent with the Islamic law.

Keywords. Derivatives; Future; Forward; Islamic law; Hedging.

JEL. G10, G13, G15.

1. Introduction

Futures and forwards contracts are considered of the main derivatives contracts, traded in most global financial markets, in addition to the options and swaps contracts. Futures and forward contract are defined as a binding contracts to buy or sell underlying assets either commodities assets or financial assets on future date at a specified price agreed upon at the time of the trade (Chance, 2004; Kamali, 2007; Vashishtha & Kumar 2010).

Futures contracts includes trading stocks, bonds, currency, commodities and index and the contracts follow daily settlement procedure of clearinghouse (Chance, 2004). Futures contracts are traded only in organized market.

Forwards contracts, like futures contracts, include trading stocks, currency and commodities, except that they are traded in the-over-the-counter market rather

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organized market, where the contract can be designed and tailored to the contractors' needs and desires.

Futures and forwards contracts offer many advantages and benefits like other derivatives contracts such as risk management services (hedging) by protecting participants against risks which cannot be eliminated unless by using derivatives contracts. Futures and forwards contracts also provide other advantages such as speculation by exploiting leverage feature, arbitrage and price discovery by determining the future price of securities and commodities in the financial markets (Chance, 2004).

However the Islamic law perspective of futures and forwards contracts differ, where, there are who see futures and forward contracts as not valid or not comply with *Shari'ah* requirements as the contracts involve *riba* (interest), *gharar* (Uncertainty), *Maysar* (gambling) and speculative purposes. Due this factor, it will limit an alternative for investment for Muslim investors. Therefore, they could not take full advantageous of future and forward contracts for the purpose of risk, while on the other side, there are who see the future and forward contracts as valid to their importance in risk management and its similarity to a number of Islamic contracts.

Because of these reasons, the study tries to investigate on the current application of future and forward contracts and identify factors that contributed towards non-*Shari'ah* compliance. At the same time, the paper tries to look on the requirements of Islamic law towards implementation of future and forward contracts.

The study gathered the Islamic scientists and researchers views in this field then has been compared between them in scientific and neutral manner in order to reach a clear and precise view about the mechanism of these contracts in the global financial markets from Islamic law perspective, as well as to develop the conditions and terms that should be available in these contracts, to be fully compliant with *Shari'ah* provisions.

This paper will be presented as follow, Section one will discuss on the introduction of the study. Section two will cover the summary of the scholarly debate in prohibit futures and forward contracts. Section three discuss the scholarly arguments in favor of futures and forward contracts. Section four requirements of *Shariah*-compliant future contract. Section five that will cover on study findings. Finally, section six study conclusion.

2. Summary of the Scholarly Debate in Prohibit Futures and Forward Contracts

The majority of Muslim expertise views that the futures and forwards contracts that are currently trading in the financial market are not permissible because they involve high risk and *gharar* resulting from the sale of what is not with you or an asset not in the possession of the seller, debt by debt sale and gambling (El-Gamal, 2008; Abdelwahab, 2007; Al-Suwailem, 2007; Hattab, 2005; Al-Shatnawi, 2009; Dawabah, 2006; 2007; Abu Al-Nasr, 2006; Kamel, 2006; Al-Suleiman, 2005; Fayyad, 1998; Ahmad, 1995; Al-Qura Daghi, 2002; Radwan, 2005; Al-Khalil, 1424H; 1426H; Al- Al-Zuhaily, 2006; Al-Salous, 2006; Usmani, 1996; International Islamic Fiqh Academy, 1992; Islamic Fiqh Academy of Muslim World league, 1984).

The following are explaining of the main criticisms of prohibited futures and forwards contracts:

Futures and forwards contracts include sell dose not won, where this sale lead to *ghara*. Radwan, (2005), Abu Al-Nasr (2006), Dawabah, (2007), Obaidullah (2002),

and Al-Sa'ati (2012) stated these contracts contain sale of underlying asset does not exist on their ground and not in the seller ownership as well.

Ibn Qudamah (1401H) Al-Husseini (n.d), Al-Hashemi (n.d), al-Humam, (1970), and Al-Sanani (1353H) prohibited sell dose not won in Islamic law. Al-Sywasi (n.d) and Ibn Abdeen (n.d) considered this sale is void for the lack of ownership. Imam al-Shafei also considered it contract involves *gharar* (Al-Mazni, 1321H).

Further, sell dose not won is a part of *qimar* and *maysar* (gambling) (Ibn al-Qayyim & Ibn Taymiyah, n.d). Finally, this sale is considered as *al-ma'adum* (non-extant) sale (Al-Shawkani, 1994) where futures contracts concerning things are basically invalid on the account of non-existent items (Mahmassani, 1983).

Futures and forwards contracts include selling items prior to taking possession (Abu Al-Nasr 2006; Dawabh, 2007). The lack of real possession (sale prior to taking possession) making these contract not valid (Usmani, 1999). Current futures contracts are prohibited because the contracts include selling item prior to taking possession (International Islamic Fiqh Academy, 1992). Selling items prior to taking possession is prohibited sale (Al-Shafei, 1321H; Al-Sarkhasi,1986; Al-Shirazi, n.d). In addition, the delivery of the item (underlying assets) in sales contracts is required, and if the seller is unable to deliver it, the transaction would entail *gharar*, gambling and risk Al-Zuhaily, 2002.

Most of current futures and forwards include sell dose not won, and selling item prior to taking possession which are consider pictures of *gharar* and thus making these contracts not valid in Islamic law.

According to the latest statistics of derivatives markets, the amount estimated for direct trade in financial derivatives contracts that have not yet been paid by the end of December 2008 was \$592 trillion and this amount is equivalent to almost ten times the value of the gross domestic product of all countries in the world.

The *gharar* pictures reflected in these contracts when the parties or one of them unable to fulfill his obligation to deliver underlying assets at expiration day, simply because he did not possess or owns the underlying asset, and thus waste the right of the contractors.

The deferment of both final payment and item delivery is another criticism for futures and forwards contracts (Jobst & Sole, 2012; Al-Sulayman, 2005; Salehabadi & Aram, 2002, International Islamic Fiqh Academ, 1992; Islamic Fiqh Academy of Muslim World league, 1984). This is due to the fact that these contracts include *bay' al-kali bil kali*, (*bay' al-dayn*) (sale of debt) where both parties - seller and buyer - agree to defer both price payment and delivery of item in the future.

The consensus of Muslim scholars prohibited *bay' al-kali bil kali* (Ibn Taymiyah1385H; Ibn al-Qayyim,1973; Ibn Qudamah,1401H; Ibn al-Munthir, 1405H; Ibn Rushd, n.d; Al-Dharir, 1967).

And the prohibition of *bay' al-dayn* is a logical consequence of the prohibition of *riba* (Al-Dharir, 1967; Usmani, 2005). Ibn Taymiyah and Ibn al-Qayyim considered *bay' al-kali bil kali* (*bay' al-dayn bil dayn*) as a means to *riba*, and thus not a valid legal benefit, and leads to conflict between parties, *gharar* and excessive risk (Ibn al-Qayyim,1973).

A part from that, the current application of future and forward contracts in the markets does not involve the contract effects when established by deliver price or item, but rather, the participants in that market deferred the contract effects and provisions (paying the price and settling underlying asset) to expiration date in the future, which is considered like prohibited debt sale in Islamic law.

The consensus of Muslim scholars prohibits selling of *al-A'ayans* (assigned item) on credit sale (Ibn Rushd, n.d). It is not permissible to sell *al-a'ayans* on credit, for technical considerations in Islamic *fiqh* (Al-Sanhoori, 2001; Al-

Sulayman, 2005). For example, it is not accepted to sell an assigned car (this car) on credit but it is accepted to sell a car inclusive of characteristics of such and such on credit sale. Additionally, stocks trading on credit sale (futures on stocks) is prohibited because the stocks are *a'ayans*, which is not permitted for selling on deferring base, and the postponement of delivery of stocks has no valid purpose (Al-Sulayman, 2005). Further, the underlying stocks are not accepted in credit sale (futures markets) (al-khalil, 1424H; Nasbnh, 2013). Meanwhile, the accepted underlying asset in futures contracts is only for stereotyped goods (quantity and quality) that have active demand, storable, and have a value compared to their size, such as agricultural crops and minerals (Hindi, 1997).

Futures and forwards contracts conducted on prohibited underlying asset are definitely considered as impermissible such as when underlying asset is interest rate such as futures and forwards interest rate contracts. And when underlying asset is hypothetical such as futures and forward index are prohibited and are considered as a form of gambling (International Islamic Fiqh Academ, 1992). The prohibition occurs on these contracts also when the underlying asset is money (currencies) such as futures and forward currencies contracts since currencies are not considered as a commodity for selling and buying rather, it is a method for trading (Danila & Jeffers, 2009). The currencies must be traded on spot rather than on deferment basis so it is not accepted in futures and forward contracts. Currencies should only be traded hand to hand on spot basis, not on deferment basis (Jobst & Sole, 2012). Further, International Islamic Fiqh Academy (1992) and Islamic Fiqh Academy of Muslim World league (1984) considered deferring currencies are prohibited because it is *riba al-nasiah*.

Futures and forwards contracts are used for speculation and gambling purposes (Al-Khalil, 1424H; Abu Al-Nasr, 2006; Dawabh, 2007). Where many of these contracts are not intended to be settled by delivery or by making real possession or even real ownership and thus, they are not genuine contracts (Radwan, 2005).

Any contract that includes false contract (*suwari*) or fake does not intend to deliver item and price is void contract (Al-Zarqa, 1985). This fully applies to futures and forwards contracts where many of these contracts are not intended to be settled by delivery or by making real possession or even real ownership and thus, it is not a genuine contract.

Instead, it is considered a type of prohibited speculation activity aimed to exploiting price fluctuations to achieve capital gains (Gupta, 2006). The reason can be traced to leverage features in derivatives contract, where the buyer and the seller are required to deposit only a fraction of the contract value which enables them (speculators) to enter into more contracts than spot market. This causes the market to be more liquid, consequently increasing the speculative volume in derivatives market.

Trading volume of futures contracts is often much larger than underlying assets and this is due to speculating activity and gambling in derivatives (Bacha, 1999). Al-Suwailem (2007) stated that based on the office of the comptroller of currency (OCC), only 2.7 % of derivatives transactions used by end users for hedging ended by actual delivery while the majority, 97.3 %, is used for speculation by speculators and dealers which ended by cash settlement. Salehabadi & Aram (2002) and Gupta (2006) asserted that those who participate in future contracts are not for risk protecting rather, for speculating and in fact, hardly 1% or 2% percent of traded derivatives instruments are settled by actual delivery of the underlying assets while the rest were ended through cash settlement, not including real sale.

The speculation and gambling pictures in futures and forwards contracts also reflected in the huge trading volume of derivatives relative for the gross domestic products GDP of the world, where the trading volume of derivatives all over the

world in the parallel market at end of 2012 amounted to more than \$1.270 quadrillion and in the organized market more than \$52 trillion. Meanwhile, the gross domestic products (GDP) volume of the world at end of 2012 was only at \$71.9 trillion, and this amount is equivalent to almost 18 times the value of the gross domestic product of all countries in the world.

As result, [International Islamic Fiqh Academy \(1992a\)](#) and Islamic Fiqh Academy of Muslim World league (1984) indicated that these contracts are forbidden because the ultimate goal from that is just for paying and receiving price differences between sellers and buyers and is considered as gambling and is therefore impermissible.

Another criticism is the availability of offsetting sales and purchases in the futures markets as whole. Where, the sale of underlying asset in *Salam* contract prior to possessing it is prohibited ([International Islamic Fiqh Academy, 1992](#)).

Reasoned that the repeated sale of the same underlying asset in the chain while none of the participants took possession will add burden to the customers by adding the extra profit of repeated sale to the commodities' price and the burden of having to pay this extra profit is passed to the customers ([Al-Zarqa, 1985](#)).

[International Islamic Fiqh Academy \(1992a\)](#) and [Dawabah \(2007\)](#) stated that futures contracts are different from *salam* contracts, where the price in futures contracts is deferred to expiration date, while in *salam* contracts the price paid during the contract session or can be delayed until three days further, [El-Gari, \(1993\)](#) indicates that commodity futures contracts include selling prior to taking possession which is not the case in *salam* contract.

3. Arguments in Favor of Futures and Forward Contracts

Futures contract and Forwards contracts have important role in risk management and hedging. Where, some Muslim jurists have differing opinions of futures and forwards contracts.

[Kamali \(2007\)](#) and [El-Gari \(1993\)](#) concluded that Futures contract is permissible when it does not violate a decisive principle, is clear of *riba* and gambling, and does not include excessive *gharar*.

The first criticism pertaining to *gharar* results from the sale does not own. [Al-Dardir \(n.d\)](#) stated its accepted, but the contract must be non-binding, where at least one of contractors has right to revoke the contract .

The *hadith* of prophet Mohammad that prohibits sale does not own applies only to the sale of underlying assets in rem (*bay' al-a'ayans*), not to fungible goods [Al-Baghawi \(1974\)](#) and [Al-Khattabi \(1949\)](#). Further, [Ibn Al-Qayyim \(n.d\)](#) concluded the *hadith* is related to a specific item, not for described goods and also [Ibn Al-Qayyim \(n.d\)](#) and [Ibn Taymiyah \(1398H\)](#) the *hadith* is related to sale of what is not present and what the seller cannot deliver.

The *hadith* that prohibit "sale does not own " applies only to sales that include specific objects and not to fungible goods, and the futures contracts normally proceed over fungible goods ([Kamali, 2001; 2002; 2005; 2007](#)).

Also, for selling prior to taking possession, some Muslim scholars have differing opinions on the possession of other items where for these scholars they do not require the possession of non-food stuff [Ibn Rushd \(n.d\)](#) stated selling non-food item before taking possession is acceptable. Also, real estate and non-weighted items can be sold before taking possession ([Al-Hashemi, n.d; Al-Bahooti, 1997](#)).

The *ilah* (causality) of prohibited sale does not own and sale prior to taking possession, is *gharar* (dispute) due to the seller's inability or failure to deliver underlying assets, where if he ensured the delivery, then the existence or possession of the subject-matter is no longer an issue and the prohibited thing is the

inability to deliver (Al-Qaradawi, 1998; Obaidullah, 1999). Further, selling non-existent items but whose existence is certain in future is permissible (Mansuri, 2005). Muhammad (2000) assured that the existence of the subject-matter is not a prerequisite for a permissible contract.

There is clear sanctity of the sale of goods or financial securities before taking possession, for the presence of usury and *gharar* however, if there is no *riba* and *gharar*, it becomes permissible as in *salam* contract, but it is better to take possession on the commodities (financial securities) before the sale. Apart from that, the food is excluded from that, must be possessed before selling, but if the food is a preserved-type food, it can be sold before taking possession (Hattab, 2007).

For the deferring of delivery of price payment and underlying item, some Muslim experts in Islamic finance accept that deferring. Deferring both price and subject matter is accepted in the forward markets for the underlying commodities only, while for financial securities, it is impermissible (Ahmad, 1995). Meanwhile, Hamoud (1976) stated deferring both in exchange is accepted based on *muawadhah*. This type of contracts which include selling debt for debt is in the needs of traders and industrialists, so based on *hajah* (needing) and *dharurah* (necessity), it can be used as soon as it retains the legal standard (Hammad, 1994). Deferring is accepted as long as it does not include foodstuff asset or any form of *gharar* (Al-Zuhaily, 2002).

There are some contemporary specialists in Islamic finance who accepted deferring (postponement) in both price and item, under certain conditions (Fayyad, 1998; Al-Sa'ati, 2003; Hattab, 2005; Kamali, 2007; Haneeni, 2010). In fact, the reason for this flexibility is that there will be no available room for speculation in price differences, unlike the futures and forwards contracts, since the products cannot be easily found in the market place (Obaidullah, 2002; Al-Sa'ati, 2002).

A part from that, there is no conclusive proof in the *Sunnah* on prohibition sale of debts (Kamali, 2007) Al-Albani (n.d) stated the *hadith* of *bay' al-kali bil kali* is weak. The *hadith* that talks about the prohibition of selling debt by debt is weak and thus cannot be used as inference for prohibition, and for the contract and its effects, it is right but the obligation to be contacted urgently, there is no evidence for that.

Some contracts that involve deferring for both price and item were accepted such as supply and *istisna* contracts, where supply contract is permitted (Khan, 2003; Al-Masri, 2007). International Islamic Fiqh Academy (1992b) concluded that *istisna* contract is permissible contract and can be used to defer price payment. Further, Al-Ashqar *et. al.*, (1998) stated *istisna* contract is debt for debt sale but is excluded from the prevention.

For futures and forwards as a form of *al-a'ayan* sales, Fdad (2000) declare the consensus of Muslim scholars accepted the sale of *al-ayan al-gha'ibah* (absent sale) as soon as underlying item is fully described, not of *al-ma'adum* sale, as well as owned by seller at contracting period. In fact, there are many scholars who accept *al-a'ayan* sales, however, many of them stipulated granting the buyer right to perform the contract after seeing the underlying item.

There is some level of needs for speculation activities for the purpose of market enhancing even though many Muslim jurists prohibit speculation. Al-Amine (2005) stated that some financial and economic experts believe that speculation has good reflection with regard to allocation of resources, decreasing price fluctuations in markets, restoring equilibrium between demand and supply and minimizing periodic gluts and shortages, it creates efficiency in the market.

In the matter of offsetting transaction, the opinion that speculation causes the offsetting of transaction which adds burden to the customers is not true. Instead, it

is improper to assume that everyone in the chain of sale makes profit when in fact people can make profit and also can make losses, and also some people may need to resort to a reverse transaction before taking delivery on the same point (Azzam, 1985). Apart from that, the validity of offsetting must be based on (*ibahah*) which means that the reverse trade must not include any contravention of Islamic law to be considered lawful (Kamali, 2005).

Forward contracts are in line with *bay' al-sifah* (sale of description) where the sale of item that is not present at the time of contracting is very well described and is to be delivered at later date and thus, the sale is accepted by Hanafi, Maliki and Hanbali scholars (Al-Amine 2005). On the other hand, other Muslim scholars see forwards and futures contracts as being similar to *bay' salam* and *bay' istisna*, which are Islamic contracts accepted by Islamic law.

Khomeini stated that, because we define the futures contracts as those that two parties settle on a future transaction, seller agrees to deliver the commodity in a future date to the buyer and buyer agrees to pay the price to the seller at that future time and as such, those futures contracts are in the form of *sulh* and are permissible (Salehabadi & Aram, 2012). Apart from that futures contracts are permitted if they are adjusted according to the Islamic rules, especially since these contracts reallocate risks, and collect and distribute information about the future course of prices in the spot market in order to achieve price stability in future (Al-Sa'ati, 1999).

Apart from that, Bacha (2007) considers futures trading is accepted in Islam based on *dharurah* (necessity) and need, where some futures contracts should be applied in Malaysia's derivatives market. Further, based on *Syariah* (law) Advisory Council of Securities Commission, Malaysia's opinion about futures trading of commodities is that it is acceptable as long as the underlying asset is not prohibited (Bacha, 2007).

4. Requirements for Accepting Futures and Forwards Contracts in Islamic Law

Futures and forwards contracts have many criticisms and are not accepted in Islamic law, according for many Muslims jurists however, the availability of some terms and conditions in futures and forwards contracts, based on the main criticisms, may correspond and match with the Islamic law. The terms and conditions include the following;

Futures and forwards contracts must not include any prohibited element such as *riba*, *gharar*, and gambling (*maysir*). Futures and forwards contracts must be governed and controlled tightly to prevent gambling, speculation and manipulation. Further, the intention of such contract must be for genuine buy and sale (economic activity) and all transactions must be on delivery basis and not on cash basis, intended for hedging purpose. Next, ownership and possession of underlying assets before entering into such contracts namely futures and forwards contracts that include something default or unreal is not acceptable. Futures and forwards contracts do not include currencies assets to avoid *riba* and they are only traded on spot market hand to hand. Also as important, futures and forwards contracts must be conducted on *halal* products or on assets that are accepted in Islamic law (*halal* commodities). Further, the contracts do not include deferring both items (price and subject matter) and offsetting contract before expiration date is not allowed. Finally, the clearinghouse must be included in all transactions as guarantee to all parties in an attempt to eliminate *gharar* resulting from counterparties' risk and ensure underlying asset delivery.

5. Study Findings

Based on the criticisms against futures and forwards contracts and arguments in favor of using futures and forwards, we can conclude that the prohibition of non-existent item sale and sale prior to taking possession do not have importance, if the *gharar* element does not exist in the contract and this *gharar* does not apply in the current transaction in the financial market under the clearinghouse converge and guarantees provided especially in organized markets. However, this does not mean that it is permissible to sell what is not with you or sell prior to taking possession of food, because this issue is still unfinished between scholars and experts of Islamic finance, and thus, to get out from the cycle of suspicion, the item (underlying asset) should be owned and possessed before selling.

The prohibition for the deferring of both price and subject-matter (*bay'al-kali bil kali*) is not considered as the main reason used for prohibition. This is because the *hadith* of *bay'al-kali bil kali* is weak and there is no conclusive proof in the *Sunnah* on its prohibition. Furthermore, deferring is accepted in supply and *istisna* contracts, but this does not mean that it is permissible to postpone both price and subject matter because this prohibition is supported by a consensus of Muslim Scholars and this issue is still unfinished between scholars and experts of Islamic finance, and to get out from the cycle of suspicion, the contractors should deliver at least the price or item (underlying asset) in advance.

The most important things are the current application, the use as well as the purpose of futures and forwards contracts in the global financial market are impermissible and are considered prohibited and forbidden because the contracts do not comply with the Islamic law principles. The prohibition comes from the falsity of these contracts where in fact, these contracts are not genuine contracts because they do not include real effect, there is no real sale or real buy; it's just a game used to calculate the profits and losses between parties ended by cash settlement rather than by delivery, and many of them are conducted on prohibited assets. These are considered as a picture of prohibited gambling, excessive *gharar*, *riba*, and harmful speculation (El-Gamal, 2008; Al-Ghoul, 2008; Abdelwahab, 2007; Al-Suwailem, 2007; Hattab, 2005; Haneeni, 2010; Al-Shatnawi, 2009; Dawabh, 2006; 2007; Abu Al-Nasr, 2006; Kamel, 2006; Al-Suleiman, 2005; Fayyad, 1998; Ahmad, 1995; Al-Qura Daghi, 2002; Radwan, 2005; Al-Khalil, 1424H; 1426H; Al-Al-Zuhaily, 2006; Al-Salous, 2006; Usmani, 1996; International Islamic Fiqh Academy, 1992; Islamic Fiqh Academy of Muslim World league, 1984).

Proven by the high percentage of derivatives contracts that use for speculation purpose which ended by cash settlement, the huge amount of derivatives contracts that have not yet been paid since years, the huge size of derivatives volume which is equivalent many times the value of the gross domestic product of world, and many of these contracts are conducted on prohibited underlying assets. Thus, it is of no doubt that the current conventional derivatives in the financial market is prohibited and forbidden contracts in Islamic law.

6. Conclusion

The current application of futures and forwards contracts in the financial markets is impermissible and they are considered prohibited contracts because they do not comply with Islamic law, where the main prohibition comes from the falsity of these contracts. In fact, these contracts are not genuine contract as they are ended by cash settlement and many of them are conducted on prohibited assets, and

this is considered as a picture of prohibited *riba*, *gharar* and gambling. However the availability of a some terms and conditions in these contracts may make them compatible and consistent with the Islamic law.

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Journal of Economics and Political Economy

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