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A thesis submitted to
The University of Gloucestershire
in accordance with the requirements of the degree of
Doctor of Philosophy
in
Islamic Banking, Finance and Management

The Markfield Institute of Higher Education

June 2012
This thesis analyses the resolution made by the Shariah Advisory Council of the Malaysian Securities Commission (SAC) which resolves that the crude palm oil futures contract is permissible. This resolution is controversial as it collides with the resolutions of other mainstream or internationally represented organisations of Shari'ah scholars. These mainstream resolutions rule that the commodity futures contract transgresses Shari'ah principles. However, the SAC contends that it is permissible on the principle of public interest ( masculinity) and on the notion that trading regulations have overcome Shari'ah prohibitions; namely, that of gharar (uncertainty) and maysir (gambling). The focus of this thesis is thus to analyse the adequacy of the SAC resolution in terms of its coherence with the real trading of the crude palm oil futures contract as well as the adequacy of the crude palm oil futures legal framework in overcoming Shari'ah prohibitions. This is an area which has not been given adequate attention in the current literature. Apart from the literature on the legality of the commodity futures contract, this thesis examines the legal framework of the Malaysian commodity futures market as well as the American and European markets. To compliment this research, non-structured interviews and discussions have been undertaken. In the final analysis, the data gathered from the interviews and discussions, as well as the relevant literature, evidences that the SAC resolution is not coherent with real trading and that the elements of gharar and maysir have not been eliminated by the trading regulations. Additionally, the analysis finds that, contrary to the argument of its proponents, the commodity futures market has failed to represent its purpose as a risk management tool as well as a price discovery tool. In summation, an inadequate resolution would inevitably undermine the SAC's position as Malaysia's sole Islamic capital market's Shari'ah advisor, and Malaysia's reputation as the international Islamic capital market hub.
DECLARATION

I declare that the work in this thesis was carried out in accordance with the regulations of the University of Gloucestershire and is original except where indicated by specific reference in the text. No part of this thesis has been submitted as part of any other academic award. The thesis has not been presented to any other education Institution in the United Kingdom or overseas.

Any views expressed in the thesis are those of the author and in no way represent those of The University.

Signed:                        Date: 22 JUNE 2012
ACKNOWLEDGMENTS

In the name of Allah, Most Gracious, Ever Merciful

All praise unto Allah alone. With His Will and Help, I have finally completed one of the most arduous journeys in life. Yet there is still much to learn.

My sincere and deepest gratitude goes to Dr. Ugi Suharto, my guru cum first supervisor. For without his advice and guidance, particularly in the initial stage of writing, my work would not have reached this standard. I am upmost grateful to my second supervisor, Dr. Uzaimah Ibrahim for her guidance, and abundance of faith she has placed in me, more than I did in myself. I am indebted to my former supervisors, Dr. Seif Tag el-Din and Dr. Mehmet Asutay for their supervision and advice during the critical early stage of my research journey.

A special thanks to my funder, the International Shari‘ah Research Academy for Islamic Finance (ISRA), for two and a half years of financial support. I also want to thank Muslim Aid UK for aiding me during the first few months of my study.

I would like to make special reference to the Islamic Foundation Library, particularly Humeyra, Jasmine, Hayee and Rafeek for their continuous and endless support. All of whom, have, without a doubt, eased this long and arduous journey.

A very special and most deserved thanks goes to my son, Izad Anwar, for his continuous sacrifice and patience, to my mother, Ishah Hassan, for her countless sincere prayers and words of comfort, and to my little guru-brother, Manan Lubis, for the countless discussions and guidance on fiqh issues. To my siblings Nor Aswati, Nor Hajar, and Manan Mudzaffar, thank you for believing and just being there for me. Last, but not least, I would like to offer thanks to my other family members (especially to Rita, Nurza Azrin, Azizan and Amir), relatives, friends and everyone who has been instrumental, directly or indirectly, in the completion of this thesis.

I dedicate this thesis to my late father, Kasri Ibrahim and to the Ummah. May truth and justice prevail...
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<td>AAOIFI</td>
<td>Accounting and Auditing Organisation for Islamic Financial Institutions</td>
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<td>CBOT</td>
<td>Chicago Board of Trade</td>
</tr>
<tr>
<td>CEA</td>
<td>U.S. Commodity Exchange Act</td>
</tr>
<tr>
<td>CFTC</td>
<td>U.S. Commodity Futures Trading Commission</td>
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<td>COMMEX</td>
<td>Malaysian Commodities and Monetary Exchange</td>
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<td>CPO</td>
<td>Crude Palm Oil</td>
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<tr>
<td>DOBI</td>
<td>Deterioration of Bleachability Index</td>
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<tr>
<td>EIA</td>
<td>US Energy Information Administration</td>
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<tr>
<td>FAO</td>
<td>United Nation’s Food and Agricultural Organisation</td>
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<tr>
<td>FFA</td>
<td>Free Fatty Acid</td>
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<td>FIA</td>
<td>Malaysian Financial Industries Act 1993</td>
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<td>FIMA</td>
<td>Fima Palmbulk Services Sdn Bhd</td>
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<td>FFM</td>
<td>Federal Flour Mills Bhd</td>
</tr>
<tr>
<td>GSHE</td>
<td>Guan Soon Heng Edible Oil Sdn Bhd</td>
</tr>
<tr>
<td>ICM</td>
<td>Islamic Capital Market</td>
</tr>
<tr>
<td>IFAJ</td>
<td>Jeddah-based Islamic <em>Fiqh</em> Academy</td>
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<tr>
<td>IFAM</td>
<td>Mecca-based Islamic <em>Fiqh</em> Academy</td>
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<tr>
<td>IPGA</td>
<td>Idaho Potato Growers Association</td>
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<td>IEA</td>
<td>International Energy Agency</td>
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<td>IV</td>
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<td>KLCCH</td>
<td>Kuala Lumpur Commodities Clearing House</td>
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<tr>
<td>KLCE</td>
<td>Kuala Lumpur Commodity Exchange</td>
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<tr>
<td>KLIBOR</td>
<td>Kuala Lumpur InterBank Offered Rate</td>
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KLOFFE  Kuala Lumpur Options and Financial Futures Exchange
LCTM  Long-Term Capital Management
MDCH  Malaysia Derivatives Clearing House
MDEX  Malaysia Derivatives Exchange
MME  Malaysia Monetary Exchange
M&I  Moisture and Impurities
NASAA  North American Securities Administrators Association
NOCE  New Orleans Cotton Exchange
NSR  Negotiable Storage Receipt
NYCE  New York Cotton Exchange
NYME  New York Mercantile Exchange
OPEC  Organisation of the Petroleum Exporting Countries
PORIM  Palm Oil Research Institute of Malaysia
SAC  Malaysian Shariah Advisory Council
SEOI  Sun Edible Oil Industries (M) Sdn. Bhd.
SIA  Malaysian Securities Industries Act 1983
SMP  Slip Melting Point
USDA  U.S. Department of Agriculture
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<td><em>al-dayn al-mustaqirr</em></td>
<td>A confirmed debt at maturity.</td>
</tr>
<tr>
<td><em>al-dayn ghayr mustaqirr</em></td>
<td>An unconfirmed and immatured debt.</td>
</tr>
<tr>
<td><em>al-khamr</em></td>
<td>Intoxicants.</td>
</tr>
<tr>
<td><em>al-anšāb</em></td>
<td>Idolatry.</td>
</tr>
<tr>
<td><em>āḵl al-māl bi ’l-bāṭil</em></td>
<td>Unlawful consumption of property of others.</td>
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<tr>
<td><em>al-azlām</em></td>
<td>Fortune telling and divining arrows.</td>
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<tr>
<td><em>‘aqd</em></td>
<td>Contract.</td>
</tr>
<tr>
<td><em>‘ayn</em></td>
<td>Unique objects.</td>
</tr>
<tr>
<td><em>bay’ al-dayn bi ’l-dayn</em></td>
<td>Debt clearance sale.</td>
</tr>
<tr>
<td><em>bay’ al-gharar</em></td>
<td>Sale involving risk.</td>
</tr>
<tr>
<td><em>bay’al hasah</em></td>
<td>Sale of the object which is dependant on the fall of the stone or pebble.</td>
</tr>
<tr>
<td><em>bay’ al-ma’dum</em></td>
<td>Sale of the non-existent object.</td>
</tr>
<tr>
<td><em>bay’al-mu’ajjal</em></td>
<td>Deferred sale.</td>
</tr>
<tr>
<td><em>bay’al-murābahah</em></td>
<td>Cost plus profit sale.</td>
</tr>
<tr>
<td><em>bay’ al-kāli’ bi ’l-kāli’</em></td>
<td>Sale of one debt for another debt.</td>
</tr>
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<td><em>bay’ atayn fi bay’ah</em></td>
<td>Sale in which two prices were quoted, one prompt and the other deferred.</td>
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<td><em>bay’ bithaman ajil</em></td>
<td>Sale contract where the payment is deferred and usually made in instalments over an agreed period of time.</td>
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<tr>
<td><em>damān</em></td>
<td>Liability for loss.</td>
</tr>
<tr>
<td><em>dayn</em></td>
<td>Debt, which comes into existence as a result of any other contract or credit transaction.</td>
</tr>
<tr>
<td><em>dhimmah</em></td>
<td>Personal responsibility or obligation.</td>
</tr>
<tr>
<td><em>fiqh</em></td>
<td>Islamic law as developed by Muslim jurists.</td>
</tr>
<tr>
<td><em>ghālib</em></td>
<td>Winner.</td>
</tr>
<tr>
<td><em>gharar</em></td>
<td>Uncertainty, risk, deception.</td>
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<tr>
<td>Arabic Term</td>
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<td>-----------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------</td>
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<tr>
<td>ḥabal al-ḥabalāh</td>
<td>Sale of the offspring of an unborn animal.</td>
</tr>
<tr>
<td>ḥabs</td>
<td>Retention.</td>
</tr>
<tr>
<td>ḥadīth</td>
<td>The reported sayings and teachings of the Prophet Muhammad (peace be upon him).</td>
</tr>
<tr>
<td>hamish jiddiyah</td>
<td>Earnest money taken from a person who intends to purchase a commodity from or enters into a contract with anyone to confirm his sincerity to actually purchase the commodity when offered. In the case of breach of promise, the promisee has the right to recover his actual loss incurred due to the breach.</td>
</tr>
<tr>
<td>hilah</td>
<td>Ruses, tricks used in transaction to circumvent basic sharī'ah prohibitions.</td>
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<tr>
<td>hisbah</td>
<td>Supervisory function carried out by the state or appropriate Islamic authority to regulate the market place which includes taking whatever steps to maintain a fair and orderly market operation.</td>
</tr>
<tr>
<td>ibāḥah</td>
<td>Permissibility.</td>
</tr>
<tr>
<td>ijmā'</td>
<td>Consensus of scholars and jurists.</td>
</tr>
<tr>
<td>īllah</td>
<td>Effective cause of a particular ruling.</td>
</tr>
<tr>
<td>istīsnā'</td>
<td>Contract of manufacture.</td>
</tr>
<tr>
<td>'iwadh</td>
<td>Recompense or equivalent counter-value in an exchange.</td>
</tr>
<tr>
<td>jahālah</td>
<td>Ignorance.</td>
</tr>
<tr>
<td>jāʾiḥah</td>
<td>Climate disaster or disease.</td>
</tr>
<tr>
<td>juʿalah</td>
<td>Rendering a service against a reward. Achievement of the end result is necessary for the entitlement of the reward.</td>
</tr>
<tr>
<td>khatar</td>
<td>A kind of gharar-khatar will be involved if liability of any of the parties to the contract is uncertain or contingent, delivery of one of the exchange items is not in the control of any party or the payment of one side is uncertain.</td>
</tr>
<tr>
<td>maddhab</td>
<td>Juristic or theological school.</td>
</tr>
<tr>
<td>madāmin waʾl-malāqīh</td>
<td>Loins and wombs (of animals).</td>
</tr>
<tr>
<td>maghlūb</td>
<td>Loser.</td>
</tr>
<tr>
<td>māl</td>
<td>Anything that could be possessed, for example gold, silver,</td>
</tr>
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monetary units, commodities, assets – movable or immovable.

maqāṣid
Goals and objectives.

maṣlaḥah
Consideration of public interest.

maṣāliḥ mursalah
Unrestricted public interest.

maysir
Game of chance, gambling.

milk
 Owned.

muʿāmalāt
Civil or commercial transactions.

muaʿawamah
A sale for example, fruit of a tree or an orchard, for years to come without stipulating the amount, price or time of delivery.

mudārabah
A form of partnership where one party provides the fund and the other provides the expertise and management.

mukhāfara
Risk-taking.

mulāmasah
Sale by touching the object without knowing its details.

munābadhah
Sale, usually of clothes, concluded when parties threw the objects to one another.

musāwamah
Cost price sale.

muzāyadah
Sale by auction.

qabd
Possession.

qimār
Gambling.

ribā
Usury.

takhliya
Evacuation.

taqlīd
Imitation.

salam
Sale where the payment is made in advance and the delivery is deferred to a future date.

shariʿah
Islamic law as contained in the divine guidance of the Qurʾān and the Sunnah.

sunnah
The teaching and exemplary conduct of the Prophet Muhammad (peace be upon him).
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Ironmonger & Co. v Dyne (Times, Jan. 27 – 2 Feb, 1928)

In Crowley, Alien Property Custodian v Commodity Exchange, Inc. et. al. (141 F. 2d 182; 1944 U.S. App. LEXIS 3625)

In Re: Dairy Farmers of America, Inc. Cheese Antitrust Litigation (767 F. Supp. 2d 880; 2011 U.S. Dist. LEXIS 13307)

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Pet Far Eastern (M) Sdn Bhd v Tay Young Huat & Ors [1999] 2 CLJ 886

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**Arabic Consonants**

Initial, unexpressed medial and final:

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<th>Transliteration</th>
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**Vowels, diphthongs, etc.**

Short:

- a
- i
- u

Long:

- a
- i
- ū

Diphthongs:

- aw
- ay
CHAPTER ONE

Introduction

1.1 Thesis: At a Glance

"However loudly the opponents of interest condemn them as sinful, there will be people prepared to articulate reasons why they are beneficial to Muslims, consistent with the spirit of Islam, and in keeping with the ban on riba... Efforts to develop Islamic derivatives amount to an insurance policy against a future ban on options and futures." (Kuran, 2001: 28)

This thesis is a study of the resolution made by the Shariah Advisory Council of the Malaysian Securities Commission (SAC) which resolves that the crude palm oil futures contract is permissible (SAC resolution). This resolution is a contentious one as it conflicts with the resolutions of other mainstream, or internationally represented, organisations of Shari’ah scholars. While the mainstream organisations of Shari’ah scholars rule that this trading transgresses the principles and fundamentals of the Shari’ah, the SAC argues that it is permissible on the principle of public interest (maṣlahah) and on the notion that the trading regulations have overcome Shari’ah prohibitions. This study will critically examine the adequacy of the SAC resolution from the aspect of its coherence with the real trading of the crude palm oil futures contract and the adequacy of the crude palm oil futures contract legal framework in overcoming Shari’ah prohibitions. This subject is undertaken as it has not been given adequate attention in existing literatures.

This chapter will commence by giving a brief background on the subject which will lead to the reason as to why this study is being undertaken. This will be followed with the aim of this study, its objectives, research questions, its contribution and limitations. A later section of this chapter will explicate the study’s research methodology, and this chapter will end with a brief outline of the thesis.

1.2 What is the Crude Palm Oil Futures Contract

Simply put, the crude palm oil futures contract is a future sale and future purchase of crude palm oil. However, this sale and purchase transaction is not like any ordinary retail cash sale and/or purchase of commodity. The difference lies in the intricate trading system of
the crude palm oil futures contract, as described by the Malaysian Securities Industry Development Corporation:

“Futures are contracts, legally binding agreements, made on the trading floor of a futures exchange or via an electronic screen dealing system, to buy or sell something in the future. That something could be gold, tin, cocoa or palm oil, a foreign currency, shares or interest rates. Each contract specifies the commodity, the quantity, quality and time of delivery or cash settlement. The buyer and seller of a futures contract agree on a price today to be delivered and paid for in the future...In most cases, actual delivery of the underlying security does not take place. Instead, the contracts are closed out by opposite deals before the delivery date is reached.” (2007: 1-3)

In Malaysia, the trading of crude palm oil futures contracts began in the Kuala Lumpur Commodity Exchange1 (KLCE) where it was first traded in July, 1980.2 KLCE then became the world’s first trading site for crude palm oil futures contracts and the price of its crude palm oil futures contracts became the global benchmark price. The purpose of trading crude palm oil futures contracts, then, was to assist local crude palm oil producers to hedge, and at the same time to utilise it as an instrument for price setting, and the dissemination of market information, as a means to reduce market risk (Rasiah and Shahrin, n.d.: 7).3 This role was later developed to include speculation – where traders can use crude palm oil futures contracts to make gains from the movements of the crude palm oil futures price. Due to globalisation, the KLCE, now known as the Bursa Malaysia Derivatives Berhad (the Exchange), becomes a platform for global fund managers and proprietary traders to trade and be part of an active commodity market instantaneously (Bursa Malaysia Derivatives, n.d.: 1).

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1 In the midst of the 1990s, the KLCE set up the Malaysian Monetary Exchange (MME) to trade financial futures, though during the same period, a financial futures exchange, the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) had already existed. Both the MME and KLOFFE had different trading instruments and trading systems. The MME followed the KLCE open-outcry trading system by launching its first derivatives product, the Kuala Lumpur InterBank Offered Rate (KLIBOR). The KLOFFE, meanwhile, started with the Index Futures which is based on screen, namely, the KLOFFE Automated Trading System (KATS). On January 1998, the Kuala Lumpur Stock Exchange (KLSE) completed its acquisition of KLOFFE and by the end of that year, the KLSE had merged with the MME to form the Commodities and Monetary Exchange of Malaysia (COMMEX). The merger of the KLOFFE and COMMEX changed the landscape of the Malaysian derivatives market where all the derivatives markets were subsumed under one new entity called the Malaysian Derivatives Exchange (MDEX). The MDEX is now known as the Bursa Malaysia Derivatives Berhad (the Exchange) (Pheng, 2009: 2). For more insights into the historical development of the financial derivatives market, please see Securities Commission (2004).

2 Nonetheless, physical delivery of crude palm oil was less than three per cent of the trade involved as the role of the futures market was to serve as a financial or "paper" market. This infrastructure made Kuala Lumpur the world's palm oil capital (Pletcher, 1991: 633).

3 Before the crude palm oil futures contract began its trading in KLCE, the Joint Selling Committee, located in London, was authorised to quote crude palm oil futures prices and to receive supply commitments from shipping companies, which were all based on the decisions of brokers in Europe.
The crude palm oil futures contract is currently the most actively traded of derivatives in the Exchange as compared to the nine other derivatives products offered and traded. It is reported that as at 31 December, 2011, from a total of around 9 million derivatives contracts, 5.9 million are crude palm oil futures contracts (Bursa Malaysia Berhad, 2012b: 8). The trading of crude palm oil futures contracts alone have contributed to almost a third of the total trading revenue of the local derivatives market, totalling Ringgit Malaysia 51.2 million (Bursa Malaysia Berhad, 2012b: 46).

1.3 The Crude Palm Oil Futures Legal Framework

In Malaysia, the crude palm oil futures contract is governed by a set of legal frameworks. This framework is led by the Capital Markets and Services Act 2007 (the 2007 Act), which is its principal statute. Apart from the 2007 Act, the crude palm oil futures contract is also regulated by the Capital Markets and Services Regulations 2007, the Bursa Malaysia Derivatives Berhad Business Rules, and the Bursa Malaysia Derivatives Clearing Berhad Business Rules. This legal regime governs the whole trading operation of crude palm oil futures contracts, including the features or the standard specification of crude palm oil futures contracts, the manner in which crude palm oil futures are created and traded on the Exchange and their settlement in the Bursa Malaysia Derivative Clearing Berhad (Clearing House). Rule 102 of these two Business Rules clearly stipulates that all persons trading on

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4 Other derivatives that are offered and traded at the Exchange: Commodity Derivatives: USD Crude Palm Oil Futures and Crude Palm Kernel Oil Futures; Equity Derivatives: FTSE Bursa Malaysia KLCI Futures, FTSE Bursa Malaysia KLCI Option and Single Stock Futures; and Financial Derivatives: 3-Month Kuala Lumpur Interbank Offered Rate Futures; 3-Years Malaysian Government Securities Futures and 5-Years Malaysian Government Securities Futures (Bursa Malaysia, 2012a). The Securities Commission (2011: 41) has projected the growth of the derivatives market by the year 2020 to reach a notional value of Ringgit Malaysia 4.2 billion.

5 This is the principal body of statutory laws that regulates the futures industry (as well as the securities industry). It comprehensively encompasses matters pertaining to, inter alia, administration and futures trading activities, market intermediaries, establishment of the Exchange and Clearing House, the Securities Commission’s enforcement power, and capital market offences. In order to insulate futures trading and guarantee the performance of futures contracts against legal and credit risk, the Act has laid out provisions, the effect of which being that its provisions prevail over the written law of contract and insolvency.

6 This Regulation governs matters pertaining to safeguarding capital market investors and futures market institutions from adverse financial or credit risk. It regulates, inter alia, payment and maintenance of deposit and the Fidelity Fund, the purpose of which is to compensate clients from financial losses suffered from defalcation or fraudulent misuse of monies or property caused by capital market intermediaries.

7 This Business Rules prescribes “house-keeping rules” for the Exchange. This rule is intended to ensure fair and open market on the Exchange and to provide protection to the public in its contact with the Exchange, its participants, and registered representatives.

8 This Business Rules is the “house-keeping rules” for the Clearing House. It elaborates the procedure of settlement which its participant must adhere to. In view of the fact that the Clearing House guarantees the due performance of futures contracts amongst its participants, the rule emphasises that the liability of the Clearing House is limited only to the losses resulting from the non-performance of its contractual obligations, to its participants. The Clearing House’s liability is however, not extended to any third party.

3 Page
the Exchange and settling through the Clearing House, and all contracts made therein, are subject to this legal regime.  

1.4 What is the Shariah Advisory Council (SAC)

The SAC was established by the Malaysian Securities Commission on May 16, 1996, by virtue of section 18 of the Securities Commission Act 1993. The establishment of the SAC was part of the Securities Commission’s agenda to create a more organised and efficient Islamic capital market. The SAC advised the Securities Commission on all matters pertaining to Islamic capital market issues and the development of an Islamic capital market. Members of the SAC were appointed by the Securities Commission and are comprised of experts in Islamic commercial law (fiqh mu'amalāt), Islamic jurisprudence, Islamic finance, and other relevant disciplines (Securities Commission, 2006: v).

In 2010, the 2007 Act was amended by the Capital Markets and Services (Amendment) Act 2010. By virtue of this amendment, the SAC is officially inaugurated as the sole authority in ascertaining the applicability of Shari'ah principles for the purpose of the Islamic capital market business or transactions. With this statutory power, the SAC is able to change the status of the conventional capital market business or transaction into becoming “the Islamic capital market business or transaction”. Section 2 of the 2007 Act enumerates the areas for this transformation, which includes any transaction relating to futures contracts, and the establishment, operation and maintenance of a futures market. The SAC’s power to do so, is however, caveated by principles of Shari’ah.

The key to the 2010 amendment is that it elevates the position of the SAC hence empowering its resolution. Being the sole reference for the Islamic capital market in Malaysia, its resolution is to be considered, referred to and held binding upon the Exchange, the Clearing House, their members, the judiciary as well as the arbitrators. Nonetheless, as will be shown in the later part of this chapter, the judiciary argues that they

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9 The hegemony of this regime surpasses even conventional law relating to contract.  
10 Section 18 of the Securities Commission Act 1993 empowers the Securities Commission to form a committee which would assist the Securities Commission in its statutory duty. The Securities Commission was established on March 1, 1993 for the purpose of developing the securities and futures market in Malaysia. It is a self-funding statutory body with the power of supervision, investigation and enforcement over the capital market industry. It reports to the Ministry of Finance (Securities Commission, n.d.(b)).  
11 See section 316C of the 2007 Act.  
12 See section 316A of the 2007 Act. The SAC is also empowered to determine its own procedure.  
13 See section 316E and 316F of the 2007 Act.
still retain the power to determine whether such financial instruments are *Shari'ah*-compliant.

The 2010 amendment also delineates the statutory functions, or duties, of the SAC, which are as follows:¹⁴

(a) to ascertain the applicability of *Shari'ah* principles on any matter pertaining to Islamic capital market business or transactions and issue a ruling upon references made to it;

(b) to advise the Securities Commission on any *Shari'ah* issue relating to Islamic capital market business or transactions;

(c) to provide advice to any person on any *Shari'ah* issue relating to Islamic capital market business or transactions; or

(d) any such other functions as may be prescribed by the Minister of Finance.

In performing its duties, the SAC adopts two methods of research. Firstly, the SAC evaluates conventional capital market instruments through the lens of *Sharī’ah*. In examining such products, the focus of the SAC is on the structure, mechanism, and the use of such instruments. Secondly, the SAC formulates and develops new financial capital market instruments which are in compliance with *Shari'ah* principles (Securities Commission, 2006: 2). The underlying notion behind its operation is to ensure that the approved instruments are not inconsistent with any of the *Shari'ah* principles, namely: the elements of *ribā* (usury), cheating, *gharar* (uncertainty or cheating) or other such practices forbidden by the *Sharī’ah* (Securities Commission, 2006: vii).

### 1.5 The Driving Force: An International Islamic Capital Market Hub and The World’s Second Largest Exporter of Crude Palm Oil

The establishment of the SAC and the proliferation of numerous permissive resolutions on conventional capital market instruments, including crude palm oil futures contracts, are part of the Malaysian government’s agenda to establish Malaysia as an international

¹⁴ See Section 316B of the 2007 Act.
Islamic capital market centre (Securities Commission, 2001: 174).\textsuperscript{15} Being the only country in the world which validates crude palm oil futures trading as Shari'ah-compliant\textsuperscript{16}, Malaysia prides itself as being a pioneer and at the forefront of Islamic capital market development. The proliferation of such SAC resolutions may be driven by the governing system where members of the SAC are being appointed by the government\textsuperscript{17} and their remuneration and allowance are determined and paid by the Securities Commission, a body answerable directly to the Ministry of Finance.\textsuperscript{18}

Furthermore, until 2007, Malaysia had been the largest producer and exporter of palm oil and palm oil products in the world.\textsuperscript{19} However, Indonesia has since overtaken Malaysia and is now the leader in the crude palm oil production and export industry (Teoh, n.d: 5). Despite Indonesia also contributing greatly to crude palm oil production and being located geographically next to Malaysia, Indonesia has, to date, not issued any such similar resolution on their crude palm oil futures contracts.

1.6 The Rationale for Permitting Crude Palm Oil Futures Contract

On November 26, 1997 the SAC resolved that the crude palm oil futures contract was permissible.\textsuperscript{20} The contract was permissible as it was free from Shari'ah issues, namely, gharar (uncertainty), maysir (gambling), buying something that does not exist (bay' ma'dūm), speculation, and the non-exchange of counter-values (‘iwadh). The SAC also ruled that the crude palm oil futures contract is permissible on the basis of public interest

\textsuperscript{15} The aim of becoming an international hub for the Islamic capital market was part of the national plan introduced in the Malaysian Capital Market Master Plan. This plan maps the direction of Malaysia’s capital market over the next ten years from the period of 2000 till 2010 (Securities Commission, n.d.(a)).

\textsuperscript{16} Shari'ah-compliant means that the product that are imported from conventional finance and converted into Islamic products. Meanwhile, Shari'ah-based means that products that have been produced on the basis of Islamic law rules and principles, for example, salam and mudārabah (Lahsasna and Hassan, 2011: 37).

\textsuperscript{17} Section 316C(1) stipulates that "The Yang di-Pertuan Agong (the King) may, on the advice of the Minister after consultation with the Commission, appoint persons as members of the Shariah Advisory Council...".

\textsuperscript{18} Section 316C(4) states that "The members of the Shariah Advisory Council shall be paid such remuneration and allowances as may be determined by the Commission."

\textsuperscript{19} Malaysia currently accounts for 39% of world palm oil production and 44% of world export. Malaysia is able to sustain its production and contribution due to the growing global need for sustainable oils and fats (Malaysian Palm Oil Council, 2012). Malaysia’s contribution in the palm oil industry is not only in terms of its mass palm oil-based production but also its crude palm oil futures price being referred to as the global price benchmark (Bursa Malaysia Berhad, 2012b).

\textsuperscript{20} Besides SAC, the Shariah Board of Iran’s Securities and Exchange Organisation (SEO) has also permitted the trading of futures contracts (Securities and Exchange Organisation, 2009). Their futures contracts used billion, copper wires and gold coins as their underlying commodities. According to Dr Ali Saleh Abadi (2009), the Chairman of the Board and President of SEO, SEO is planning to launch other underlying futures commodities; namely petrochemicals, oil, agricultural products, metals and securities.
The impetus for such a ruling could be traced back to Mohammad Hashim Kamali, the main driver behind the legitimacy of crude palm oil futures contract in Malaysia. Kamali (1997, 1999, 2000, 2002(a), 2002(b) and 2005) has conducted extensive studies on the legality of commodity futures contract, particularly in his 1999 paper, which explicates the rationale for permitting crude palm oil futures contract in Malaysia. His main thesis is that the crude palm oil futures contract is a new mode of trading. Thus being a new mode of trading, it needs a fresh response, formulated in light of its operative procedures. Furthermore, as it is a centralised and carefully regulated mode of trading, embedded with the clearing house guarantee mechanism and contract standardisation, the prospect of risk taking and uncertainty (gharar) have been virtually eliminated.

1.7 Why Study the SAC Resolution?

Study of the adequacy of the SAC resolution is warranted on the following grounds. Firstly, Kunhibava, in her thesis, discovered that the SAC resolution was not adequate. She found that:

"...the SAC had not discussed the reality of futures trading. Even though it involved trading in commodity futures most of the players do not take possession. This pertinent feature was not dealt with." (2009: 56).

In addition to this, she also found the need for further research into examining the internal rules, regulations, and guidelines of current boards of trade and exchange. The purpose of this examination is to determine whether these legal regimes could actually overcome the Shari'ah objections in commodity futures contracts.

Secondly, the in-depth analysis of the SAC resolution and the crude palm oil futures legal framework revealed that there are adequacy issues with them. While the crude palm oil futures contract and its secular-based legal framework are not subject to Shari'ah proscriptions, namely; gharar and maysir, the duly SAC-resolved crude palm oil futures contract and its governing legal framework must and should be free from these Shari'ah prohibitions. The importance of this notion is clearly stipulated in a report by the Islamic
Capital Market Task Force of the International Organization of Securities Commission where it states:

“In relation to Islamic capital market products and activities, regulators should begin to consider issues related to the clarity and consistency of regulation and their application. Furthermore, regulators should consider and/or review its capital market laws to ensure that it adequately deals with the risks associated with the new products structures based on the Shariah principles…” (2004: 52)

Thirdly, despite resolutions on the validity of financial instruments having been issued by the Shariah Advisory Council of the Central Bank of Malaysia and the Shariah Advisory Body of the financial institutions, the Islamic banking and financial industry, in Malaysia, often has to face legal battles which challenge the validity of their Shari'ah-compliant instruments. For example, in 2009, in Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor And Other, the Kuala Lumpur High Court ruled that the bank’s Bay' bi-thaman al-‘ajil (BBA) home financing facility, which had operated and existed in Malaysia for the past twenty five years, was contrary to the religion of Islam. The validity of the BBA financing facility was also tested in Bank Islam Malaysia Bhd v Adnan Omar,21 Dato’ Hj Nik Mahmud Daud v Bank Islam Malaysia Bhd, 22 Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd,23 Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors; Koperasi Seri Kota Bukit Cheraka Bhd (Third Party) And Other Cases,24 Affin Bank Berhad v Zulkifli Abdullah,25 CIMB Islamic Bank Bhd v LCL Corporation Bhd & Anor26 and Tan Sri Abdul Khalid Ibrahim v Bank Islam Malaysia Berhad & Another Case.27 The validity of the bank’s leasing financing facility is also challenged in the case of Tinta Press Sdn Bhd v Bank Islam (M) Berhad.28

While the Malaysian Islamic capital market has yet to be tested with such a legal battle, with increasing interest in this market, legal challenge on the validity of SAC-approved financial instruments is foreseeable (Oseni and Hassan, 2011: 96).29 From a survey on the

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21 (1994) 3 CLJ 735.
23 [2003] 1 CLJ 625.
24 [2009] 1 CLJ 419.
29 The potential for such legal challenges is perhaps due to the interpretation of section 56 of the Central Bank of Malaysia Act 2009, in which its provision is similar to section 316F of the 2007 Act. Mohammad Zawawi Salleh J. states in the case of Mohd Alias Ibrahim v RHB Bank Bhd & Anor [2011] 4 CLJ 654, 682.
performance of the Shari'ah Committee in the Malaysian Islamic banking and financial market, Hassan et. al. found that:

"...in the current practice many Shari'ah advisors have limited exposure to and knowledge of banking practices at the ground and technical levels. ...Furthermore, lack of detailed disclosure proceedings, discussion and deliberations of the meeting of Shari'ah advisors, particularly regarding product approval and/or issuance of fatwa, could raise queries about the validity of the rulings given. This is because a healthy discussion is always hindered by lack of disclosure of specific reasons and justifications, especially when rulings or fatwa issued are questionable." (2010: 3)

Although the Securities Commission (2012: 3-5) maintains that the 2010 amendments have the effect of binding the courts with SAC resolutions, the legal battles faced by the Islamic banking and finance industry demonstrated otherwise. Thus, SAC resolutions may still be up for legal scrutiny and legal battle.

Finally, an inadequate resolution undermines Malaysia's position as an international Islamic capital market centre. Shari'ah-compliance is a key feature in an Islamic capital market. The Bursa Malaysia defines Islamic Capital Market (ICM) as:

"...the market where activities are carried out in ways which does not conflict with the principles of Islam. The ICM represents an assertion of religious law in capital market transactions where the market is free from prohibited activities and elements such as riba (usury), maisir (gambling) and gharar (ambiguity)." (n.d.: 2)

It follows that the reliability of the Shari'ah approval process and the credibility of such approval processes are central to its integrity (International Organisation of Securities Commissions, 2004: 57). Therefore to sustain this position in the wake of opposing...
resolutions from three distinguished international bodies of Shari'ah scholars\textsuperscript{30}, Malaysia inevitably has to ensure that its Shari'ah-compliant crude palm futures contract is true to its label.

1.8 Aim and Objectives of the Study

For the reasons stated, this study aims to investigate the adequacy of the SAC resolution. To meet this aim, this research will firstly analyse the contention of the SAC resolution and discern the coherence of the SAC contention with the real trading of crude palm oil futures contract. Secondly, this research will investigate the relevant parts of the crude palm oil futures contract legal framework which have not been explored by existing literature. An in-depth analysis of this part of the legal framework will enable the researcher to determine whether the trading regulations have actually overcome the Shari'ah prohibitions inherent in the crude palm oil futures contract.

1.9 The Research Questions

The central question of this study is to examine whether the SAC resolution is adequate. Specifically, this study will address the following two general questions:

i- Whether the SAC resolution is coherent with the real trading of crude palm oil futures contracts?

ii- Whether the legal framework of the crude palm oil futures contract has overcome Shari'ah prohibitions inherent in crude palm oil futures contract?

1.10 The Research Methodology

In answering these research questions and achieving the research objectives, this study adopts the qualitative research methodology. The study embarks on its exploratory process by first gaining an adequate understanding of the crude palm oil futures contract and its trading process. This is done by studying the literature on commodity futures contracts. The comprehension gained from this literature aids in the understanding of crude palm oil

\textsuperscript{30} The Mecca-based Islamic Fiqh Academy (IFAM), the Jeddah-based Islamic Fiqh Academy (IFAJ), and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).
futures statutes, regulations and its other by-laws.³¹ This legal framework is not studied in isolation. Legal frameworks from other jurisdictions are also examined, for example the trading regulations of the United States of America, the United Kingdom, as well as other European countries. Case laws from Malaysia as well as from these countries also form part of the legal analysis. The reason for referring to the American, British, and European legal framework is because their commodity futures markets are more mature and their commodity futures case laws are more extensively reported. Moreover, the trading of commodity futures contracts is generally similar globally.

The knowledge gained on crude palm oil futures contract is then analysed by comparing them to the SAC resolution as well as to resolutions from the internationally represented body of Shari'ah scholars, namely the Mecca-based Islamic Fiqh Academy (IFAM), the Jeddah-based Islamic Fiqh Academy (IFAJ), and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The IFAM, the IFAJ and the AAOIFI have been chosen as most Muslim countries in the world are members of these institutions, Malaysia being not excluded.³² In this part of the research, the literature which discusses Islamic law on contract, commerce, and particularly the legality of commodity futures contract is studied. At this level, the literature referred to is mainly written in English by contemporary scholars with reference to Arabic literatures being beyond the expertise of the researcher. Despite this, the formulation of the Shari‘ah issues inherent in crude palm oil futures contract is distilled mostly from English written literature, which comprises most of the existing literature on the legality of the commodity futures contract. These Shari‘ah issues then became the foundation for the selection and identification of legal provisions examined in this study.

Thirdly, in addition to the above method of textual analysis, the researcher has also conducted non-structured interviews and discussions with crude palm oil futures traders, crude palm oil producers, as well as Shari‘ah scholars from the Securities Commission and the SAC in Malaysia. The objective is to gain information which is not available in the texts as well as to increase the understanding of this subject. The additional views and

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³¹ This legal framework is the law applicable and enforceable in Malaysia as of March 31, 2012.
³² AAOIFI for example has almost 180 members representing more than 46 countries (AAOIFI, 2010: vii). Besides IFAM, IFAJ, AAOIFI and SAC, other Shari‘ah advisory institutions have also resolved that the commodity futures trading is not in accordance with the Shari‘ah. Please see Permanent Research Committee of the Board of Great Scholars in Saudi Arabia (as referred to by ai-Amine (2008: 21)); European Council for Fatwa and Research and India based Islamic Fiqh Academy (as referred to by Kunhibava (2009: 48).
insights garnered through this method complement the analysis of the trading regulatory framework and its related Shari'ah issues.

1.11 Contributions of the Study

This study on the adequacy of the SAC resolution is timely. Hence this study hopes to be able to contribute to the dearth of literature on the subject of the legality of commodity futures contract, principally from the aspect of the legal or regulatory perspective. Although the focus of this study is on the Malaysian experience, its findings would still be applicable to the experience of other jurisdictions as the nature of commodity futures contract is homogenous. Additionally, this critical and systematic investigation into the legal framework, which has not been encountered in the existing literature, breeds a fresh perspective on the subject. Finally, it is hoped that in the light of this finding, the SAC will perform its statutory duty to (i) re-visit and re-examine the application of Shari'ah principles on crude palm oil futures contract33 and (ii) advise the Securities Commission accordingly.34

1.12 Limitations and Constraints of the Study

This study critically analyses the adequacy of the SAC resolution with the aim of unleashing any adequacy issues found. To do this exhaustively, this study is limited only to the SAC resolution on crude palm oil futures contract. It does not include SAC resolutions on composite index futures contract or single stock futures35 even though they fall under the category of futures contracts. Other instruments not examined and resolved by the SAC, such as the forward contract, options, and swap, will not even be touched in this study. This study did not aim to question the credibility of the learned members of the SAC but only the width and depth of their scrutiny of crude palm oil futures contract. This study is not a Shari'ah-based study with the aim of formulating a fresh Shari'ah ruling of crude palm oil futures contracts, nor of formulating and proposing crude palm oil futures contract

33 See Section 316B(a) of the 2007 Act.
34 See section 316B(b) of the 2007 Act.
35 In March 19, 1998 the SAC resolves that the mechanism for stock index futures contracts does not contradict the Shari'ah principles. This is manifested by the launch of the Shari'ah Index by the Bursa Malaysia that functions as a benchmark for the performance of Shari'ah-compliant securities. The SAC resolves that so long as the index component is made up of Shari'ah-compliant securities, the stock index trading is permissible (Securities Commission, 2006: 79). Later, in April, 2006, single stock futures of Shari'ah compliant underlying stocks was launched by the Bursa Malaysia to provide investors with Islamic investment alternatives as well as a risk management tool (Bursa Malaysia: April, 2009).
models free from *Shari'ah* prohibitions, or even of revamping the current secular-based legal framework. Beyond that, this study is constrained by the inability of the researcher to produce some credible information gained from the interviews and discussions with the *Shari'ah* scholars in Malaysia on the basis that this information was requested to be held in confidence.

1.13 **Outline of the Study**

In order to address the research questions and to meet the research objectives, this thesis is divided into seven chapters. This introductory chapter will be followed by Chapter two which reviews the literature on the legality of commodity futures contracts. The literature includes the resolutions of the SAC, the IFAM, the IFAJ and the AAOIFI. Chapter three through until Chapter six form the backbone of this thesis. The SAC resolution and the crude palm oil futures contract legal framework are critically and systematically analysed in these chapters in order to find the answers to the research questions.

Chapter three examines the element of *gharar* in crude palm oil futures contract. The analysis is based on the three *Shari'ah* issues identified as having a close relationship with the concept of *gharar*. These *Shari'ah* issues have been discussed by the SAC, the IFAM, the IFAJ and the AAOIFI as well as in other literature. The issues discussed involve the element of non-exchange or a deferment of both counter-values, the sale of non-existing, non-owned crude palm oil, and the sale of an outstanding debt or obligation for a corresponding outstanding debt or obligation. The aim of this chapter is to ascertain whether, firstly, the elements of *gharar* exist and contaminate the crude palm oil futures contract, and, secondly, if they are so found, they have been eliminated by the crude palm oil futures contract legal framework.

Chapter four extends this discussion on *gharar*, focusing mainly on the settlement of crude palm oil futures contract. This chapter analyses the elements of *gharar* in the following areas:- (i) the determination of the settlement price in the event of emergency; and (ii) the default by the seller to physically deliver the underlying commodity. The latter issue is further divided into two sections; namely, where the default is due to the unavailability of the supply of the commodity, and where the default is due to the non-fulfilment of the commodity's deliverable quality or grade. The driving force behind this chapter is to illuminate real case laws depicting the implication of *gharar* in crude palm oil futures
contract. Thus this chapter reaffirms the findings of Chapter three - that *gharar* elements have not been overcome by the crude palm oil futures legal framework.

Chapter five examines the elements of *maysir* in crude palm oil futures contract. Like *gharar*, the issue of *maysir* is also studied by the SAC, the IFAM, the IFAJ and the AAOIFI. This chapter examines whether the elements of *maysir*; namely, betting, the element of chance, the gain of one party at the loss of another party, the unlawful acquisition of wealth, and hatred and enmity are to be found in the futures margin system, offsetting transaction, and futures speculation. The discussion here is based on the notion that *Shari'ah* scholars are not against commodity futures contract being utilised as a risk management tool, rather only when it being utilised as a gambling tool. The method of this chapter is to show, firstly, whether the futures margin system, offsetting transaction, and futures speculation, are facilitating the betting on the future movement of crude palm oil futures prices, and, secondly, whether this betting would eventually cause the winner to gain at the loss of the loser.

Chapter six is a substantiation of Chapter five. It traces the historical development of the conventional law on gaming or wagering. This chapter will show that the revolution of the law on gaming or wagering took place through the development of three legal tests: namely, mutual gain and loss, the subjective intention test, and the literal intention test. The implication of these legal tests is that it revolutionised the law on gaming or wagering to a point where the law finally validates and enforces a futures contract even though, by nature, this contract is formed and entered into for the purpose of betting or wagering. As a result, betting or wagering on the rise and fall of the price of crude palm oil futures contract is now legitimate and enforceable. In short, the purpose of this chapter is to establish that section 103 of the 2007 Act was based on the fact that wagering or betting is legitimate.

Chapter seven concludes this thesis. It explains what has been investigated and suggests its implications.
CHAPTER TWO

Legality of Commodity Futures Contract: The Literature Review

The legality of the commodity futures contract has been a contentious subject for decades in the Islamic capital market, banking, and finance industry. It was made more pronounced by the presence of the two current opposing Shari'ah resolutions. That is, one side pronounces its legality while the other side abhors it. This was shown quite explicitly when in 1985 the IFAM pronounced that the commodity futures contract was not in line with Shari'ah principles. Seven years later, in 1992, the IFAJ issued a similar ruling which was echoed by the AAOIFFI in 2004. However in 1997 the SAC ruled otherwise. Although the findings of the SAC were not synchronised with these three internationally represented bodies of Shari'ah scholars, they were in agreement in terms of the Shari'ah issues affecting commodity futures contract. These issues relate to maysir, gharar, the non-exchange or deferment of both counter-values, the sale of non-existing or non-possessed or unowned commodity, and the sale of an outstanding debt or obligation for a corresponding outstanding debt or obligation.

This chapter will commence by reviewing the resolutions issued by these bodies. The purpose is to show that though the SAC resolution conflicts with the three international bodies of Shari'ah scholars, all these resolutions discuss common Shari'ah issues. Nonetheless, in line with the theme of this thesis, the SAC resolution will be the focus of the review. The analysis of the SAC resolution will be followed by a review of the main literature on this subject. The review of this literature, will unleash the gap in this subject, and hence to address this gap, this research is being undertaken.

36 The IFAM, IFAJ and AAOIFFI resolved that the commodity futures contract is not Shari'ah-compliant as it involves elements of maysir and gharar. Notwithstanding that their resolutions were on commodity futures contracts and not precisely crude palm oil futures contract, their resolutions are still applicable as crude palm oil futures fall squarely within the remit of commodity futures. Thus, it follows that by virtue of their resolutions, crude palm oil futures contract is not Shari'ah-compliant.
The first institutional discussion on the legality of commodity futures contract was led by the IFAM. In 1985, the IFAM resolved that, despite commodity futures contract engendering benefits, viewed as public interest, its trading was accompanied by transactions forbidden in the Shari’ah. The commodity futures contract was forbidden as (as cited in al-Amine, 2008: 14):

i- they contain the element of gambling, exploitation and unlawful devouring of the property of others;

ii- they are deferred contracts which conclude on the basis of the description of the asset, which asset the seller does not own;

iii- they are by and large paper transactions and not genuine purchase and sale as they do not involve real delivery or taking possession of the underlying commodities; and

iv- they do not qualify as salam\textsuperscript{38} sale which is validated by the Shari’ah. The buyer, in the futures contract, does not pay the price of the underlying commodity at the time of entering into the futures contract. The commodity is also not delivered at the time of making the contract as well as in the later transactions, entered throughout the life of the futures contract. In this circumstance, the parties are deemed to gamble by giving and taking the price difference.

Apart from the reasons stated above, the IFAM ruled that the commodity futures contract was prohibited as it is detrimental to the economy by means of (i) oppressive monopoly practices – making large sales and purchases which result in small traders incurring loss and hardship; (ii) price distortion - the price is no longer dictated by real supply and demand or genuine sale and purchase but by unscrupulous acts such as cornering,

\textsuperscript{37} The resolution was issued in its seventh session which took place from 11\textsuperscript{th} till 16 Rabial Akhir 1404. The IFAM was established in July 1983 in Mecca, Saudi Arabia, after the idea of setting up such a body was mooted by King Khalid in one of the OIC meetings in 1981. The IFAM consists of renowned scholars and jurists from the Muslim world that deliberate on contemporary issues or problems arising in Muslim society and answer these problems accordingly (as cited in Usmani, 1997).

\textsuperscript{38} Salam is the sale and purchase of items known only by specification or description. Delivery of such items will take effect at a later specified time while the price for such items is paid in full at the time of the contract (Securities Commission, 2006: 174).
profiteering, or false rumours; and (iii) massive losses incurred from global financial crises (as cited in al-Amine, 2008: 15).

Nonetheless, Kamali views that the IFAM resolution was inadequate as it does not consider the commodity futures contract as a new phenomenon which requires a fresh interpretation. He states:

"...in the light of the Shari'ah principle of permissibility (‘iba‘ah) that renders all commercial transactions permissible in the absence of a clear prohibition, the verdict of not only the Mecca-based Fiqh Academy but also many Muslim scholars who have proscribed futures trading and declared it totally forbidden is a most discouraging form of imitation (taqlid). This body of opinion is mainly founded on the analysis that futures trading does not fulfil the requirements of the conventional Islamic law of sale - and turns a blind eye to the fact that futures trading is a new phenomenon which has no parallel in the conventional law of mu‘āmalāt,39 and should therefore be governed by a different set of rules." (2002: xii)

However, the thesis of Ibrahim (2000) contradicts Kamali’s view that the commodity futures contract needs a different set of rules outside of the classic laws of mu‘āmalāt. By examining the structure of the commodity futures contract and analysing its legality from the perspective of the orthodox rules and law of mu‘āmalāt, she concludes that the current trading of the commodity futures contract is generally permissible.


Al-Amine’s analysis of the Shari‘ah issues in commodity futures contract and his argument for a fresh interpretation of the Shari‘ah is comparable to Kamali. Al-Amine (2008: 16) contends that the IFAM has not examined the different views of the classical

39 It means Islamic commercial law.
schools of thought. He also argues that the IFAM has also not considered new alternatives which would recognise the benefits of futures contract. Despite his critical comment on the inadequacy of the IFAM resolution, he admits that he had not examined the papers delivered during the IFAM’s resolution hearing. Al-Amine and Kamalis’s contentions against the IFAM resolution are also found to be inadequate. Relative to their arguments and their supporting evidence against the element of gharar in commodity futures contract, their works, on the other hand, have not shown that they have exhaustively argued and proved against the element of maysir in commodity futures contract and that, like gharar, this maysir element has been overcome by the trading regulatory safeguard.

2.2 Islamic Fiqh Academy of Jeddah (IFAJ)\textsuperscript{40}

Similar to IFAM, in 1992, the IFAJ\textsuperscript{41} resolved that the commodity futures contract traded in the organised market was not permissible (Islamic Research and Training Institute, 2000: 131). The IFAJ explicates two out of four methods of futures trading which transgresses Shari'ah principles. The methods and grounds are as follows:

\begin{enumerate}
\item A type of commodity futures contract which provides for the delivery of the described and secured merchandise at some future date. This type of contract also provides for the contract to end at that particular future date with the exchange of the actual physical delivery and its purchase payment. The IFAJ resolves that this type of contract is not permitted as two elements of exchange, namely, the delivery of the merchandise and its payment, are deferred to sometime in the future. The IFAJ further resolves that if such a contract is amended to meet the well-known conditions of the salam contract, in which payment for the merchandise is paid in advance, the contract is then permissible in Shari'ah.

\item Another type of commodity futures contract is where it provides for the delivery of described and secured merchandise at some future date and also the payment for this merchandise is to be paid upon its delivery. The contract however does not stipulate that it can only end with actual physical delivery but could also be
\end{enumerate}

\textsuperscript{40} The Jeddah-based Islamic Fiqh Academy is formed in July 1983 under the auspices of the Organisation of Islamic Conference. This body consists of Shari'ah scholars and jurists from all around the world that would discuss new issues presented by the contemporary world and resolutions are then produced on these issues (Usmani, December 12, 2010).

\textsuperscript{41} The resolution on financial markets (which includes its ruling on commodity futures contract/trading) is issued during its seventh session from 9-12 May, 1992/7-12 Dhul Qi‘da 1412H.
terminated by an opposite contract. The IFAJ resolved that this type of contract was the most prevalent in the commodity market and it is not at all permissible in the *Sharī'ah* (Islamic Research and Training Institute, 2000: 131-133). Although the reason for the prohibition of this type of contract is not explicitly spelt out, it is assumed that the reason may be similar to the IFAM’s - paper transactions and not a genuine purchase and sale as they do not involve the delivery or taking possession of their underlying commodities.

Al-Amine (2008: 21) refutes the IFAJ resolution. He argues that it inadequately considers the basis for *Sharī'ah* prohibition on the deferred sale. He based his argument on the basis that the IFAJ has relied on a weak *ḥadīth* (on *bayʿ al-kālī bi al-kālī*).42 The IFAJ should, instead, examine the authenticity of this *ḥadīth* before accepting it. Nonetheless, Zarqa (2005: 44) maintains that all the four major *fiqh* schools and all well-known classical Muslim jurists have upheld the prohibition of selling debt for debt differing only in its interpretation. Similarly, Al-Sallami (cited in Zarqa, 2005: 44) argues that, despite the weakness of the *ḥadīth*, the jurists have justified the prohibition of selling debt for debt with the following four ‘*‘illah*: (i) it leads to disputes; (ii) it increases the *gharar* level; (iii) it is a useless contract as neither party gets a counter-value that it could benefit from; (iv) it is similar to the prohibition of selling one currency for another on a deferred basis; and (v) it is similar to gambling for the seller has given nothing and is betting on the future price movement.

In addition to the above argument, Al-Amine (2008: 21) contends that the IFAJ fails to adequately ascertain the ‘*‘illah* behind the prohibition of sale prior to the taking of possession, or as is stated by the *ḥadīth* “do not sell what is not with you”. Though the IFAJ has not explicitly prescribed the ‘*‘illah*, its predecessor, the IFM (as cited in Kamali, 2000: 120) resolved that the basic rationale of the ruling in the above *ḥadīth* is *gharar*, which consists of possible failures with respect to delivery. The buyer stands the risk of not receiving the goods as it is possible that the seller may delay the delivery or wish to revoke the contract. The resolution further states that while *gharar* of this kind tends to be of a general application, there may be an additional element of *gharar* in the sale of food grains

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42 In the IFAJ’s resolution hearings, Mohamed Ali Elgari and Taqi al-Usmani (cited in Al-Amine, 2008: 17 and 20) presented their papers. Both of them argued that the futures contract is a kind of *bayʿ al-kālī bi al-kālī* and relying on the *ḥadīth* of *bayʿ al-kālī bi al-kālī*, the transaction is prohibited. However, Al-Amine (2008: 21) rebuts the authenticity of this *ḥadīth* and argues that the IFAM has accepted this *ḥadīth* without examining its authenticity.
and agricultural crops as they may be perished or destroyed due to jāʾīḥah (climate disasters and disease).

Echoing Kamali, Al-Amine argues that the organised system of the commodity futures market would address this prohibition with its in-built guarantee system. However, Rahman (2011: 112) maintains that, irrespective of the clearing house guaranteeing the delivery of the underlying commodity, gharar still exists. This is because, in derivatives transactions, delivery is not a significant matter. In this respect, neither the clearing house nor the exchange will be responsible for locating the underlying commodity. Therefore, in the event of a default by the seller to deliver, the exchange will automatically pay the margin to the buyer, the payment is being taken from the seller’s deposit account. Nonetheless, Rahman seems not to be aware that apart from the non-delivery of the underlying commodity, under the actual futures regulatory framework, when there is a default, the exchange will first determine a cash settlement price for the seller to pay to the buyer (and not just taken from the margin account). The determination of the cash settlement price is an issue as its method of calculation is not explicitly mentioned in the trading regulation.

2.3 The Malaysian Shariah Advisory Council (SAC)

In its eleventh meeting, on November 26, 1997, the SAC resolved that the crude palm oil futures contract was in accordance with Shari’ah principles. The SAC ruled that the crude palm oil futures contract was free from Shari’ah issues: namely, maysir, gharar, buying something that does not exist (bay’ ma’dūm), speculation, and the non-exchange of counter-values (‘īwadh). The SAC also ruled that the crude palm oil futures contract is permissible on the basis of public interest (maṣlaḥah) and on the notion that trading regulations have overcome Shari’ah prohibitions: namely, that of gharar and maysir (Securities Commission, 2006: 75).

Investigating the permissibility of crude palm oil futures contract from the principle of masāliḥ mursalah (unrestricted public interest or public benefit),43 Mohammed (2011) however finds that crude palm oil futures contract cannot be approved as it involves Shari’ah issues, which are clearly prohibited by the Shari’ah. Apart from this

43 Unrestricted in the sense that it has not been regulated by the Law Giver and no textual authority can be found on its validity or otherwise (Obaidullah, 2001: 190).
contravention, the contract also contravenes the objectives (maqāsid)\textsuperscript{44} of Shari‘ah. In examining the method of the SAC in approving the contract, Mohammed states that:

"...in order to achieve its goal (to becoming the hub for Islamic finance in the Asian region) sometimes it goes out of the bounds and renders a conventional transaction Islamic, without factoring the ethos and objectives of Shari‘ah in. Acting upon pick and choose policy it justifies the structure of that particular transaction, finding legitimacy of different components of a single transaction from wherever it could be found in the classical fiqh literature, going not only against the majority view but overlooking or uprooting whatever comes in its way. Legitimacy of palm oil futures trading is one of the instances of this kind." (2011: 11)

On the other hand, Bacha (2007: 331) agrees with the SAC. By doing so, the SAC has accommodated the market’s need for modern financial instruments. Instead, Bacha laments the majority of jurists who objected to derivatives by examining them within the confines of a contractual arrangement, missing the broader picture of the market’s need. Nevertheless, the drive to accommodate the needs of the market must be supported by a resolution that is adequate and coherent with the real trading of such modern financial instruments. The following discussion analyses the adequacy of the SAC resolution.

2.3.1 Definition of Commodity Futures Contract

The SAC defines commodity futures contract as:

"an exchanged-traded agreement to buy and sell a commodity in an actual market (cash market) in a standard quantity, at a future date and at a determined place of delivery" (Securities Commission, 2006: 75).

However, this definition does not accurately describe an exchange-traded commodity futures contract. This is based on, first, the actual selling/making delivery and actual buying/taking delivery transpires on an exchange and not in a cash market. Its delivery process entails delivery of crude palm oil by the seller to a port tank installation located at one of the delivery points. The payment for this delivery is not made at this delivery point but at the Clearing House, after the oil has been appraised and issued with a negotiable storage receipt (Bursa Malaysia Derivatives Berhad, n.d.: 9).

\textsuperscript{44} The primary objective of the Shari‘ah is the realisation of benefit (maslahah) to the people, both in this world and in the hereafter. It is generally held that the Shari‘ah in all of its parts aims at securing a benefit for the people or protecting them against corruption and evil. The objectives of Shari‘ah are closely related to the concept of maslahah (Laldin, 2009: 26).
Second, most commodity futures contracts do not end with actual delivery. Kunhibava spotted the inadequacy in the SAC resolution. Her thesis explored the potential of the conventional derivatives law in overcoming Shari'ah objections in derivatives. Commenting on the inadequacy of the SAC resolution, she said:

“...the SAC had not discussed the reality of futures trading. Even though it involved trading in commodity futures most of the players do not take possession. This pertinent feature was not dealt with.” (2009: 56).

2.3.2 Free from Gambling

According to the SAC, gambling refers to:

“any activities which involve betting, whereby the winner will take the entire bet and the loser will lose his bet” (Securities Commission, 2006: 104).

Hence, the SAC (2006: 76) contends that the placement of a deposit as margin payment at the start of the trading is neither a bet nor gambling. Though the amount of the deposit fluctuates, they argue that the fluctuation is not based on luck but due to the change in the demand of crude palm oil, which is a common phenomenon in the trading world. Based on this, the deposit payment is not a prohibited bet, as betting or gambling depend solely on luck and are not related to demand and offer.

However, in reality, the futures margin system comprises not only the initial margin, which is paid at the start of trading, but a set of other margin mechanisms: namely, maintenance margin, variation margin, margin call, as well as marking to market. However, these mechanisms are not analysed in the SAC resolution. The discernment of the whole structure of the futures margin system is fundamental, as the futures margin system is alleged by the opponents of the commodity futures contract to be contaminated with maysir element.

2.3.3 Free from Gharar

The SAC defines gharar as:
something that is not certain...relates to uncertainty in obtaining goods that have been bought and in receiving potential profits.” (Securities Commission, 2006: 100)

Gharar is also referred to as “elements of uncertainty that can expose someone to danger” (Securities Commission, 2006: 100). According to the SAC, the question which needs to be asked is whether gharar really exists in crude palm oil futures contract. In answering this question, the SAC contends that there is no element of gharar in the crude palm oil futures contract as when the contract is offered, specifications such as its quantity, type, price and delivery date are made known to market players. The SAC also argues that there is no element of gharar as the contract can be settled in cash before the due date or settlement by delivery on the due date. This argument is supported by the existence of the Clearing House which ensures the delivery and settlement of crude palm oil futures contract. Even if there is gharar, it is eliminated by the provision of the Futures Industry Act 1993 and the Business Rules (Exchange and Clearing House) which provides surveillance and insurance against any cheating (Securities Commission, 2006: 77).

In reality, however, the legal framework of crude palm oil futures contract does not sufficiently describe the grade or quality of the oil. The phrase “crude unbleached palm oil of good merchantable quality” is not sufficiently described to enable the seller to be informed of the required constituents of crude palm oil. It even fails to stipulate the actual delivery date. What is stipulated is only the month of delivery. Since no actual delivery date is fixed in the contract, the exact date for the buyer to remit the oil’s purchase price is also vague. These issues involve gharar elements yet they have not been shown to be raised and/or analysed in the SAC resolution.

2.3.4 Free From Buying Something That Does Not Exist (Bay’ Ma’dûm)\textsuperscript{45}

In resolving the issue of bai’ ma’dûm, the SAC adopts the opinion of Ibn Qayyim. Ibn Qayyim views that the prohibition of bai’ ma’dûm is due to the element of uncertainty in handing over the sold goods and not due to the non-existence of the object at the time when the contract is being made. Hence, bai’ ma’dûm is prohibited because of the element of gharar rather than the element of ma’dûm. In support of this proposition, the SAC refers to salam and istisna’ (contract of manufacturer) as, in these contracts, the real delivery\textsuperscript{45} In the Islamic law of contract, one of the conditions for the object of trade to be legitimate is that the object must exist when the trade or contract is being made. Hence, the purchase of an object that does not exist when the contract is being made is termed as bai’ ma’dûm (Securities Commission, 2006: 23).
takes effect in the future. Hence such commodities or products may or may not exist at the
time of forming the contract (Securities Commission, 2006: 77).

In reality, the commodity futures contract is seldom settled with delivery. Even its legal
framework provides that the contract can be settled by way of physical delivery or cash
settlement, in lieu of such delivery. However in cases where it is intended to be settled by
physical delivery, the history of commodity futures has often witnessed massive defaults in
the physical delivery of the underlying commodities. In such an event, the exchange is
empowered to coerce parties to settle by cash instead of by physical delivery, and
henceforth determine and impose a cash settlement amount. Though the regulation is
explicit in providing such power to the exchange, the regulation is silent in providing a
clear method on how the exchange arrives at the cash settlement amount. This scenario is
not attended to in the SAC resolution.

2.3.5 Speculation is Permissible

The SAC (Securities Commission, 2006: 109) refers to speculation as “making profits out
of the price movements of goods.” On this basis, the SAC views that speculation exists in
all forms of business, including the commodity futures market. The question is whether
such acts of speculation are conducted excessively or under normal circumstances
(Securities Commission, 2006: 78). The SAC substantiates its argument by making
reference to the fact that Islam allows sale and purchase transactions, examples of these
being bay’ muzāyadah and murābaḥah - transactions which involve making profit from
the difference in the price. In this circumstance, what matters is that the transaction must
be monitored and supervised in ensuring fairness to market players and to avoid forbidden
practices like fraud and manipulation (Securities Commission, 2006: 109). Apart from the
above contention, the SAC also argues that speculation is different from gambling. The
difference lies in the motives and conduct of the investors. To the SAC, speculators are

46 Taking the definition from the Dewan Bahasa and Pustaka, the SAC defines speculation as “the act of
buying and selling something (shares and others) in anticipation of making a big profit but at a great risk”
(Securities Commission, 2006: 109). The SAC also refers to the Kamus Ekonomi which defines speculation
as “the taking of risks by investors or businessmen in the hope of making profits through financial or
business trades. Speculators usually buy securities for capital gains and not for dividends” (taken from
Securities Commission, 2006: 109). The Dictionary of Business Terms is also cited by the SAC where it
defines speculation as the “purchase of any property or securities with the expectation of obtaining a quick
profit as a result of price change, possibly without adequate research. Compare with gambling, which is
based on random chance; contrast with investment” (taken from Securities Commission, 2006: 109).
47 Bay’ muzāyadah is a sale by auction (Securities Commission, 2006: 171).
48 Murābaḥah is a cost plus profit sale (Securities Commission, 2006: 174).
investors who are well informed and invest with careful consideration while gamblers are investors who enter the market and invest solely based on luck. In this way, gamblers expose themselves to risk which conduct contradicts the teachings of Islam (Securities Commission, 2006: 111).

In reality, however, futures speculation is different from speculation involved in a typical commercial sale and purchase transaction. Though both transactions involve parties profiting from price difference, futures speculation does not involve the intention or act of taking or making a delivery, nor any connection with the production or use of the commodity. Even though a commodity is not involved, the speculators could still make a profit if they bet on the future movement of the price correctly. What is being gained is the differential payment, taken from the account of the loser and given to the account of the winner. Yet this context of futures speculation is not captured in the SAC resolution.

2.3.6 No Issue on ‘Iwadh (Equal Counter-values)

Though ‘iwdh forms the focal ground for objecting to commodity futures contract in the IFAM and IFAJ resolutions, this is the last issue addressed by the SAC. In addressing this fundamental issue, the SAC argues that the trading of crude palm oil futures contract has increased the value of economic activities. The SAC illustrates this notion by taking the example of hedging. By able to hedge, producers of crude palm oil are able to cut costs. In return, this will improve the profit of the producers and enable their products to be more competitive (Securities Commission, 2006: 78). To justify its stand and eschew the painstaking task of bringing order over doctrine, the SAC apply the principle of maslahah.

In the history of commodity futures contract, the deferment of physical delivery and its purchase payment have spawned a long list of legal disputes. The case laws evidenced the pecuniary loss suffered from the default in the physical delivery – due to the lack of supply of the underlying commodities or the inferior quality of the delivered commodities. Disputes were also triggered by parties feeling discontent about the fairness of the cash settlement amount (in lieu of delivery) determined by the exchange. The massive defaults, particularly through the vehicle of manipulation or corner, prove that societies were forced to pay the brunt of the failure of commodity futures markets. In this respect, Mohammed (2011: 42), Rahman (2011: 119) and Dean (2010: 35) maintain that the harm caused by the futures contract transgresses the very objectives (maqāsid) of Shari‘ah.
2.4 Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)\(^{49}\)

Seven years after the SAC resolution, in 2004, the AAOIFI issued a ruling which, opposite to the SAC, categorically prohibited commodity futures contract.\(^{50}\) The AAOIFI’s resolution, or commonly called as standard, defined commodity futures contract as:

“...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” (2010: 363).

The AAOIFI resolves that futures commodity contracts are not, according to the Shari'ah, permissible either through their formation or by trading in them. The basis for prohibiting such a contract is as follows:

i- The verse from the Quran in Chapter An-Nisā’ verse 29 where Allah says,

“Eat not up your property among yourselves with injustice, but let there be amongst you traffic and trade by mutual consent.”

ii- Both counter-values are delayed hence creating two liabilities which equals the impermissibility of delaying capital in salam.

It is interesting to note that, though the Shari'ah Board of the AAOIFI is comprised of Malaysian Shari'ah scholars who sat in the SAC when the resolution of crude palm oil futures contract was made, the SAC does not seem to have taken any steps to review its resolution in light of the opposing ruling of three distinguished international bodies of Shari'ah scholars.\(^{51}\)

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\(^{49}\) The Accounting and Auditing Organisation for Islamic Financial Institutions is the standard-setting organisation for Islamic financial institutions. It was registered on 27 March 1991 in the State of Bahrain as an international autonomous non-profit making corporate body. The standards that have been issued by the organisation comprise of mainly accounting, auditing, and governance, in addition to codes of ethics and Shari'ah standards. The organisation has progressively issued new standards, redrafting current ones by taking into account all newly emergent requirements and needs of Islamic financial institutions from all around the world (The Accounting and Auditing Organisation for Islamic Financial Institutions, 2008: vii).

\(^{50}\) This resolution is the result of its Shari'ah board meeting held from 15-20 May 2004 (26-30 Rabi’ al-Awwal, 1425H) and issued under the title of “Sale of Commodities in Organised Markets”.

\(^{51}\) According to DeLorenzo (2011: 230), the Malaysian Securities Commission encourages its Shariah scholars to sit on international boards to deepen and broaden the experience of these scholars. The inclusive nature of the attitude of, and resolutions by, the SAC, keeping in mind the jurisdictional differences within the factions of the scholarship in the Shariah, has been a real strength for the Islamic capital market in Kuala Lumpur.
2.5 The Gap in the Existing Literature

Ever since the subject of the legality of commodity futures contract was officially discussed in 1985 by the IFAM, not much literature has been written on the topic. Shahabudin (1994), the former Chief Executive of the Kuala Lumpur Commodity Exchange, extolled the benefits of the commodity futures contract and recommended it to be adopted by the Malaysian Islamic capital market. As the SAC had yet to issue its resolution then, the question remained whether such contract was permissible by the *Shari'ah*. In 1997, the SAC resolved that it was permissible. Nonetheless, the legitimacy of the commodity futures contract remains a contentious subject in Malaysia. Bakar (2007), being one of the SAC members involved in the issuance of the SAC resolution, presented a paper on this subject. In his presentation, he deliberated on the *Shari'ah* issues found in derivatives products: namely, margin payment, setting-off, cash settlement in lieu of physical delivery, hedging, arbitrage, short sale, and questioned its permissibility.

Usmani (2000, n.d.) and Dean (2010) analyse the commodity futures contract purely from the *fiqh* (jurisprudence) perspective and maintain that it breaches the rules and principles of *Shari'ah*. Neither of their analyses, however, relates exhaustively to the trading regulatory framework which forms part and parcel of the commodity futures contract. On the other hand, Kamali (1997, 1999, 2000a, 2000b, 2002a, 2002b, 2005), Ibrahim (2000, 2002), Al-Amine (2001, 2005, 2008), and Alamad (2006) argue that the commodity futures contract is permissible as its *Shari'ah* issues have been overcome by its legal framework. Spearheading this team, Kamali and Ibrahim contend that in exercising any *fiqh* analysis, one must take into account its trading regulations. Having done so, they find that the regulatory safeguards and surveillance mechanisms have eliminated the elements of *gharar* from the contract. Though Zarqa (2005), Khan (2005), Mohammed (2011), and Rahman (2011) agree to the relevance of the trading regulations, they opine that Kamali has misappropriated the methodology in adducing the *fiqh* ruling on the permissibility of the commodity futures contract. They argue that for Kamali to legitimise the commodity futures contract on the basis of permissibility (*ibākah*) - to provide ease and avoid hardship - Kamali has to ensure that the contract is not in collision with any explicit prohibitive *Shari'ah* injunctions and that it does not cause any harm to the social welfare of the community.
Rahman (2011), and in particular, Mohammed (2011) examines the commodity futures contract in light of the principle of *mašālih mursalah* – its benefit and harm to the society. Deliberating on past economic crises and market failures, they argue that the contract transgresses a fundamental *Shari'ah* principle, namely, devouring the wealth of others. This transgression is also in conflict with *maqāsid* of *Shari'ah*. They further argue that though the commodity futures contract brings some benefits, its benefits are largely undermined by its harmful effects. Similarly, Khan (2005) analyses the contract from the basis of Islamic economic principles and economic reality. Based on his analysis, he concludes that the commodity futures contract is not permissible as it transgresses Islamic economic principles. Bacha (2008), meanwhile, evaluates the needs of the commodity futures contract and examines the technical part of its trading. Though he finds that there is a need for such an instrument, he concedes that there are a number of technical issues which require *Shari'ah* deliberation. For instance, the huge trading volume indicates extensive speculation in the futures market, the issue of non-delivery, and the cash settlement in lieu of delivery.

On other hand, Ahmad (2009), who examines the contract from the perspective of *maslahah*, argues that by permitting derivatives instruments, the public could manage risk and hardship. Unlike Mohammed, her analysis is short of real evidence which could augment her claim on the applicability of the *maslahah* principle. Her analysis on the futures contract is also inaccurate as it does not reflect real trading. For example, she viewed that the process of marking to market is not a transfer of money from a loser to a winner but is a process of securing parties from default. In reality, marking to market is indeed a method for the winner to receive his winnings from the loser as this gain is transferred directly into the account of the winner and the winner can enjoy this gain instantaneously.

Jobst (2008), and Jobst and Solé (2012) review the literature which discuss the *Shari'ah* issues and find that the prohibitive injunction against derivatives curtails the development of financial derivatives in the Islamic capital market. Similarly, Uberoi and Khadem (2011) analyse and evaluate the *Shari'ah* issues. According to them, the *Shari'ah* restrictions could be overcome if *Shari'ah* scholars play their role and duty in enhancing the welfare (*maslahah*) of the society and cater for the needs of the Islamic finance industry. Khan F. (1995), El-Din (2001), and Ayyash (2008) realise the real market needs for an Islamic futures market which is to be devoid of any of the *Shari'ah* issues. Based on the needs for
a *Shari'ah*-compliant derivatives market, Khan F., El-Din and Ayyash explore the rich resources of Islamic jurisprudence and suggest *Shari'ah*-compliant derivatives modelled on the concept of *salam, istișnā* and *juʿālah*.

As mentioned earlier, the proponents of the commodity futures contract contend that futures regulations have overcome the *Shari'ah* prohibitions. In support of this proposition, Kamali (2002a) and Al-Amine (2001, 2008) discuss the Malaysian futures market legal framework. Kamali (2002a: 49) describes the relevant provisions in the then Commodity Trading Act 1985 which relate to: the setting up of the Exchange and the Clearing House; the licensing of intermediaries in the futures market; the clients' protection against pecuniary loss caused by the default of any members of the Exchange; the trading, registration and settlement of contract; the trading limits; and trading offences like false trading, manipulation, cornering etcetera. Meanwhile, Al-Amine (2008: 177) refers to the then Futures Industry Act 1993. Apart from what was described by Kamali, Al-Amine went further in comparing the Securities Commission, being the supervisory authority of the futures market, with the institution of *Hisbah* in Islam; and comparing futures market offences with market offences in Islam. Although they have analysed the commodity futures legal framework, their analysis is superficial as they only studied a small portion of the trading regulations. Both seem to focus on these few provisions which they deem as safeguards, hence claiming to have sufficiently addressed *Shari'ah* concerns.

On the other hand, Kunhibava (2009) explores the prospective of the conventional derivatives legal system in overcoming *Shari'ah* objections in derivatives. She studies how conventional law has evolved from invalidating the commodity futures contract on the basis of gambling to validating it by regulatory intervention. Her work involves the examination of the UK and American regulatory framework, which she argues is able to overcome *Shari'ah* objections. In support of her proposition, she explores provisions relating to restricting derivatives trading which include: limiting the number of days for futures delivery; trading limits and imposing taxes on each futures sale; the licensing of the Exchange as well as the traders; designating a regulating body to oversee the market; the training of those involved in derivatives trading; investor protection against rogue traders; prohibitions in trading; and the imposition of stiff penalties for violation of laws (2009: [insert page number]).

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52 The Commodity Trading Act was repealed by the then Futures Industry Act 1993.
53 The institution of *hisbah* originates from the concept of market supervision established during the period of the Prophet Muhammad (peace be upon him). It developed from a small supervisory market institute into an institute comprising of various departments and dealing with almost everything that affects the Muslim community – their economy, health, security, environment and etcetera.
It is established that risk management tools are needed in Islamic finance. However, futures and options as they exist in their current form are considered not to be Islamically permissible. Nevertheless if all the objections imposed by Shari'ah could be overcome towards derivatives then they would be accepted in Islamic finance. The conventional laws identified from the legal history usage of derivatives in conventional finance can be used to overcome excessive speculation and gambling. However to overcome other objections towards derivatives in Islamic finance, the solutions will have to be found within Shari'ah itself, to achieve complete acceptance of derivatives.” (2009: 274)

On this finding, she recommends that further research on the internal rules, regulations and guidelines of the current boards of trade and exchange be carried out in order to determine whether these legal frameworks could actually overcome the Shari'ah objections.

This suggestion is timely and important and it is also concurrent with the view held by Al-Basil (2005) regarding the novelty of commodity futures contract in which he said:

“It is also necessary to analyse actual contracts in futures markets; it is obvious that this entails investigating all forms and circumstances of such contracts, and then we can make our judgements on a case-by-case basis. The same criticism applies to other studies which call for banning or allowing such contracts.” (2005: 49).

This literature highlights the areas that have been covered on this subject and at the same time accentuates the gap that needs to be addressed. A comprehensive and exhaustive study on the mechanics of the crude palm oil futures contract and its legal framework is wanting. Though Kamali, Al-Amine, and Kunhibava have examined this legal framework, their examination is restricted to a certain area of the framework, leaving other fundamental parts of the framework untouched. This study will examine the remaining fundamental parts of this legal framework. The selection of these legal provisions will be made using the criteria of Shari'ah prohibitions and issues as discussed by the SAC, the IFAM, the IFAJ, the AAOIFI and the existing literature. By critically examining this part of the legal framework, this study will be able to discern whether the SAC resolution is coherent with real trading and whether the crude palm oil futures legal regime has actually overcome the Shari'ah prohibitions inherent within crude palm oil futures contract.

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54 In one of her surveys, it is shown that almost seventy per cent of her respondents agree to conventional law being used to regulate futures, but to do this, the conventional law must be within the principles of Shari'ah (2009: 210).
CHAPTER THREE

Reasons for Gharar in Eligible Delivery Agreement and Contract Specification

3.1 Introduction

This chapter sets out to analyse the element of gharar in crude palm oil futures contract in particular the eligible delivery agreement and its contract specification. Gharar literally means deception (International Shari’ah Research Academy for Islamic Finance, 2010: 131). According to the SAC, the crude palm oil futures contract is Shari’ah-compliant. It claims that the contract is free from any gharar elements and even if there is gharar, it has been eliminated by the crude palm oil futures legal framework. This stand is taken in spite of the contrary resolutions of the IFAM, the IFAJ and the AAOIFI. Although the SAC, on the one hand, and the IFAM, IFAJ and AAOIFI on the other hand, came to opposing rulings on the legality of commodity futures, all these institutions have, in fact, adjudicated one common denominator issue - the non-exchange or deferment of both counter-values at the time of sale.

This common denominator issue will be discussed in this chapter as it relates to the issue of gharar. In addition to this, this chapter will also analyse the element of gharar in other controversial issues related to crude palm oil futures contract: namely, the sale of non-existent, non-possessed, or unowned crude palm oil, and the sale of an outstanding debt or obligation for a corresponding outstanding debt or obligation. The analysis of these issues and its affiliation with the doctrine of gharar will be framed based on the views expounded by the classical and contemporary Shari’ah jurists including the institutions of Shari’ah scholars.

The discussion on the technical aspect of crude palm oil futures contract will be drawn from the interpretation of Malaysia’s crude palm oil futures legal framework, namely the 2007 Act, the Business Rules of Bursa Malaysia Derivatives Berhad, the Business Rule of Bursa Malaysia Derivatives Berhad as well as local case laws. Data collected through interviews with a number of Malaysian futures market practitioners, as well as prominent

55 Technically gharar refers to “sale of a thing that is not present at hand, or the sale of a thing whose consequence or outcome is not known; or a sale involving risk or hazard which one does not know whether it will come to be or not, such as fish in the water or a bird in the air.” (Khan, 2003: 66).
Shari'ah scholars, will be used to complement the analysis. Apart from the Malaysian legal framework, the commodity futures legal framework of the United States and other European countries will also be studied. This includes their case laws. The reference to these foreign jurisdictions is due to their commodity futures market being more mature, similarity in the trading process and the fact that case laws related to commodity futures contracts are more extensively reported in these jurisdictions. Finally, this chapter will seek to establish that, inconsistent with the stance of the SAC, the element of gharar does exist in crude palm futures contract.

3.2 Gharar in Commodity Futures Contract: The Divergence in the Resolutions

The resolutions of the SAC, the IFAM, the IFAJ and the AAOIFI have shown that gharar is conspicuous in commodity futures contract. The IFM resolves that commodity futures contract is not in accordance with the Shari'ah as it is a deferred contract; it involves the sale of a commodity which the seller does not own or possess; and it concludes over a thing which does not exist at the time of the contract (taken from Kamali, 2000: xviii and al-Amine, 2008: 15). Similarly, the IFAJ resolves that the commodity futures contract is not permissible as it defers the delivery as well as the payment (Islamic Research and Training Institute, 2000: 131). Likewise, the AAOIFI categorically prohibits the undertaking of futures transactions as: they it involve a sale without a real physical exchange or delivery of commodities; and by delaying the exchange of both counter-values, two liabilities are created; and finally, lack of delivery negates the requirement of a sale (Accounting and Auditing Organization for Islamic Financial Institutions, 2010: 361).

Nonetheless, despite the above arguments, the SAC resolves that the crude palm oil futures contract is permissible as it is free from gharar, it does not involve buying something that does not exist at the time of sale (bay' ma'dūm), and it does not involve the non-exchange of counter-values (i'wadī). Furthermore, it argues that even if there is gharar, the regulatory framework of the crude palm oil futures contract extinguishes the gharar element (Securities Commission, 2006: 75). Despite the divergence in the rulings between the IFAM, IFAJ and AAOIFI on the one hand, and the SAC on the other hand, these rulings display that they have deliberated on one, common gharar issue. This issue is the non-exchange or deferment of both counter-values at the time of sale. This issue strikes at the core of the crude palm oil futures contract to the extent that the IFAJ has illegalised commodity futures contract solely on this ground. Apart from this issue, these resolutions
have also discussed other *gharar* issues related to commodity futures contract: namely, the sale of non-existing, non-possessed, or unowned crude palm oil; and the sale of an outstanding debt or obligation for a corresponding outstanding debt or obligation.

These *gharar* issues will be analysed in this chapter. To commence the analytical process, the next section will briefly explain the prohibitive injunctions of *gharar* in a sale or an exchange transaction.

3.3 The Prohibition of *Gharar* Transactions

The prohibition of *gharar* transactions is sourced from the *hadith* or the tradition of the Prophet Muhammad (peace be upon him). According to Ibn Rushd (2000: 179), though the majority of jurists do not dispute these transactions, the meanings of the names of these sales are disputed. Amongst those transactions that have been expressly proscribed are as follows:56

i- Abu Hurairah reported that the Prophet (peace be upon him) forbade the type of sale which involves *gharar* (risk or uncertainty) and *bay’al-ḥasāḥ* (a transaction determined by the throwing of a stone). According to al-Nawawi, this *ḥadīth* can be explained in various ways: first, for instance one says, I sell you one of these clothes on which the stone falls which I am throwing; secondly, I sell you this object on condition that you have the option till I throw this stone; thirdly, if I strike this cloth by throwing a stone to it, that is sold to you for such and such price (as cited in Hassan, 1988: 959). Sales completed in such a way may lead to injustice and hardship to one of the parties and hence is prohibited (Siddiqi, 1978: 796).

ii- Abū Sa‘īd al-Khudrī reported that the Prophet (peace be upon him) forbade two types of business, *mulāmasah* and *munābadhah*. *Mulāmasah* is a sale where a man touches the other person’s garment without unfolding or turning it over. The sale is binding when he touches that garment. *Munābadhah*, on the other hand, is a sale where a man says to another, “If I throw this garment to you, the sale will be

56 Other prohibited transactions are the sale of a foetus in the womb of the conceiving animal (*ḥahl al-ḥabl*); the sale of that not yet created; the sale of fruits before they are ripe; *bay’ al-mulāmasa*; *bay’ al-munābadha*; *bay’ al-ḥasāḥ*; the sale of fruit-bearing trees for several years (*mu’āwama*); two sales in one; a sale linked to a loan; the sale of grain ears before they whiten; the sale of grapes before they are blackened; and the sale of foetuses and sperm of animals (*maḍāmīn and maḍāqīḥ*) (Ibn Rushd, 2000: 179). See also Al-Muwatta Imam Malik (1982: 301).
certain” (Hassan, 1988: 959). Both forms of transactions are prohibited as, in either case, the buyer is not given any opportunity to examine the things sold to him. The bargain is thus likely to prove unduly disadvantageous to one side (Siddiqi, 1978: 795).

iii- Ibn ‘Umar reported that the Prophet (peace be upon him) forbade the transaction called ḥabāl al-ḥabalah. This is the sale of an offspring of another offspring. At the time of sale, the offspring is still in the womb of the mother, the she-camel. This term, ḥabāl al-ḥabalah, can be explained in various ways. Firstly, the seller says to the buyer: I sold this article for a price to be paid later when that she-camel delivers an offspring, a she-camel, and this she-camel becomes pregnant. This form of sale is prohibited as the period fixed for payment is obscure. Secondly, the seller says to the buyer, when that she-camel delivers an offspring, a she-camel, and this she-camel becomes pregnant and delivers an offspring. I sell you this offspring now. This sale is forbidden as the object is unknown (Hassan, 1988: 960).

The next section will further explain the meaning of gharar and its application in the contract of exchange.

3.4 Gharar: Its Definition and Concept

In a literal sense, gharar means deception (International Shari’ah Research Academy for Islamic Finance, 2010: 131). It also connotes risk, hazard, jeopardy, danger, and/or peril (Cowan, 1979: 781-782). Taghreer, being the verbal noun, refers to deception or misrepresentation in the context of which it includes exposing oneself (or his property) or others (or their properties) to jeopardy (Al-Saati, 2003:6). The noun of garra, ghurur has been mentioned in the Qur’ān in Chapter Āl-i-‘Imrān (The Family of ’Imrān), verse 185, which depicts the life in this world as mere deception, relative to real life in the Hereafter (Badawi and Haleem, 2008: 662). The verse says:

“Every soul shall have a taste of death. And only on the Day of Judgement shall you be paid your full recompense. Only he who is saved far from the Fire and admitted to the Garden will have attained the object (of Life); for the life of this world is but goods and chattels of deception”.

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In Islamic jurisprudence, the term *gharar* has been given a variety of meanings by classical as well as contemporary jurists including the institutions of *Shari'ah* scholars. Al-Zuḥaylī (2003: 83), for example, assembled the definitions of *gharar*, as given by classical jurists, illustrating how each school of thought (*madhab*) has its own interpretation of *gharar*. The myriad of interpretations is perhaps due to differences in the perception and comprehension of the *gharar* injunctions as well as distinctive prevailing market practices.

Al-Sarakhsi from the Hanafi school describes *gharar* as that whose consequences are hidden. Al-Qarafi, a scholar from the Mālikī school views that *gharar* is what is not known to exist in the future, for example, birds in the air and fish in the water. According to Al-Ṣhirāzī of the Ṣḥāfi‘ī school, *gharar* is that whose nature and consequences are hidden. While another scholar from the Ṣḥāfi‘ī school, Al-‘Insawi, relates *gharar* to two possibilities, with the worse consequence being the more likely. Similarly, ‘Ibn Hazm of the Zāhirī school defines *gharar* as a transaction where the buyer does not know what he has bought or the seller does not know what he has sold.

Ibn Taymiyyah defines and explains *gharar* as:

"...things with unknown fate. Selling such things is *maysir* and gambling. This is because when a slave runaway, or a camel or a horse is lost, his owner would sell it conditional on risk, so the buyer pays much less than its worth. If he gets it, the seller would complain: you have "gambled me, and got the good with a low price. If not the buyer would complain: you’ve gambled me and got the price I paid for nothing. This will lead to undesired consequences of *maysir*, which is hatred and enmity, in addition to getting something for nothing which is a sort of injustice. So *gharar* exchange implies injustice, enmity and hatred.” (as cited in Al-Suwailem, 2000: 65).

His disciple, Ibn al-Qayyim, shares a similar view but extends the meaning of *gharar* to (i) the failure by the seller to deliver the subject matter, regardless of the existence or non-existence of the subject matter; (ii) the acquisition of its object being unknown or the object being incapable of delivery or the quantity of the object being undetermined; and (iii) there being a state of doubt between its existence or non-existence (as cited in Zahraa and Mahmor, 2002: 386).

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57 Ibn al-Qayyim echoes IbnTaymiyyah’s notion of *gharar* where he said, “*Gharar* is possibility of existence and non-existence. Its sale is forbidden because it is sort of gambling, which is *maysir*. Allah forbade it because it was likened to eating one’s fortune wrongly, and this is injustice that Allah has forbidden. It becomes gambling when one party gets reward (benefit) while the other might or might not get it, so this becomes illegal, like the sale of runaway slave, lost camel, and ḥabl al-ḥabalah” (as cited in Al-Suwailem, 2000: 65).
The variety of the classical interpretations of the term *gharar* is echoed in the writings of contemporary jurists. Al-Dhareer (1997: 10), for example, summarised the many definitions of *gharar* into three headings where: (i) *gharar* applies exclusively to cases of doubtfulness or uncertainty, as in the case of not knowing whether something will take place or not; (ii) *gharar* applies only to the unknown, to the exclusion of the doubtful; and (iii) a combination of the two above: uncertainty and the unknown. Likewise Al-Sanhuri (as cited in Mansuri, 2005: 96) views *gharar* as having a lack of knowledge of the material aspects of the contract. It occurs in the following circumstances: (i) when it is not known whether the subject matter exists; (ii) if it exists at all, whether it can be handed over to the buyer; (iii) when want of knowledge affects the identification of the genus of species of the subject matter; (iv) when it affects the quantum, identity or necessary conditions; and (v) when it relates to the date of future performance.

Additional characteristics are given to the concept of *gharar* by the following contemporary jurists. Al-Zuḥaylī (2003: 84) adds “risk” to *gharar* where he views it as “risk in the sense of lack of certainty regarding the existence of an object”. Hence, from the aspect of a sale contract, the object (i) is not known to exist, or (ii) its measures are not known to be large or small, or (iii) it is undeliverable. In concurrence with the definition given by Ibn Taymiyyah and Ibn al-Qayyim, Al-Zarqā’ adds the characteristic of gambling where he defines *gharar* as “the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes it similar to gambling” (as cited in Al-Zuḥaylī, 2003: 83). Similarly, Al-Suwailem (2000: 62) interprets the *gharar* transaction as “equivalent to a zero sum game with uncertain payoffs”. In this sense, the zero sum game is not referred to as merely the gain of one party at the loss of the other party, but it strictly refers to the payoff of a player being unable to increase without also reducing the other player’s payoff. El-Gamal (2001: 4) defines *gharar* as the risk and danger of loss. Hence, *bay‘ u al-gharar* is risk-trading. According to him, risk-trading is inherently inefficient as it imbalances the cost-benefit equilibrium.

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58 This third view is the view most favoured by most jurists, and Al-Dareer too opted for this third view as it is the one with the most exhaustive coverage.

59 Warde (2001: 59) cautions the practice of using interchangeably the term *gharar* with the broad concept of risk. This is so as Islam does not advocate the avoidance of risk nor prohibit risk. In fact, incurring commercial risk is allowed and so encouraged provided that it is equitably shared. Similarly Al-Suwailem (2000: 64) cautions that risk becomes desirable only when it stimulates productive effort and value-adding activities and not otherwise.

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Another perspective of *gharar* is propounded by other contemporary scholars. Shimizu (1989: 64), for example, describes *gharar* as “a possibility of risk where the equilibrium of countervalues is upset or an unjust or inequitable gain or loss is produced”. Hence to maintain equilibrium in a contract, a fixed obligation or a definite subject matter is needed. Lacking this, the substance of a contract is not determinable. The importance of equivalence in a contract of exchange is emphasised further by Chehata where he views that the basis for prohibiting *gharar* transactions is to ensure equivalence in such transactions (as cited in Hassan, 2002: 292). In a similar context, Hassan (1994: 74) maintains that the purpose of the doctrine of *gharar* is to avoid risk building up excessively at the time when the contract is formed rather than at a later point. The hazard that this causes would eventually lead to inequitable, unfair, and unjust gains to either one of the parties. Nonetheless Warde (2001: 59) contends that *gharar* is more accurately defined as aleatory transactions, as they are conditioned on uncertain events. He observes that the *hadith* on *gharar* are all against aleatory contracts where gain is the result of chance or undetermined causes.

A similar attempt is made by Vogel and Hayes (1998: 88) where they succinctly draw a spectrum of risk based on *gharar hadith*. This risk spectrum starts from where risk is at the core of the transaction, namely: (i) pure speculation – a sale, which is equivalent to gambling, as values obtained from such a sale are unknown, hence are entrenched with the highest level of risk; (ii) uncertain outcome – a sale whose countervalue is not only of an uncertain value but may not be realised at all (though the risk may be greater in this category compared to the pure speculation category, it is less essential as the transaction could be made to take effect upon the outcome becoming certain); (iii) unknowable future benefit – a sale in which valuable benefits are precisely known and defined but...
whose future benefit to the buyer is unknown (though it contains less initial risk, the transaction may potentially be infected by the evil of gambling when the buyer has had false hopes or has paid too much); and (iv) inexactitude – a sale which involves measurement and weight (this category exhibits the least risk of the gambling element as it is only concerned with exactitude).

Gharar is also defined by the IFAJ, the AAOIFI and the SAC in their resolutions. It is observed that the definition of gharar is more uniform among these institutions where “uncertainty” is the common meaning used in all of them. For instance, the IFAJ (Islamic Research and Training Institute, 2000: 264) refers to gharar as uncertainty. Similarly, the AAOIFFI (Accounting and Auditing Organization for Islamic Financial Institutions, 2010: 537) defines gharar as “a state of uncertainty that exists when the process of concluding a transaction involves an unknown aspect.” In other words, gharar refers to the status of results that may or may not materialize. Likewise, the SAC (Securities Commission, 2006: 100) interprets gharar as “elements of uncertainty that can expose someone to danger”. According to the SAC, when “the ‘aqad has the element of gharar, it means that there is an element of uncertainty in the ‘aqad.”

The difference of views by these jurists as to what constitutes gharar also affects their views on whether such transactions are contaminated with excessive gharar. The effect of excessive gharar is that it invalidates the sale transaction at its inception. Hence, the next section examines juristic views on what constitutes elements of excessive, or forbidden, levels of gharar.

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66 Such sales include the covering of the stallion and the stroke of the diver.
67 This kind of sale may either involve one to deliberately exposing oneself to risk or alternatively it could be a thoroughly mundane and practical process, such as the sale of a heap of goods without parties measuring the goods or the sale by the pound.
68 The IFAJ made this interpretation in their resolution prohibiting the instrument of indexation. The IFAJ ruled that the Shari'ah prohibits the repayment of a contract of debt to be linked to the price of a certain commodity or price of a basket of commodities. The reason for such a prohibition is due to the involvement of a great deal of gharar and jahālah (uncertainty and lack of information), since both parties would not be in a position to know what the commitment would be at the end. If the indicator (the price of the commodity or basket of commodities) happens to show an increase, this will lead to a discrepancy between the original debt amount and the amount to be repaid. Hence this kind of arrangement could result in usury.
69 The AAOIFI came up with Shari'ah No. 31. This standard deals with the controls of gharar in financial transactions.
70 The definition of gharar is given in its resolution permitting the trading of the commodity futures contract.
71 For example, a sale and purchase contract which does not state its price is said to possess an element of gharar as cheating in price can occur.
3.5 The Characteristics of Excessive Gharar

Al-Bājī Al-ʿAndalusī clearly describes the predicament faced by these jurists in determining elements of excessive gharar in a sale transaction. He states:

“His (pbuh) prohibition of bayʿu al-gharar renders such a sale defective. The meaning of bayʿu al-gharar, and Allāh knows best, refers to sales in which gharar was the major component (ghalabaʿalayhi) until the sale is justifiable described as bayʿu al-gharar. This is the type of sale which is unanimously forbidden. On the other hand, minor (yāsir) gharar does not render a sales contract defective, since no contract can be entirely free of gharar. Thus, the [legal] scholars differ in determining which contracts are defective due to differences in opinion regarding the extent of gharar inherent in each: sic. whether it is substantial and invalidates the contract, or minor and retains the contract’s validity” (as cited in El-Gamal, 2001: 3).

This unanimity amongst the jurists applies only to the notion that excessive gharar renders a sale defective while minor gharar does not. The issue of whether gharar in such a sale is excessive remains outstanding. The difficulty in getting such a consensus is perhaps due to the differences in perception and market practices as well as the means and facilities of one society compared to another. Besides having to determine whether gharar in such a sale is excessive, gharar is also determined from the aspect of whether such a sale is not something which is necessitated by society. Taqiyyuddīn Al-Subkī states that:

“The scholars said that the criterion for invalidity of the contract based on gharar or its validity despite the existence of gharar is thus: if necessity dictates committing gharar which cannot be avoided without incurring an excessive cost, or if the gharar is trivial (ḥaqīr), the sale is rendered valid, otherwise it is rendered invalid...” (as cited in El-Gamal, 2001: 3).

Hence, if people are in need of such exorbitant gharar transactions, the prohibition of gharar will not have any effect on such transactions. This is because the purpose of an exchange transaction is to alleviate hardship and to meet the needs of the people. In this context, Musleḥuddīn (1979: 180) opines that the Shariʿah recognises the genuine need of society and provides facilities to those who are confronted with hardship, hence promulgating the rule on necessity and need. However this rule of necessity and need ceases to be in operation once the urgency is over. Even while this rule is applied, people must seek measures to identify a proper solution in light of the Shariʿah.72

72 See also, the Accounting and Auditing Organisation For Islamic Financial Institutions (2010: 539). In this regard it is important to note that to cater to the real need of society, Islam approves bayʿsalam and bayʿ istisnaʿ where both transactions are structured on deferment of both counter values.
As mentioned earlier, excessive *gharar* invalidates a sale contract. The reason is that in Islam, an exchange is rooted in a concept of a consensual present transfer or conveyance of a property for a price (Othman, 2005: 129). Hence, the existence of excessive *gharar* would not only inhibit the mutual consent between contractual parties but also eliminate the very objective of the contract which is to gain benefit from the exchange. However, excessive *gharar* is overruled when there is clear necessity in the form of a clear economic benefit (El-Gamal, 2001: 1). Apart from the condition that the excessive *gharar* transaction is not necessitated by society, the principal object, and not subsidiaries or derivatives to the object, is affected by the characteristic of excessive *gharar* (Al-Dareer, 1997: 48).

In discerning the characteristics of excessive *gharar* in a sale transaction, Ibn Juzay (as cited in Zahraa and Mahmoud, 2002: 387) has succinctly described them as follows: (1) difficulty in performing the delivery of the subject matter; (2) lack of sufficient knowledge (*jahl*) regarding the type of price or subject matter; (3) lack of sufficient knowledge regarding the characteristic of the price or of the subject matter; (4) lack of sufficient knowledge regarding the quantum of the price or the quantity of the subject matter; (5) lack of sufficient knowledge regarding the date of future performance; (6) having two sales in one transaction (*bay' atān fī bay' atin*); (7) sale of what is not expected to revive; (8) *bay'al-ḥasāh*; (9) *bay' munābadhāh*; and (10) *bay'al-mulāmāsa*. Similarly, Ibn Rushd (2000: 179) expounds a similar thread of characteristics; namely, lack of knowledge (*jahl*) (i) about the identity of the subject-matter or failure to determine the contract; (ii) about the attributes of the price, or the priced commodity, or about the quantity, or the deferred period (of delivery); (iii) about its existence or the impossibility of its acquisition which relates to the obstacles of delivery; and (iv) about its sound existence, that is its continued existence.

After all this, the question now is whether any of the excessive *gharar* characteristics, as characterised by Ibn Juzay and Ibn Rushd, exist in the crude palm oil futures contract. If it does not exist, the contract is valid. Otherwise, the contract is invalid. The next question, if

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73 A classic example is the selling of the foetus in the womb of the mother. It is not permissible to sell the foetus as it entails excessive *gharar* but it is permissible to sell the mother, being the principle object of the sale as the foetus is only the subsidiary.

74 *Bay' al-ḥasāh* is a type of sale whose outcome is determined by the throwing of the stone.

75 *Bay' munābadhāh* is a type of sale which is performed by the seller throwing a cloth at a buyer and concluding the sale transaction without giving the buyer an opportunity to properly examine the object of the sale.

76 *Bay'al-mulāmāsa* is a type of sale where the bargain is concluded by touching the object of the sale without examining it.
it does exist, is whether the trading regulatory framework of crude palm oil futures contract has disabled the identified excessive gharar characteristic. If there is evidence to show that the excessive gharar characteristic has been eliminated from the crude palm oil futures contract, the contract is then valid. This method of examination is important as it addresses the contention of the SAC resolution. These questions will be addressed in the next section. For the sake of convenience and for the avoidance of doubt, the term “gharar” is used to represent “excessive gharar” throughout this thesis.

3.6 Element of Gharar in Eligible Delivery Agreement and Contract Specification

This section examines two important contracts in the crude palm oil futures legal framework. They are the eligible delivery agreement and its contract specification. However before analysing these contracts, it is worth noting the effect of the 2011 amendment on eligible delivery agreement. On October 3, 2011, the 2007 Act was amended by the Capital Markets and Services (Amendment) Act 2011. As a result, the term “futures contract” is deleted and substituted with the word “derivatives”.77 Section 2 of the 2007 Act now defines futures contract as:

“futures contract” means a derivatives78 that is traded on a derivatives exchange which creates an obligation for physical delivery or acceptance of physical delivery of the underlying instrument of such derivatives, the quantity and quality of which is determined by that derivatives exchange, at a fixed date in the future at a fixed price, and which may be cash settled in lieu of physical delivery.”

Due to this amendment, the term “eligible delivery agreement” is deleted from the 2007 Act. The issue now is whether the newly defined futures contract and the deletion of the

77 The reason for such amendments is to enable not only the on-exchange derivatives (futures contracts and options) but also the over-the-counter derivatives to be regulated by the 2007 Act. This is in line with the global regulatory reform towards improving the transparency and regulatory oversight of the over-the-counter derivatives market. By inserting the word “derivatives” in the definition, all types of derivatives, other than derivatives which are excluded or exempted, is now officially regulated. Hence, reference to the “futures market” and “futures exchange” is now being referred to as the “derivatives market” and “derivatives exchange” (Securities Commission, 2011).

78 Section 2 of the amended 2007 Act defines “derivatives” as “any contract, either for the purposes of creating an obligation or a right or any combination of both, of which its market value, delivery or payment obligations are derived from, referenced to or based on, but not limited to, underlying securities or commodities, assets, rates, indices or any of its combination, whether or not a standardised derivative or an over-the-counter derivatives, but does not include-(a) securities; (b) any derivative to which Bank Negara or the Government of Malaysia is a party; (c) any over-the-counter derivatives whose market price, value, delivery or payment obligations are solely derived from, referenced to or based on, exchange rates; or (d) any agreement, when entered into, is in a class of agreements prescribed not to be derivatives.”
term “eligible delivery agreement” have any effect on this study. It is important to note that this study is on the SAC resolution issued in 1997 under the then prevailing statute, the Futures Industries Act 1993 (1993 Act). Under the 1993 Act and the 2007 Act, the futures contract referred to either the eligible delivery agreement or the adjustment agreement. The eligible delivery agreement is chosen by this study, as unlike the adjustment agreement, it envisages physical delivery which tallies with the description of crude palm oil futures contract in the SAC resolution.

It is observed that the newly defined futures contract does not incorporate a number of constituents, which once formed part of the eligible delivery agreement. These constituents consist of the following:

(i) The agreement is entered into, with or without the existence of the underlying commodity;

(ii) The capability of the agreement to be varied or discharged before its expiration;

(iii) The making and taking delivery of the underlying commodity is by the person who actually makes and takes the delivery at the time when the agreement matures; and

(iv) The capability of any of the parties to offset his/her contractual obligations prior to its maturity.

Though these constituents are no longer part of the newly defined futures contract, this study found that the constituents are still ingrained in other parts of the crude palm oil futures legal framework. Therefore these constituents, as contained in the eligible delivery agreement, are still relevant in the description of a crude palm oil futures contract. It follows that the eligible delivery agreement can still be referred to in this research. Therefore, for the purpose of this study, and to be in coherence with the SAC resolution, the term and conception of “futures contract” and “eligible delivery agreement” as defined in the 2007 Act, prior to the 2011 amendment, are maintained and referred to throughout this thesis.
3.6.1 Eligible Delivery Agreement

In the Exchange, the selling and buying of crude palm oil futures is essentially the selling and buying of a contract called the “eligible delivery agreement”. The eligible delivery agreement is defined in section 2 of the 2007 Act as:

"An agreement that is one of two or more standardised agreements the effect of which is that a person is under an obligation to make or accept delivery at a particular future time of a particular quantity of a particular instrument. (a) for a particular price; or (b) for a price to be calculated in a particular manner,

whether or not-
(i) the subject matter of the agreement is in existence; or
(ii) the agreement is capable of being varied or discharged before that future time,

and in respect of which it appears likely at the relevant time, having regard to all relevant circumstances, that-
(A) the obligation of the person in the short position to make delivery will be discharged except by the person making the delivery;
(B) the obligation of the person in the long position to accept delivery will be discharged except by the person accepting the delivery; or
(C) the person in the short position or long position will assume an offsetting long position or offsetting short position, as the case may be, under another agreement of the same kind."

The definition of the eligible delivery agreement above draws on the following facts:

(i) The selling of crude palm oil is by selling the eligible delivery agreement and the buying of crude palm oil is by buying the eligible delivery agreement. By selling, the seller is under the obligation to deliver a certain quantity and quality of crude

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79 Section 2 of the 2007 Act prescribes that the futures contract can be “eligible delivery agreement” or “adjustment agreement” or options or any other class of agreements prescribed as a futures contract. However for the purpose of this chapter, the relevant futures contract for crude palm oil is the eligible delivery agreement as it envisages the making and taking of physical delivery of the oil at the point when the contract matures.

80 Instrument means “anything that is capable of delivery under an agreement for its delivery, including a commodity, or a document creating or evidencing a thing in action”. See section 2 of the 2007 Act.

81 Relevant time means the time when the eligible delivery agreement is entered into. See section 2 of the 2007 Act.

82 Relevant circumstances include (a) the provisions of any agreement; (b) the rules and practices of any market; and (c) the manner in which the respective obligations of persons in short positions and persons in long positions under agreements of the same kind as the agreement concerned are generally discharged, but does not include the respective intentions of the person in the short position and the person in the long position under the agreement concerned”. See section 2 of the 2007 Act.
palm oil at a certain time in future. By buying, the buyer is under the obligation to pay for such delivery at an agreed purchase price.

(ii) Hence the delivery of the oil and the payment of its purchase price do not take place at the inception of the eligible delivery agreement. Instead the delivery and the payment take place at a future time agreed to in the agreement.

(iii) At the time when the seller sells his eligible delivery agreement, the crude palm oil may or may not be in existence.

(iv) The seller and the buyer are not bound to remain in their position throughout the tenure of the eligible delivery agreement. In fact, the parties are allowed to discharge or offset their positions before the agreement matures.

(v) Therefore, if the seller wants to discharge his selling position, the seller will have to sell off his short (selling) futures position. He can do so by entering into a new eligible delivery agreement with a new party who is interested to taking over his short position. Under this new eligible delivery agreement, the seller sells and the new buyer purchases his short futures position. Physical delivery of the crude palm oil does not take place at the inception of this new eligible delivery agreement. From the sale of his short futures position, the seller would either gain or remit a certain sum of money depending on the price that the new buyer is purchasing his short futures position at.

(vi) The buyer will go through a similar procedure. In order to discharge or off-set his buying position, the buyer will have to sell off his long (buying) futures position. He can do so by entering into a new eligible delivery agreement with a new party who is interested in taking over his long position. Under this new eligible delivery agreement, the buyer sells and the new buyer purchases his long futures position. Remittance of the purchase price of the crude palm oil does not take place at the inception of this new eligible delivery agreement. From the sale of his long futures position, the buyer would either gain or remit a certain sum of money depending on the price that the new buyer is purchasing his long futures position at.

(vii) The discharge or offset does not terminate the eligible delivery agreement. The seller or the buyer who does not discharge or off-set his position will continue with
his obligations to sell or to purchase as the case may be. This will remain so until he plans to discharge or off-set his obligation or until the expiry of this agreement, in which case he will deliver the oil or remit the purchase price, as the case may be.

(viii) The effect of the discharge or offset is that the seller who actually delivers the crude palm oil and the buyer who actually pays for the oil’s purchase price may not be the original seller or the original buyer but anyone who holds the selling and buying position at the time when the delivery is materialised.

3.6.1.1 Gharar in Eligible Delivery Agreement

From the examination of the facts above, gharar could be located in the following areas:

(i) At the time of entering into the eligible delivery agreement, the seller and the buyer do not exchange between themselves any counter values, namely, the crude palm oil and its payment. Instead, these counter-values are deferred to some time in the future.

(ii) At the time when the seller enters into the eligible delivery agreement to sell the crude palm oil to the buyer, the oil may not be in existence. Hence the seller is selling what he does not own or possess at the time of sale.

(iii) At the time when the seller or the buyer sells his/her futures position for the purpose of discharging or offsetting, this futures obligation is still outstanding. The new buyer who purchases this futures obligation is also purchasing it without making any payment for this futures obligation. Hence what occurs at the inception of the new eligible delivery agreement is essentially the sale of an outstanding debt or an obligation for another corresponding outstanding debt or obligation.

3.6.2 Contract Specification

83 The payment, if there is any, is merely a margin payment which is being transferred either from the seller or from the buyer to the new buyer, or vice versa. This money is actually paid depending on who is gaining from the sale. In relation to this margin payment, it is submitted that it does not account for the actual payment for the purchase price of the crude palm oil.
Contract specification is part of the eligible delivery agreement. Though the term “contract specification” is not defined in the crude palm oil futures legal framework, Schedule 13 of the Bursa Malaysia Derivatives Berhad Business Rules provides for the specification of crude palm oil. In general, contract specification stipulates the quantity, quality, delivery process and the price trading limit of crude palm oil. A specimen of contract specification can be viewed in Appendix I. However this chapter will only analyse provisions relevant to the examination of gharar:

(i) “Final Trading Day and Maturity Date
Contract expires at noon on the 15th day of the delivery month. If the 15th is a non-market day, the preceding Business Day.”

(ii) “Tender period
First business day to the 20th Business Day of the delivery month, or if the 20th is a non-market day, the preceding Business Day.”

(iii) “Contract Grade and Delivery Point
Crude Palm Oil of good merchantable quality, in bulk, unbleached, in Port Tank Installations located at the option of the seller at Port Kelang, Penang/Butterworth and Pasir Gudang (Johor)...(palm oil delivered shall contain prescribed percentage of) Free Fatty Acids (FFA), ...Moisture and impurities (M&I)...deterioration of bleachability index (DOBI)....”

These relevant provisions indicate that:

(i) the crude palm oil is delivered by tendering it in the delivery month. This period is known as the tender period. The tender period commences from the first business day till the twentieth business day of such delivery month.

(ii) the crude palm oil is to be delivered in a good merchantable quality, in bulk, unbleached. In addition to that, the oil must also contain a certain level of FFA, M&I and DOBI.

3.6.2.2 Gharar in Contract Specification

From the examination of the above provisions, gharar could be located in the following areas:

84 According to Rule 201 of the Bursa Malaysia Derivatives Berhad Business Rules, “Business Day” is defined as any day on which the Exchange is open for trading.
With regards to the delivery date of the crude palm oil, the contract specification stipulates only the delivery month. Although a range of dates is given, namely, the first business day till the twentieth business day of the said delivery month, it does not eliminate the lack of knowledge and uncertainty pertaining to the actual date of delivery as well as to the date of payment for the said delivery.

With regards to the quality of the crude palm oil, the contract specification does not define the phrase "good merchantable quality, in bulk, unbleached". Though the contract specification stipulates that the oil must contain certain components; namely, the FFA, the M&I and the DOBI, these components do not sufficiently describe the phrase "good merchantable quality, in bulk, unbleached". Instead, the description of this phrase should include other inherent fundamental components: namely, the Iodine Value (IV) and the Slip Melting Point (SMP). Hence, the insufficient description of the oil fails to eliminate the lack of knowledge and uncertainty in the constitution of crude palm oil's good merchantable quality.

The pursuing section will articulate why gharar is found in these identified areas. This discussion will be divided into three parts; namely, the sale with the deferment of both counter values, the sale of a non-existing or non-possessed or unowned crude palm oil, and the sale of an outstanding debt or obligation for a corresponding outstanding debt or obligation.

3.7 The Sale with the Deferment of Both Counter Values

The legality of the sale with the deferment of both counter values has been the subject of dispute amongst both classical and contemporary Shari'ah jurists. This is because this sale is not expressly covered in the primary sources of the Shari'ah, namely the Qur'ān and the Ḥadīth or the Sunnah (the actions of the Prophet Muhammad’s (peace be upon him) (Ibn Rushd, 2003: 187-189). The non-exchange or deferment of both counter-values, namely the crude palm oil and its payment, at the time of entering into the eligible delivery agreement is identical to the type of sale known in the Shari'ah as bay'āl-dayn bi-al-dayn (the sale of debt for another debt) (International Shari’ah Research Academy for Islamic Finance, 2011: 600).
Although a direct injunction prohibiting bay' al-dayn bi-al-dayn is not explicitly stipulated in the Sharī'ah, a similar structure of sale, namely, al-kāli' bi-al-kāli' is prohibited. The sale of al-kāli' bi-al-kāli' literally means the exchange of two things both delayed or the exchange of a delayed (nasi'a) counter-value for another delayed counter-value (Vogel and Hayes, 1998: 115). The prohibition is made by virtue of a hadīth of the Prophet Muhammad (peace be upon him), who forbids the sale of al-kāli' bi-al-kāli'. Notwithstanding the authenticity of this hadīth being disputed by some jurists⁸⁵ as it is narrated by a single narrator, Mūsā Ibn 'Ubaydā Al-Rabī'ī, the majority of the jurists unanimously agree on the invalidity of a sale of one debt for another (al-Zuhaylī, 2003: 79).

In connection with this ruling on prohibiting the sale of one debt for another, jurists have derived two additional rules from the said hadīth, al-kāli' bi-al-kāli' (the second rule will be dealt with later in the section dealing with the selling of outstanding debt for a corresponding outstanding debt). The first rule is that the said hadīth prohibits any exchange or sale contract which stipulates delay terms, not just for the transfer of title but also for the actual payment or delivery of two counter-values. This is termed as al-nasi'a bi-al-nasi'a (delay for delay), or as the Maliki termed it as ibtidā dayn bi-dayn (initial dayn for dayn). This rule prohibits doubly delayed exchanges, not only if one or both of the goods are dayn but also when they are 'ayn. For example, it forbids the exchange of a clock later for a horse later or a clock later for money later (Vogel and Hayes, 1998: 116).

Nonetheless Kamali (1999: 539) argues that the transaction involving the deferment of both counter-values is allowed as it is mentioned in the Qur'ān, verse 282 of Chapter Al-Baqarah. The first part of the verse stipulates that:

"O you who believe! When you deal with each other in transactions involving future obligations in a fixed period of time reduce them to writing."

Conversely, Ismail (2002: 48 and 2008: 356) contends that the word "tadayantum" in this verse does not permit deferment of both counter-values. Instead it conveys the meaning of entering into transactions giving rise to al-dayn or future obligation. To augment his view, he refers to Al-Qurtubi who maintains that the word "al-dayn" in the Arabic language is

⁸⁵ Kamali and Al-Amine vehemently argue that due to the weakness of this hadīth, it should not be the basis for the prohibition of futures contract.
essentially referring to a future obligation or a deferred settlement of either one of the two commodities exchanged in a contract of exchange.\[^{86}\]

3.7.1 Why is the Sale with Deferment of Both Counter Values Prohibited?

According to Ibn Rushd (2003: 189), a majority of jurists agree that the underlying cause for the prohibition of the exchange of a debt for another debt is due to "gharar, owing to the lack of delivery from both parties, not to a case of riba". Similarly, Vogel and Hayes maintain that:

"It seems that the more basic objection to sales of debt for debt is not riba but gharar. For example, gharar easily accounts for the ban on the bilateral delayed sale. First such contracts encouraged speculation, since with little or no capital investment one takes a position as to future prices. With immediate delivery, in contrast, at least one counter-value is delivered on terms that are acceptable to both parties and those goods are moved from further market risks...Lacking these factors, sales with simultaneous delays are likely to leave one party feeling the loser, creating the "enmity" which Qur'an associates with gambling. Second, the purchase of generic goods that may not exist or be owned introduces gharar on one side of the transaction. If a similar risk were allowed on the other side, the transaction arguably becomes too unstable"(1998: 123).

Likewise, Al-Dhareer argues that the structure of a future contract with deferred counter-values affects the real consent of the parties to the contract.\[^{87}\] He finds that gharar:

"... lies in the possible lapse of the interest of either party and to his consent with the contract when the time set therein comes. If someone buys something by a mudhaf (future) contract and his circumstances change or the market changes bringing its price down at the time set for fulfilment of contract, he will undoubtedly be adverse to its fulfilment and will regret entering into it. The object may change and the parties may dispute over it. (1997: 15)"

\[^{86}\] To the Arabs, the commodity which is paid immediately or on the spot is known as al-\textquoteleft ayn while al-dayn refers to the commodity which is absent at the time of forming the contract of exchange and its settlement is deferred to sometime in the future. At this juncture, it is important to note that in Islamic law of contract, property (mal) is owned (milk) either as 'ayn or dayn. 'Ayn is a specific existing thing, considered as a unique object and not merely as a member of a category, for example this horse, not a thoroughbred mare'. Dayn is any property, not an 'ayn that a debtor owes, either now or in future; or it can refer to such property only when it is due in the future. Property owned as dayn is usually fungible, such as gold or wheat. Sometimes non-fungible manufactured goods defined by specification are treated as dayn. Although dayn literally means "debt", in fizh it refers not to the "obligation" per se, but rather to the property the subject of the obligation, which is considered to be already owned by the creditor (Vogel and Hayes, 1998: 94).

\[^{87}\] Landa expressed similar view where she states, "The problem of contract uncertainty, however cannot be neglected if one takes account of the dynamics of trading, the limited foresight of traders, and the absence of rules of contract behaviour. In any contract that requires performance in the future, objective circumstances may have changed so that a contract, which initially was mutually advantageous, may become unfavourable to one of the parties. Because traders are not omniscient, there is always the possibility that some previous contracts will turn out to be costly mistakes." (1976: 911)
Sheikh Muhammad al-Mukhtar Al-Salami (as cited in Zarqa, 2005: 45) expressed a similar view where he found four 'illah (justifications), based on the arguments of the jurists, for prohibiting the sale of one debt for another debt. Hence the sale is prohibited as: (i) it leads to disputes or litigations; (ii) it increases gharar; (iii) they are useless contracts as neither party gets the counter-value that they could benefit from; and (iv) it is similar to the prohibited sale of one currency for another on a deferred basis. Kamali (2000: 134) also views that a deferred sale, unless the deferment is specified and carefully regulated, tends to give rise to the possibility of uncertainty, gharar and ribā (unlawful gain). Gharar which is apprehended here relates to "the price changes over the course of time, changes that might affect the subject-matter of sale and parties disputes the terms".

3.7.2 Salam, Istiṣnā' and Crude Palm Oil Futures Contract: A Level Playing Field?

The question now is, if a sale with deferment of both counter-values is prohibited, why are deferred sales; namely, salam and istiṣnā', allowed. Salam and istiṣnā', though are anomalous to the basic tenet of the rule of immediate exchange, and are approved by the Sunnah of the Prophet Muhammad (peace be upon him), the ʿijmā' and the rules of necessity, where society is facing hardship without the permissibility of this kind of transaction (Mohammed, 1988, 124). On the other hand, the commodity futures contract is prohibited by three international bodies of Shari'ah scholars. This contract is ruled to contain the prohibited maysir and gharar elements. Unlike gharar, the prohibition of maysir is not overruled by the rules of necessity. Though salam and istiṣnā' are formed when their subject matter are not in existence, these transactions will eventually end with physical delivery. Nonetheless, in crude palm futures contract, physical delivery only transpires in five per cent of its total trading while the rest are offset prior to the delivery month (Bacha, 2007: 44). On this basis, it is submitted that crude palm oil futures contract could hardly match the establishment and validity of salam and istiṣnā'.

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88 Salam is a sale of goods known by specification or description for delivery at a later specified time, with payment for its price paid in full at the time of the contract.
89 Istiṣnā' is a manufacturing contract where delivery takes place in the future, upon completion of the manufactured goods and payment are made progressively or upon its completion.
90 Chapter five will investigate the element of gambling (maysir) in crude palm oil futures contract.
91 Al-Amine (2001b: 25) argues that istiṣnā' is different from a typical sale as in a sale, there is no labour but in istiṣnā', it represents the cornerstone of the contract.
3.7.3 Is Gharar Eliminated from the Deferment of Both Counter Values?

The question now is whether the element of *gharar* - default in the contractual performance by the seller or purchaser, disputes arising from the discontentment of the actual value of object of sale, or mismatch of one's expectation - has been effectively disabled by the crude palm oil futures legal framework?

Kamali (2000: 94) acknowledges the fact that deferment of both counter values in commodity futures contract does involves *gharar* - which is normally unacceptable and excessive, yet he opines that the operational methods of futures contract are such that they virtually eliminate the prospect of non-delivery or failure of the parties to fulfil their obligations. This is because the Clearing House provides a guarantee system - guaranteeing the payment and delivery of the underlying commodity - without which exorbitant risk and *gharar* permeates the futures contract. The same position is taken by the SAC (2006, 77) where it resolves that that the element of *gharar* is eliminated by the incorporation of the guarantee safeguards in the structure of the futures contract.

Notwithstanding the above learned arguments, it is submitted that the operational methods of the futures contract, or even the guarantee system, have not been able to effectively eliminate the prospects of non-delivery or the failure of parties to fulfil their obligations. The following are attestations of this failure:

i- A number of court cases have shown that, despite the incorporation of the guarantee mechanism, the sellers still default in delivering the underlying commodities. The seller's default to deliver is caused by two factors: first, the default in delivering the required quality of the commodity, and secondly, the

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92 The clearing house's guarantee does not extend to those non-defaulting customers. The 1985 failure of the Volume Investors (VI), a futures broker and a clearing member of the Commodities Exchange Inc. (COMEX) illuminates the actual relationship between the clearing house and the contractual parties. Some customers of VI defaulted on a margin call, causing VI to default on the clearing house margin call that exceeded the firm's assets. The clearing house seized the entire accumulated margin previously posted by the broker on behalf of its customer in order to pay to the other futures brokers. This left the non-defaulting customer of VI with no margin at the clearing house and no timely means of obtaining margin and payment on any gains from the failed broker. To the clearing house, the non-defaulting customers' exposure was the problem of their futures brokers and not theirs (Jordan and Morgan, 1990: 909).

93 Legal remedies have not always compensated innocent parties fully. In the Hunt brothers' episode, some creditors were obliged to settle for oil and gas properties, rather than the cash they were owed. In the London tin case, a UK court upheld the exchange's decision to settle outstanding contracts at prices considerably lower than the transacted price. In the Maine potatoes case, a delivery default was settled in cash almost a year after the incident. While instances of commodity futures market failure are uncommon, the potential for non-performance exists in all commodity exchanges (Bailey and Ng, 1990: 1072).
unavailability of the commodity supply at the time of delivery. These cases will be referred to here briefly as they will be discussed in more detail in the next chapter.

A. Cases which involve default in delivering the required quality of commodity:

(aa) **Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal.** This case involves a buyer who was not satisfied with the quality of the delivered crude palm oil. In accordance with the trading rules, the buyer would have to make the full payment of the oil before taking delivery of the crude palm oil. Upon making such a payment, the buyer would be given receipts evidencing his ownership of the duly paid oil. In this case, after making such a payment but before physically taking delivery of the oil, the buyer conducted an appraisal of the oil. The result of the appraisal indicated that the oil was not up to the prescribed grade. For this reason, the buyer refused to take delivery of the oil and went on to claim damages for the losses he suffered. The court held that the crude palm oil delivered to him was not up to the “crude unbleached palm oil of good merchantable quality, in bulk” standard as required by the crude palm oil futures’ contract specification as well as its governing regulations. This is because the delivered oil lacked certain levels of IV and SMP which resulted in the oil not being “crude unbleached palm oil of good merchantable quality, in bulk”.

(bb) **White v Barber; Same v Same.** Although this case and the following cases are American cases and do not involve crude palm oil, they are still relevant as they share similar operational methods and guarantee systems. This case involves the default of the seller to deliver his No. 2 red winter wheat to his buyers. The wheat which he delivered was rejected by the buyers as the wheat was not of the quality to be delivered under the wheat futures contract as well as its governing law. Although the dispute was settled by the buyers being paid cash in substitution of such a default, the buyers were not fully compensated. This is because at that particular time, the wheat market was cornered and in order for the buyers to get the supply of wheat from the wheat cash market, the buyers had to pay excessive inflated wheat prices.

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94 [2005] 4 CLJ.
95 123 U.S. 392; 8 S. Ct. 221; 31 L. Ed. 243; 1887 U.S. LEXIS 2184.

52 | Page
This case involves a buyer who was not satisfied with the quality of the feeder cattle delivered to him under the feeder cattle futures contract. Though at the time of delivery the buyer claimed that the cattle were inferior and not of a merchantable quality, the buyer accepted several lots of cattle but later refused to accept delivery of the rest. As a result, the buyer sued his broker as well as the Chicago Mercantile Exchange for negligence, intentional misrepresentation and fraudulent misconduct.

B. The following cases deal with the disputes arising from the default in delivery caused by the lack in the commodity supply.

(aa) Peto v Howell. This case involves a buyer who purchased on the Chicago Board of Trade, corn futures contracts, to be delivered on July, 1931. However at the time of the delivery, he, together with other sellers, were not able to procure any corn in Chicago. Due to the limited time, they were also not able to procure corn from any areas outside Chicago. Due to their default in delivering corn to their buyer, they had to pay an excessive amount of settlement to the buyer. However, the court in this case held that the unavailability of the supply of corn was due to the monopoly and unlawful cornering of the July corn market by the buyer. In fact, the unlawful cornering was intended to force all the sellers, who were contracted to deliver the corn, to pay the buyer an excessive amount in substitution of such default.

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97 Unfortunately, the court did not dwell on the default issue. Instead, the court dismissed the claim of the buyer on the technical reason that the Chicago Mercantile Exchange was not responsible for the loss suffered by the buyer as the buyer was not their registered member.
98 Attempts have been made to locate cases involving default in the delivery of crude palm oil futures in Malaysia in view of the crude palm oil futures crisis in 1984. Despite discovering a list of case laws related to the crisis (via case Sakapp Commodities (M) Sdn Bhd v Cecil Abraham [1998] 4 CLJ 812), the inquiry made at the Registry of the Kuala Lumpur High Court on the 5th December, 2011 confirmed that the court papers of these respective cases were no longer kept in the Registry. These cases are Palmco Holdings Sdn Bhd v Kuala Lumpur Commodity Clearing House (KL High Court Civil No. C2324 of 1984), Kuala Lumpur Commodity Clearing House v M&P (KL High Court Civil No. 1139 of 1984), Sakapp Commodities (M) Sdn Bhd v Kuala Lumpur Commodity Clearing House (KL High Court Civil No. C509 of 1984; C3774 of 1984; and C2400 of 1984), SUN v Kuala Lumpur Commodity Clearing House (KL High Court Civil No. C2420 of 1984 and C1890 of 1984) and Kuala Lumpur Commodity Exchange v BP ((KL High Court Civil No. D2-22-1338-89.
The following cases encountered similar dispute. For example, *Volkart Brothers, Inc., Volkart Brothers, Company, Alfred Boedtker and Kurt Muller v Orville L. Freeman, Secretary of Agriculture, and Thomas J. Flavin, Judicial Officer by Appointment of the Secretary of Agriculture*\(^{100}\) deals with a default in delivering cotton on the New York Cotton Exchange and the New Orleans Cotton Exchange.\(^ {101}\)

*Cargill, Incorporated, et. al., v Clifford M. Hardin, Secretary of Agriculture, Thomas J. Flavin, Judicial Officer by Appointment of the Secretary of Agriculture, and the United States Department of Agriculture*\(^ {102}\) deals with a default in delivering wheat on the Chicago Board of Trade.

*Great Western Food Distributors, Inc. v Brannan*\(^ {103}\) deals with a default in delivering eggs on the Chicago Mercantile Exchange.

These cases deal with the default in delivering potatoes on the New York Mercantile Exchange. The huge number of litigating parties involved in these cases as well as other similar cases demonstrates the *gharar* element in the deferred transaction of the commodity futures contract.

The failure of the crude palm oil futures guarantee system in eliminating *gharar* is replicated in the crude palm oil contract specification. Schedule 13 of the Bursa Malaysia Derivatives Berhad Business Rules stipulates that the oil must be delivered in the prescribed delivery month. Based on an e-interview with the Malaysian Derivatives Clearing House Bhd (MDCH), Ibrahim transcribes the following delivery procedure for the crude palm oil futures contract:

“The CPO (crude palm oil) contracts are settled by the clearing members making or taking delivery of the underlying commodity in exchange of receiving or paying, as the case may be, the delivery amount. A selling clearing member who intends to make delivery shall tender to MDCH a signed and completed Notice of Tender together with the Negotiable Storage Receipt on any business day beginning from the first up to the twentieth day of the delivery month. On the day of tender, a random selection process is performed to allocate the obligation to take delivery to the buying clearing members having long positions. The buying clearing members who have been allocated the tender are notified by MDCH through a Tender Advice. The buying clearing member must then make payment of the delivery amount 2 business days following the day of tender” (2000: 215).

Here, the question is whether the stipulation of the delivery month rather than the exact delivery and payment date taints the contract with *gharar*?

On this issue, Kamali (2000: 134) argues that a deferred sale (*bay'al-mu'ajjal*) is validated if it fulfils two conditions: (1) that the counter values must not include usurable items wherein deferment could lead to usury, and (2) that the counter values should be clearly identified and described to the extent that there remains no ambiguity about the delivery period or other material aspects of the transaction. With regard to the second condition, Kamali maintains that a deferment period (*ajal*) is clearly determined if it is for specific dates, counted either by the number of days and months, or specified by other indicators such as the New Year’s Day.
However, *ajal* is void if its beginning is either undetermined or uncertain; for instance, if it is designated "whenever the rain falls". If the deferment is somewhat vague, such as "the month of *Ramadhan*" or "the harvesting time", it pertains to the first of that month or period, and if it stipulates a term such as "three months", this signifies the end of that period.

However, Al-Dareer (1997: 30) contends that the majority of the jurists have agreed that making knowledge of the time of payment is a condition for the validity of the sale where the price is deferred. These jurists have also agreed that, ignorance of the time is a kind of *gharar* that is forbidden in such transactions. Similarly, Al-Kāsānī (as cited in Kamali, 2000: 85) views that *gharar* in a contract of sale may consist of doubt about the attributes of an object, matters related to timing, and other specifications of its delivery and payment.

On a similar note, Ibn Rushd (as cited from Kamali, 2000: 87) characterises excessive *gharar* as including lack of knowledge as to the time of payment, especially in sales where payment or delivery is postponed to a future date. Likewise, Ibn Juzay (as cited in Zahraa and Mahmor, 2002: 387) stipulates that a sale is forbidden if there is a lack of sufficient knowledge with regards to the date of future performance. Similarly, in an interview between the researcher and one prominent *Sharīʿa* scholar in Malaysia on 2\textsuperscript{nd} December, 2011, the *Sharīʿa* scholar viewed that the unavailability of the exact delivery date for crude palm oil futures contract contributes to *gharar*.

The implication of uncertainty in the actual delivery date and payment date is clearly explained by Stevens, the Assistant Chief Economist, U.S. Federal Trade Commission where he said: \textsuperscript{105}

"The seller has the option as to the day of the delivery month on which he will make delivery, so that the buyer is uncertain as to the exact time during the month when he will be obliged to accept and pay for the commodity."

(n.d., 87)

\textsuperscript{105} The buyer of futures will desire delivery even less, since according to the terms of the contract, a range of qualities can be delivered on any day during the delivery month - a situation which makes purchase of actual commodities on the futures exchange highly unattractive to a merchant with specific needs at specific times (n.n.(d), 1963: 173).
In view of this reality, Kamara (1990: 63) aptly argues that all futures contracts contain uncertainty, in terms of the quality of their underlying commodities, location or timing for the physical delivery.

3.8 The Sale of a Non-existing or Non-possessed or Unowned Crude Palm Oil

This is another contentious area in commodity futures contract. The discussion here will be divided into two. It will commence with the seller selling a thing which is not yet in existence and will be later followed with the seller selling a thing which he does not own or possess.

3.8.1 The Sale of a Non-existing Object

In principle, the majority of jurists have agreed that the sale of an object which is not in existence at the time of sale cannot be concluded. These jurists make an analogy to the explicit proscription of the Prophet Muhammad (peace be upon him) on the sale of the offspring of the offspring, the sale of the unborn animal in the womb, the sale of fruits and plants before they appear, and the sale of milk in the udder (al-Zuhaïlî, 2003: 75).

3.8.2 Why is the Sale of Non-existent Object Prohibited?

According to al-Shâfi‘î and Hanbalîs, the reason for prohibiting the above mentioned sales is because the object of sale does not exist with certainty (gharar). The jurists have also agreed that the prohibition of selling milk in the udder is due to the ignorance regarding the quality and volume of the milk in the udder. Another reason for the prohibition is that the milk is not deliverable at the time of sale as the milk does not collect in the udder all at once, but rather gradually. Similarly, the Hanafîs stipulate that the sale of milk in the udder is defective as it is based on ignorance. However, 'Imâm Mâlik permits the sale of milk in the udder for a specified number of days in the udder of a herd of sheep whose milk is homogeneous and whose productivity is known, but not that which is in the udder of one sheep (al-Zuhaïlî, 2003: 75-76).

Holding a similar position to 'Imâm Mâlik, 'Ibn Taymiya has permitted the sale of an object which does not exist at the time of contract if its future existence is known.
according to the custom. They opined that this kind of sale is not mentioned in the primary sources of the *Shari'a* or the talk of the companions of the Prophet Muhammad (peace be upon him). According to them, what was narrated in the *hadith* were the prohibition of sales which involve excessive risk, uncertainty, and the issue of the non-deliverability of the object and not the non-existence of such an object. They hold this view as the *Shari'a* explicitly permits the sale of non-existence; for example, in the case of the sale of fruit when their quality is beginning to appear and seeds after they start to sprout. Hence, the sale of a non-existent object is forbidden if there is ignorance about its future existence, which constitutes excessive risk and uncertainty (*gharar*) and is not based on a lack of its existence (al-Zu'aylī, 2003: 76).

The same stance is followed by Al-Qaradawi (2003: 233-234) where he states that not every sale involving what is unknown or uncertain is prohibited; for example, a person may buy a house without knowing the condition of its foundation or what is inside the walls. What is prohibited is the selling of something about which there is an obvious element of uncertainty which may lead to dispute and conflict or may result in an unjust appropriation of another person's money. Hence, if the risk of uncertainty is small – and this is determined by experience and custom – the sale is not prohibited. For example, the sale of root vegetables like carrots, onions, and radishes while they are still in the ground. He substantiates his stance with the opinion of Imām Malik, who opined that the sale of needed items in which the margin of risk is bearable, is permissible. 106

Al-Sanhuri (as cited in Zahraa and Mahmor, 2002: 389-390) is also in favour of the view that non-existence cannot be a reason for the prohibitive injunction. Hence, he divides the sale of non-existence into three categories: (i) an object that is permanently not in existence; (ii) an object that, though is non-existent at the time of contract, will necessarily occur in the future; and (iii) an object that, though is non-existent at the time of contract, may possibly exist in the future. According to him, the first category of sale - objects that are permanently non-existent - is absolutely prohibited as it renders the contract of sale invalid. The sale of the second and third category is valid so long as the availability of the object is highly probable and inevitable. Though he advocates the sale of non-existent

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106 This view, according to Ibn Taymiyyah, is the most superior to other views concerning sales as this view originates from Sa'id ibn al-Musayyab, who is the best authority in the *fiqh* (jurisprudence) of sales (as cited in Al-Qaradawi (2003: 341).
objects so long as the future existence of the object is possible, the validity of this sale is conditioned upon a sufficient description of the quality and quantity of the object of sale.

3.8.3 Is Gharar Extinguished from the Sale of a Non-existing Crude Palm Oil?

The question now is how assured is the future existence of crude palm oil. The next question is how assured is the quality of the delivered crude palm oil. The cases shown in the earlier section establish the emergence of disputes from the deferment of both counter values where sellers default in delivering the required quality of the commodities or in obtaining the commodity supply at the time of delivery. On this basis, it is submitted that the crude palm oil futures legal framework has not been able to eliminate the gharar element contained in the contract. The next section will discuss the issue of seller selling an unowned or unpossessed thing. Hence, this section will focus on the related concept of possession (qabd).

3.9 The Sale of Non-possessed or Unowned Crude Palm Oil

Possession or qabd stands as one of the requirements of a valid sale in Islamic commercial law. The word qabd indicates not only mere possession but juristically, it refers to legal custody and possession in a proprietary capacity, even if it does not involve the physical act of holding (Kamali, 2000: 117). Therefore for the sale to be a valid one, the seller must ensure that, amongst other valid conditions, he is in possession of the goods he is selling. The legality for the requirement of qabd is derived from the following hadīth (as cited in Kamali, 2000: 119):

"'Abd Allāh ibn 'Umar reported that the Prophet (peace be upon him) said: He who buys foodstuffs should not sell it unless he is satisfied with the measure with which he bought it".

In another report transmitted by "'Abd Allāh ibn 'Umar reported that the Prophet (peace be upon him) said: He who buys foodstuffs should not sell it till he has received it".

Ibn 'Abbās has also reported that the Prophet (peace be upon him) said: He who buys foodstuffs should not sell it until he has taken possession of it. Ibn 'Abbās said: I think it applies to all other things as well".
With regards to the third *hadīth*, Kamali opines that the added element denotes the personal statement of Ibn ‘Abbās; namely, he says “I think it applies to all other things as well”, and thus does not form part of the original *hadīth*.

3.9.1 Why is Sale of Non-possessed or Unowned Crude Palm Oil Prohibited?

The IFM (as cited in Kamali, 2000: 120) resolves that the basic rationale for the ruling of the above *hadīth* is *gharar*, which relates to possible delivery failures. In this instance, the buyer stands the risk of not receiving the goods as it is possible that the seller may delay the delivery or wish to revoke the contract. The resolution further states that, while *gharar* of this kind tends to be of general application, there is an additional element of *gharar* in the sale of food grains and agricultural crops, which is that they may perish or be destroyed due to *jā`i`ihah*, that is, climate disasters and or disease.

Therefore *qabd* plays a pivotal role in avoiding the effects of *gharar* in a contract of sale. *Qabd* is required for all fungible goods that are sold by weight, measurement, or number. The responsibility for loss will be held by the buyer upon the *qabd* being transferred to the buyer.\(^\text{107}\) Notwithstanding the importance of *qabd* in a sale contract, jurists are not unanimous in its method of implementation. Ibn Taymiyyah, for example, argues that the society’s prevailing custom should be the determinant factor in the implementation of *qabd*. Hence he criticises the majority of jurists who confine the meaning of *qabd* to holding and retention (*ḥabs*) or evacuation (*takhliya*) and the like. Instead he argues that there exists no specific meaning to the word “*qabd*” in either the Arabic language or in the *Shari`a*. Ibn Qudämah holds similar view where *qabd*, should be determined by custom (as cited in Kamali, 2000: 121).

The question, therefore, is whether *qabd*, as determined by the crude palm oil futures legal framework has overcome the element of *gharar*; namely the default in delivering the required quantity and quality of crude palm oil?

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\(^{107}\) Thus, some jurists argue that the physical inability to deliver when the object is already owned by the seller does not make the contract void. The contract is void when the object is not yet owned by the seller. The reason is that the subject matter is owned by the seller and its kind and species are fully known (Buang, 2000: 124).
3.9.2 Is Gharar Extinguished from the Sale of Non-possessed or Unowned Crude Palm Oil?

Applying the method of *qabd* in the commodity futures contract, Kamali (2000: 123) argues that standardised quantities and packages that are weighed and measured once, and are later sealed and labelled, do not necessarily require the commodity to be measured and weighed again each time they are sold. The warehouse receipt, which is issued once upon completion of such weight and measurement, is sufficient to evidence *qabd*. Due to this, *qabd* in the case of subsequent transactions (“the chain” of sale and purchase of commodity futures contracts) is evidenced by the issued warehouse receipt. Hence, the weighing and measuring of the commodity at the time of entering into these subsequent transactions is no longer needed.

It is submitted that this learned view could only be applied if the eligible delivery agreement is formed together with a warehouse receipt. Briefly, the procedure of issuing the warehouse receipt is as follows: according to Rule 1305 and 1306 of the Bursa Malaysia Derivatives Berhad Business Rules, the warehouse receipt, or usually referred to as the negotiable storage receipt (NSR), will be issued after an appraisal of the crude palm oil has been conducted. This appraisal takes place when a seller wishes to deliver his crude palm oil to the buyer via the Clearing House on any business day between the first till the twentieth day of the delivery month. The NSR will be issued together with a certificate of quality. The certificate of quality is a declaration of guarantee with respect to the quality of the crude palm oil. Rule 1307 stipulates that the validity of the certificate expires at midnight on the last day of the month of which the appraisal was conducted.

Based on this legal procedure, any eligible delivery agreement formed with a valid NSR would then escape the taint of *gharar*. This is because NSR evidenced the existence, quantity, and quality of the crude palm oil. However in practice, the eligible delivery agreement is formed or initiated before the issuance of NSR. The reason is that NSR is

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109 On the other hand, Al-Amine (2008: 171) contends for *qabd* in futures commodity trading to be in the form of the registration of a commodity futures contract by the Clearing House and the transfer of documents between the seller and the buyer in the commodity futures market. This is rightly criticised by Elgari (2005: 87) where he states that the commodity futures contract constitutes only the evidence of liability of the seller to deliver the underlying commodity in the future, thus, it is not an evidence to prove the ownership and existence of the underlying commodity.

110 According to Rule 201 of the Bursa Malaysia Derivatives Berhad Business Rules, “appraisal” means weighing, sampling and analysis of crude palm oil.
111 See Rule 201 of the Bursa Malaysia Derivatives Berhad Business Rules.
issued “on any business day between the first till the twentieth day of the delivery month”. Therefore, beyond this period, without NSR, the seller would not be able to guarantee the existence, quality, or quantity of the oil. This condition is exacerbated by the fact that crude palm oil is a perishable product and cannot be stored for indefinitely long periods of time (Securities Industry Development: 2005: 2-17).¹¹²

The case of Sam Wong & Son, Inc., a Corporation on behalf of itself and all others similarly situated, Plaintiffs-Appellants v New York Mercantile Exchange, Richard B. Levine, Howard Gabler, Melvyn Farlis, Jayne Ball, Alfred S. Pennisi, Peter Johnston, Michel Marks, Victor Buccellato, Salvatore Calcaterra, Horace De Podwin, Sam Fishberg, Richard Jarecki, Stanley Meierfeld, Charles Miller, Henry Polan, Jack Schwager, Ira Shein, Jacob Stern, Dennis Suskind, Sol Tanne, Harvey Wachman, Norton Waltuck, Joe Doe, Jane Roe, Richard Coe, Mary Smith, ABC, Inc., DEF, Inc., GHI Inc., JKL Inc., MNO Inc., and PQR, Inc. (the last ten names being fictitious), Defendants-Appellees; Anthony Spinale, Plaintiff-Appellant, v Sal Calcaterra, Norton Waltuck, George Gero, Stanley Meierfeld, Horace De Podwin, Jack Schwager, Sam Fishberg, Ira Shein, Jack Place, Harvey Wachman, and Charles Miller, Defendants-Appellees¹¹³, proves how the quality of agricultural crops can easily deteriorate due to the transportation process and the weather. In this case, twenty nine out of thirty two loads of potatoes failed to meet the New York Mercantile Exchange contract specification; hence these potatoes could not be delivered.¹¹⁴ The quality of these potatoes deteriorated as they suffered from pressure bruises and discolouration. An investigation was carried out and it was revealed that such defects were the result of conditions during the growing, harvesting, subsequent storage and transportation of the potatoes.

Ayubon rightly cautioned that:

"... ignorance (Jahl) is also part of Gharar that has to be avoided. The purchaser should know about the existence and conditions of the goods and the vendor should be able to deliver them on the agreed terms and at the agreed time. In other words, one should not undertake anything or any act blindly without sufficient knowledge, or risk oneself in adventure without knowing the outcome or the consequences." (2010: 144)

¹¹² The characteristic of perishability is the antithesis of storability. Hence, in the trading of potatoes futures in Chicago, an inspection certificate for quality or weights of potatoes on track is good for four days after the potatoes have been inspected, if they received adequate care during that period (Hoos, 1942: 362).
¹¹³ (735 F. 2d 653; 1984 U.S. App. LEXIS 22544).
¹¹⁴ One truckload of potatoes consists of 50,000 pounds of potatoes.
It is further submitted that even with the warehouse receipt, there will still be disputes with regards to the quality of oil, for example, the case of *Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal.*\(^{115}\) This case demonstrates the lack of knowledge or certainty due to an insufficient description of the quality of crude palm oil in Schedule 13 of the Bursa Malaysia Derivatives Berhad Business Rules. In this case, the court held that the delivered crude palm oil was not of good merchantable quality as it lacked two characteristics inherent in crude palm oil; namely, the IV and the SMP. The court based its judgement on the evidence tendered by the experts and practitioners of the crude palm oil futures market. According to Wilson and Dahl (1999: 220), the process of buying and selling a commodity subject to quality uncertainty puts parties in several forms of risk. One is the risk of not meeting the contract specification, with the effect of selling the commodity into the cash market with a greater discount. A second risk is paying a higher purchase price based on false or optimistic expectations.\(^{116}\)

The above arguments and evidence augment the submission that *qabd*, in the nature of a warehouse receipt or NSR, has not overcome the element of *gharar*, in the case where the eligible delivery agreement is formed without a valid NSR. Otherwise, the element of *gharar* has been eliminated. This view is parallel with the AAOIFI Shariah Standard on *qabd* where it states:

"The possession of documents, like bill of lading and warehouse receipts, issued in the name of the possessor or acknowledging his interest therein is deemed legal possession of what the documents represent if the ascertainment of commodities, goods and appliances is attained through them along with the ability of the possessor to undertake transactions in them." (own emphasis) (2010: 330)

3.10 The Sale of an Outstanding Futures Obligation for a Corresponding Outstanding Futures Obligation

Although the eligible delivery agreement contains an expiration period, the buyer or the seller is entitled to discharge his/her contractual obligation before its expiration. By far, 

\(^{115}\) [2005] 4 CLJ.

\(^{116}\) The fact that the purchaser cannot be certain of the grade or quality of the commodity he would receive makes delivery impractical (n.n.(d), 1963: 182). Although the contract specifies the quality, it also provides for discounts or premiums for delivering one with non-par quality. However the realised price differences can be significantly different. In reality, the futures price on a delivery date converges to the spot price of the quality that is cheapest to deliver rather than the spot price of the par delivery quality. Since it is uncertain which quality will be the cheapest to deliver, this introduces a delivery risk to every hedger in the market (Kamara and Siegel, 1987: 1007).
most futures contracts are completed through offset or via a reversing trade. To discharge a futures contract obligation through offset, the seller or the buyer enters into the futures exchange to make the offsetting or reversing trade. The party will take the opposite position to the position that he or she is currently holding and this time the party will transact with a new entrant to the market. After this reversing trade, the buyer or the seller’s net position is zero. The clearing house recognises this and the buyer or the seller is absolved from any further obligation (Dubofsky: 2003: 20). In this offsetting transaction, the parties do not exchange the crude palm oil and its purchase price, but what actually transpires is that the party exchanges his/her futures obligation, or debt, with another corresponding futures obligation or debt.

3.10.1 Why the Sale of Outstanding Futures Obligation for a Corresponding Outstanding Futures Obligation is Prohibited?

According to Kamali (2000: 129), the offsetting transaction which enables parties in commodity futures contract to close out their positions, resembles that of a debt clearance sale. A debt clearance sale is referred to as bay' al-dayn bi-al-dayn. Based on the fact that a debt clearance sale is bay' al-dayn bi-al-dayn, this section reiterates the earlier argument pertaining to the prohibition of the deferment of both counter values based on the hadīth, al-kāli’ bi-al-kāli’]. Based on the views of the jurists on the prohibition of the sale of one debt for another, Vogel and Hayes (1998: 116) propound two additional rules. The first rule has been mentioned in the deferment of both counter values117 and the second rule is to be dealt with here.

The second rule from the aforementioned hadīth prohibits the exchange of abstract property for abstract property (al-dayn bi-al-dayn). In the case of crude palm oil futures contract, the word “dayn” refers to the buyer’s future obligation to pay the price of the oil or the seller’s future obligation to deliver the oil. This future obligation will be exchanged with another future obligation at the time of discharge or offsetting one’s position in the contract. The offsetting process creates a chain of sale and purchase of an outstanding futures obligation or debt in return for another outstanding futures obligation or debt. This chain continues to grow by the creation of the additional sale and purchase of outstanding futures obligations or debt till the contract matures. The exchange of the outstanding futures obligation or debt in return for another outstanding futures obligation or debt is

117 Refer to page 69 above.

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unlawful. To make this lawful, according to Vogel and Hayes (1998: 116), "one must produce the actual goods owed at least one side of the transaction. For example, the Hanbalis hold that if X owes Y so many bushels of a type of wheat, then Y cannot sell that obligation back to X for so much of money, unless the money is actually paid over when the resale agreement is concluded; or X can produce the actual wheat and then rebuy it. In either case, when produced in concrete form the obligation becomes no longer dayn but 'ayn (ta'yin) and thus lawful."

On the issue of selling one debt for another debt, jurists differ in their ruling as to the selling of the debt to the debtor himself or to a third party. The majority of jurists have ruled this as valid due to the sale of debt to the debtor or by forgiving it as a gift. They base their reason on the basis that the prohibition of sale of debt for debt is due to the uncertainty involved in the inability to deliver. Hence, in the context of the sale of debt to the debtor, the delivery is not needed as the liability of the debtor is sold back to himself. However, jurists are not unanimous in selling the debt to a third party. The Hanafis, Hanbalis and Zāhirīs ruled that, since it is not valid to sell an undeliverable item, the sale of a debt to a person other than the debtor is not concluded. On the other hand, some of the Shāfi’i ruled that it is valid to sell a confirmed debt at maturity (al-dayn al-mustaqirr) to the debtor or a third party before receipt of the debt payment. Examples of such confirmed and matured debts are compensation for destroyed property and monies in the possession of the borrower. Though the Hanbalis ruled this as invalid for selling a debt to any party other than the debtor, Ibn al-Qayyim allowed for the sale of debt both to the debtor and a third party (Al-Zulayli, 2003: 80).

Similarly, the Mālikīs rule that it is valid to sell a debt to a party other than the debtor under the following conditions. Those conditions can be summarised under two headings:

1. Subject-matter of sale: the debt as the object of sale must not violate a legal prohibition such as gharar, ribā and etcetera. Hence, (i) the debt must be an item that may be resold prior to receipt (for example in the case of loans) and the object of the debt must not be food; (ii) the price of the sale must be paid currently to avoid selling a debt for another debt; (iii) the price must either be of a different genus than the debt, or if it is of

118 Technically, it is a debt in which the liability of the debtor is established and he has no means of extinguishing it except by a new contract, for example the price of a purchased item and compensation for a destroyed property (International Shari‘ah Research Academy for Islamic Finance, 2010: 62).
the same genus, equal to avoid ribā; and (iv) the price must not be gold if the debt is silver to avoid selling money for deferred money (ribā).

2. The condition of the debtor: (i) the repayment of the debt must be most likely (for example, the debtor must be present in the city where the contract is concluded so that his financial condition is known); (ii) the debtor must acknowledge the debt so that he may not deny it later (thus it is not valid to sell a right under dispute); (iii) the debtor must be eligible to take responsibility for the debt and its delivery (he must not be underage or under legal supervision); and (iv) there should be no enmity between the debtor and the buyer of the debt so that the buyer will not be exposed to additional risk and the debtor is not subjugated to any adversaries (al-Zuḥaylī, 2003: 81).

3.10.2 Is Gharar Eliminated from the Sale of an Outstanding Futures Obligation for a Corresponding Outstanding Futures Obligation?

According to Maliki, for the sale of an outstanding debt for another outstanding debt to a third party to be free from gharar, the transaction must comply with the conditions stipulated. It is submitted that the offsetting transaction, an equivalence to a sale of an outstanding debt for another outstanding debt to a third party, transgresses the following conditions: (1) the future debt is a confirmed debt at maturity; (2) the object of debt must not be food; (3) the price of the debt must be paid on the spot; (4) the price of the debt must be paid equal to the amount of the debt to avoid ribā; and (5) the repayment of debt must be most likely and the debtor must not deny the debt.

Firstly, the futures obligation or debt which is sold in an offsetting transaction arises not from a matured futures contract but from an immatured futures contract. The Shafi’is view that the dayn ghayr mustaqirr (an unconfirmed and immatured debt), like the obligation to deliver the subject matter of a salam sale, cannot be a valid object of sale as the delivery is not yet due. This is based on a clear provision prohibiting the sale prior to taking delivery (as cited in Zahraa and Mahmor, 2001: 226). In reality, the future obligation or debt in a futures contract will mature in the prescribed delivery month, as the making and taking of delivery transpires in any business days between the first till the twentieth day of the delivery month. However, in practice, offsetting normally takes place before the contract.

119 The obligation to deliver the subject matter of a salam sale is based on a contractual or consensual legal basis. Hence in terms of the legal basis and stability of the obligation - it is a debt that has the potential of termination or lapse. Unlike dayn mustaqirr, it is “a final and conclusive liability over which the creditor has an indisputable ownership and which is capable of unilateral termination.”

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matures. At this period, the outstanding debt is still not certain and is tainted with the possibility of default. Secondly, the condition that the object of debt must not be of food is not applicable in the case of crude palm oil futures contract. This is because crude palm oil falls under the category of edible oils and fats (Malaysian Palm Oil Board, 2011: 41).

Thirdly, the price of the debt must be paid on the spot. In offsetting, the sale of a futures obligation or debt to another third party is not reciprocated with any cash but instead is met with another future obligation or debt. Even though there is a transfer of a certain amount of money from one party to the other, this payment is not part of the purchase price of the crude palm oil. It is submitted that this payment is a margin payment paid to one of the parties, depending on the parties’ positions and the oil settlement price at the time of offsetting. Even without the offsetting transaction, one of the parties in the eligible delivery agreement would still have to make this payment solely for the reason of the change in the price of the crude palm oil futures. Fourthly, the condition that the price paid for the debt is equal to the amount of the debt, for the avoidance of ribā, does not materialise in an offsetting transaction. As mentioned before, payment for the purchase price of crude palm oil is not made at the time of offsetting.

Finally, the repayment of debt must be most likely and the debtor must not deny the debt. In this regard, Kamali (2000: 130) argues that delivery and payment for the delivery, under a commodity futures contract, is guaranteed by the incorporation of the Clearing House as counter-party to each and every futures contract. Hence, the question of the buyer or seller’s creditworthiness and ability to deliver is immaterial. In other words, there is no uncertainty and risk-taking in this transaction, as the Clearing House guarantees the delivery and payment of the price. Though Kamali has raised a significant point, his view can be rebutted from two sides. Firstly, in reality, when a seller defaults in delivering the oil, the Exchange will intervene by stipulating an emergency settlement price. The cases have shown that parties have disputed the amount of settlement imposed by the Exchange. This condition is exacerbated by the absence of a clear method of calculation in the crude palm oil futures legal framework. Secondly, the financial source of the Clearing House’s guarantee system is, in reality, co-funded by contractual parties. The failure of the

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120 See also al-Sheahabi (2003: 70) on trading in debts.
121 However, Kamali’s contention can be dismissed by the views of two practitioners in the crude palm oil futures market. Based on an interview held in Malaysia on the 6th and 8th December, 2011, these practitioners opine that the identity of the parties in crude palm oil futures contract is still material. This is because the buyers are keener to buy crude palm oil from the sellers whom the market have recognised or has a good record in selling a good merchantable quality of crude palm oil. The same applies to the sellers selling their crude palm oil to creditworthy buyers.
contractual parties to maintain their contribution would inevitably affect the Clearing House guaranteeing the payment and delivery of the contract. The 1987 Hong Kong futures’ market crash aptly illustrates this precarious situation, which will be discussed later in the chapter.

3.10.2.1 Emergency Settlement Price for a Defaulted Eligible Delivery Agreement

In accordance with Rule 1102 of the Bursa Malaysia Derivatives Clearing Berhad Business Rules, when a seller defaults in making the delivery of crude palm oil, or the buyer defaults in paying for the delivery, upon the advice of the Clearing House, the Exchange will determine a settlement price called the emergency settlement price. This emergency settlement price is the price which the defaulting party must pay to the injured party. Upon close scrutiny of the crude palm oil futures legal framework, however, it is discovered that there is no provision providing for a method of calculating the emergency settlement price. This is unlike other provisions which stipulate a certain method of calculation for the Exchange to base its calculations on when determining a settlement price for the eligible delivery agreement.

Hence, it is submitted that in the absence of a clear method of calculation, the parties’ rights and obligations cannot be determined with an acceptable degree of exactitude and certainty (Omar, 1999: 278). The absence of such a material ingredient would inevitably lead to disputes. In support of this proposition, reference is made to the following cases:

1. *Ganda Oil Industries Sdn Bhd & Ors v The Kuala Lumpur Commodity Exchange & Anor.* This case involves a number of crude palm oil futures buyers who were not satisfied with the emergency settlement price fixed by the Exchange (in this case, the Kuala Lumpur Commodity Exchange (KLCE)) on March 14 and 15, 1984. The emergency settlement price was fixed as there were 761 March 1984 defaulted crude palm oil futures contracts. Hence, these buyers applied to the court to quash the decision of the Exchange on the ground that it acted in bad faith and in excess of its jurisdiction. The court ruled in favour of the Exchange as it found that the Exchange had acted legally and properly.

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122 A similar provision is provided by Rule 1101 of the same Business Rules which stipulates that if the Exchange, upon the advice of the Clearing House finds that a fair and orderly market is not available or is not likely to be available, the Exchange will determine an emergency price for the eligible delivery agreement.

123 [1988] 1 CLJ (Rep) 56.
In this case, the buyers of the crude palm oil futures contracts challenged the emergency settlement price fixed by the KLCE on March 13 and 14, 1984. This price was fixed for 5,150 defaulted crude palm oil futures contracts. The buyers in this case alleged that the emergency settlement price was made without taking into consideration the compensation amount, payable to them due to these defaults. These two cases were significant as they showed how the price on 14 March 1984 was fixed differently by the Exchange; namely, RM1,520 in the case of *Palmco Holdings v Sakapp Commodities* and RM1,350 in *Ganda Oil v KLCE*.

The validity of the exchange’s emergency settlement price was also challenged in the United States. The case of *Crowley, Alien Property Custodian v Commodity Exchange, Inc. et al.* involves a dissatisfied company which held 418 short raw silk futures contracts. By virtue of the exchange’s board resolution on October 15, 1941, the settlement price for the raw silk futures was pegged at $3.08 per pound and this price was challenged by the company. The court in this case referred to the relevant minutes of the exchange’s board. The minutes showed that the dispute in the board was not whether liquidation should be ordered but which of the two prices should be made the settlement price. Despite the board having accepted the suggestion by an investigation committee to peg at a certain settlement price, the board went ahead with pegging at a different settlement price which was based on the government’s ceiling price.

The submission on the existence of *gharar* is supported further by an interview with a prominent *Shari’a* scholar in Malaysia on December 2, 2011. In this interview, the scholar agreed that the non-stipulation of a method of calculation for the emergency settlement price amounts to *gharar*. This echoes the view of Imam Hanbal who maintains that the price needs to be expressly stated in the contract. If the price is not stated in absolute monetary terms, as is required by the other main classical jurists, the price must be defined.

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124 Suit No. C2324 of 1984
125 Under Rule 1102 of the Bursa Malaysia Derivatives Clearing Berhad Business Rules, upon such a default, the Exchange, besides exercising its power to determine the emergency settlement price, must also determine the compensation sum payable by the defaulted party to the party who was disadvantaged by the failure to deliver.
in a manner mutually agreed to by the contractual parties in order to avoid any disputes (as cited in El-Diwany, 2010: 119).

Similarly, the AAOIFFI (2010: 540) resolves that gharar could arise if the commodity is sold without mentioning the price, or if the price is determined by one of the contractual parties or a third party. In this case, gharar arises when the emergency settlement price is determined solely by the Exchange, being a third party, without the involvement of the contractual parties.\(^{126}\) It is therefore fundamental in the Shari’a that the contracting parties accept their contractual rights and obligations with full knowledge of the extent of their commitment (Coulson, 1984: 45). If the end result of a contract is uncertain or unambiguous, the contract is tainted with gharar (Ayub, 2008: 58).

### 3.10.2.1 The Cost of the Clearing House’s Guarantee System

Although the Clearing House ostensibly guarantees futures contractual performance, it is submitted that the sellers and the buyers are actually bearing the guarantee cost. This is predicated on the payments that these parties have to pay, on top of the margins payable at the beginning and throughout the trading of the crude palm oil futures contract (Bemanke, 1990: 136):

1. The guarantee fees with respect to each and every contract that the party trades. The guarantees fees are calculated each day and are calculated on an annual percentage, determined by the Clearing House, based on the margin of the seller and the buyer;\(^{127}\)

2. The security deposit in the amount of at least Ringgit Malaysia One Million. This amount may be increased by the Clearing House, taking into consideration the obligations of, and the performance risk undertaken by, the Clearing House;\(^{128}\) and

3. The clearing fund contribution of a fixed amount of Ringgit Malaysia One Million plus a variable amount calculated in accordance with the formula determined by the Clearing House. The purpose of this contribution is to indemnify the Clearing House

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\(^{126}\) By not knowing the completion or implication of the contract, the voluntary consent of the contractual parties has, in principle, been vitiated (Iqbal and Khan, 2005: 7).

\(^{127}\) Rule 619 of Rules of Bursa Malaysia Derivatives Clearing Berhad.

\(^{128}\) Rule 206A of Rules of Bursa Malaysia Derivatives Clearing Berhad.
against losses arising from the failure of the buyer or the seller in discharging his/her obligations to the Clearing House.\textsuperscript{129}

Therefore it is reasonably foreseeable that the Clearing House might find it difficult to withstand the demands to perform the outstanding contracts if these parties default in their margin payments as well as the payments above. The 1987 Hong Kong futures' market crash is a good illustration. The run on the Hong Kong's clearing house, Guarantee Corporation, left the clearing house without adequate resources to meet the demands to perform a substantial number of defaulted futures contract. Not only that, the crash almost left the clearing house on the brink of being wound-up and smeared with a multitude of legal actions (Cooper, n.d: 188 and 205).

3.11 Conclusion

This chapter has analysed the element of \textit{gharar} in the eligible delivery agreement and its contract specification. The analysis has revealed that the agreement and the contract specification embody the \textit{gharar} related issues; namely, the non-exchange and deferment of both counter-values; the selling of non-existent, non-possessed or unowned crude palm oil; and the exchange of an outstanding futures obligation with another corresponding outstanding futures obligation. Although the SAC concedes that the crude palm oil futures contract is contained within these issues, it argues that the crude palm oil futures legal framework has eliminated the \textit{gharar} element contained therein. Nonetheless, this chapter has shown that the legal framework has not effectively overcome the Shari'a prohibition. In summation, this chapter has established that, inconsistent with the stance of the SAC, the crude palm oil futures contract is not free from the prohibited \textit{gharar}.

\textsuperscript{129} The Clearing House is entitled to review the amount of the contribution with regard to the obligation and the performance risk undertaken by the Clearing House in the contract. See Rule 400, 401, 402 and 405 of Rules of Bursa Malaysia Derivatives Clearing Berhad.
CHAPTER FOUR

Contract Settlement: The Element of Uncertainty in Crude Palm Oil Futures Contract

4.1 Introduction

Analysing the issue purely from the perspective of contract settlement, this chapter extends the discussion on *gharar*. It endeavours to establish that the element of uncertainty, or *gharar*, is ingrained in the contract settlement’s legal framework. This chapter will prove that, in reality, this element of uncertainty is central to the disputes or litigations of the contractual parties. This element of uncertainty, as discussed in the earlier chapter, is found to be comprised of the following:

(a) when there is a lack of knowledge in the attributes of the emergency settlement price (in line with the opinion of Ibn Rushd\textsuperscript{130});
(b) when the seller fails to deliver the underlying commodity (as per the view of Ibn Qayyim\textsuperscript{131});
(c) when the underlying commodity is incapable of delivery (as per the view of Ibn Qayyim\textsuperscript{132}); and
(d) when the quality of the underlying commodity is insufficiently described (as maintained by Zahraa and Mahmor\textsuperscript{133}).

This chapter will also establish that the brunt of the factors above affects not only the parties to the contract but more importantly the public’s social welfare.

These elements of uncertainty will be examined under two broad issues: firstly the issue on the determination of the emergency settlement price; and secondly, the default of physical delivery. This latter issue will be further divided into two sections: namely, where the default is due to the non-availability of the supply of the commodity; and, later, where the default is due to the non-fulfilment of the commodity’s deliverable quality or grade.

\textsuperscript{130} Ibn Rushd (2009: 179).
\textsuperscript{131} As cited in Zahraa and Mahmor (2002: 386).
\textsuperscript{132} Ibid.
\textsuperscript{133} Zahraa and Mahmor (2002: 384).
4.2 What is Contract Settlement?

Contract settlement generally refers to the discharge of the rights and liabilities of parties under a crude palm oil futures contract, whether by means of performance, compromise, or otherwise. Simply put, it is how the contractual parties settle their contractual obligations. The manner of settlement is heavily regulated by the crude palm oil futures legal framework. Rule 1303A.1 of Bursa Malaysia Derivatives Berhad Business Rules describes the settlement of crude palm oil futures contracts as follows:

“Settlement of Crude Palm Oil Futures Contracts may either be by cash or physical delivery, as determined by the Exchange from time to time.”

Hence, a crude palm oil futures contract could be cash settled in three ways, namely, (i) when the contract is closed out, (ii) when the contract expires, and (iii) when the contract is being exercised. Settlement by way of closed out or setting off has been touched upon in the earlier chapter and will be further discussed in Chapters five and six. Settlement by way of contract exercise will not be covered in this chapter as it relates to options. However, this chapter will examine the settlement of the crude palm oil futures contract at the point of its expiry – either by cash or physical delivery.

Settlement by way of physical delivery is defined in Rule 1 of Bursa Malaysia Derivatives Clearing Berhad Business Rules as:

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134 See section 2 of the 2007 Act. The contract settlement also includes partial settlements effected in accordance with the Business Rules of the Bursa Malaysia Derivatives Clearing Berhad.
135 Prior to November 18, 2009, Schedule 13 of the Bursa Malaysia Derivatives Berhad Business Rules stipulates that crude palm oil futures contract could be settled either by cash or physical delivery. This was the prevailing legal position taken when the SAC issued its resolution on crude palm oil futures contract. However, due to the amendment made to the Business Rules, by November 18, 2009, this position has now been amended and Schedule 13 now states that the “settlement of the contract shall be via physical delivery.” Despite the phrase “either by cash” was deleted from Schedule 13, Rule 1303A.1 still maintains that crude palm oil futures contract may be settled by way of cash or physical delivery. Based on this legal position and the fact that the SAC resolution was issued at the time when Schedule 13 provided for settlement by cash, it is submitted that, for the purpose of this study, the analysis of the settlement of crude palm oil futures contract by cash is deemed relevant.
136 See Rule 201 of the Bursa Malaysia Derivatives Berhad Business Rules.
137 The term “closed-out” is defined in Rule 2 of the Bursa Malaysia Derivatives Berhad Business Rules as “to discharge the obligations of a person in the Long Position or Short Position under a Contract and shall include the discharge of these obligations as a result of the matching up of the Contract with a Contract of the same kind under which the person has assumed an offsetting Short Position or offsetting Long Position, as the case may be.”
138 This mode of settlement refers to the case of an option where the holder of the option invokes the right granted under it.
139 The irony of settlement by delivery in the futures market is that it is aimed to test the futures price, rather than being a widespread incentive for actually making or taking delivery. For this reason, delivery is rarely made or taken as futures contract are entered into for reasons other than the exchange of title. Nonetheless, the incentive to deliver derives primarily from the relationship between the cash and futures prices during the
“Settlement by delivery of an Instrument\textsuperscript{140} in accordance with Chapter 8 of the Rules and pursuant to the terms of an Open Contract\textsuperscript{141} which is an Eligible Delivery Agreement or an Eligible Option.”

Chapter 8 of Bursa Malaysia Derivatives Clearing Berhad Business Rules encompasses the method for the settlement of crude palm oil futures contract by way of physical delivery. For the purpose of this discussion, Rules 800, 801, 803, 805 and 807 will be examined. In brief, Rules 800, 801 and 803 enumerate how the delivery of crude palm oil and payment for said delivery is to be made between the seller and purchaser: specifically, the Clearing Participants and the Clearing House or vice versa. Rules 805 and 807, meanwhile, stipulate the effects of default either in the delivery of the crude palm oil or the payment of the settlement amount.

4.3 Uncertainty in the Contract Settlement of Crude Palm Oil Futures Contract

From a careful study of the contract settlement’s legal provisions, two uncertainty issues have been identified: firstly is the issue on the determination of the emergency settlement price; and, secondly, the default in delivering the underlying commodity. This later issue is further divided into two sections: these are, where the default is due to the non-availability of the supply of the commodity; and where the default is due to the non-fulfilment of the commodity’s deliverable quality or grade. The following section will examine the first uncertainty issue - determination of the emergency settlement price.

4.3.1. The Determination of Emergency Settlement Price

The price of crude palm oil futures contract is determined in a number of ways:

(i) by the seller and the purchaser at the time of forming the crude palm oil futures contract;\textsuperscript{142}

delivery month: namely, the cash-future basis, that is the difference between the spot price and the futures price (Hudson et al, 1988: 156).

\textsuperscript{140} Section 2(1) of the 2007 Act defines the word “Instrument” as “...anything that is capable of delivery under an agreement (the futures contract) for its delivery, including a commodity, or a document creating or evidencing a thing in action...”

\textsuperscript{141} Rule 1 of the Bursa Malaysia Derivatives Clearing Berhad Business Rules defines the word “Open Contract” as “a Futures Contract or Option between a Clearing Participant and the Clearing House which has not been extinguished or terminated in accordance with the Rules.”
by the Exchange when it determines that crude palm oil futures contract, which remain outstanding on the final settlement day, be settled by cash. The Exchange will determine a value for this contract called the final settlement value;\textsuperscript{143}

by the Exchange after being consulted by the Clearing House that the performance or delivery of the crude palm oil is impossible. The Exchange will then determine a settlement price for this crude palm oil futures contract;\textsuperscript{144}

by the Exchange upon the advice of the Clearing House following a default by the seller or the buyer in the making or taking of delivery of the crude palm oil. The Exchange will determine a settlement price for this contract called the emergency settlement price;\textsuperscript{145} and

by the Exchange upon the advice of the Clearing House when the Clearing House considers that a fair and orderly market is not available or when it is not likely to be available. The Exchange will then determine an emergency settlement price for settlement of the open crude palm oil futures contracts.\textsuperscript{146}

It is important to note that, except for category (i) above, the crude palm oil futures contract is not settled based on the price originally agreed to by the seller and the buyer.

\textsuperscript{142} Rule 1301.2 (a) of the Rules of the Bursa Malaysia Derivatives Berhad Business Rules states that, “The value of the Contract at the time of making the Contract (hereinafter referred to as “the contract value”) shall be the price agreed to by the parties at the time multiplied by the contract multiplier of twenty five (25) metric tons and expressed in Ringgit Malaysia or such other currency as may be determined by the Exchange from time to time.”

\textsuperscript{143} Rule 1301.2 (b) of the Rules of the Bursa Malaysia Derivatives Berhad Business Rules stipulates that, “Where a Contract has been determined by the Exchange to be settled by cash, the value of the Contract on the Final Settlement Day shall be the final settlement value of the underlying Crude Palm Oil Futures Contract quoted by the Exchange in respect of such Contract, multiplied by a contract multiplier of twenty-five (25) metric tons and expressed in such currency as may be determined by the Exchange from time to time.” The phrase “Final Settlement Day” refers to “the Business day following the Final Trading Day when all Open Position are cash settled or settled by delivery in accordance with the rules of the Clearing House”. While the phrase “Final Trading Day” relates to “the last Business Day designated for the trading of a Contract.” See Rule 201 of the Rules of the Bursa Malaysia Derivatives Berhad Business Rules.

\textsuperscript{144} See Rule 708 of the Rules of the Bursa Malaysia Derivatives Berhad Business Rules.

\textsuperscript{145} See Rule 1102 of the Rules of the Bursa Malaysia Derivatives Clearing Berhad Business Rules.

\textsuperscript{146} See Rule 1101 of the Rules of the Bursa Malaysia Derivatives Clearing Berhad Business Rules. To be read with Rule 707.4 of the Rules of the Bursa Malaysia Derivatives Berhad Business Rules. Rule 707.4 enumerates circumstances which could bring about an emergency state in the market. It follows: (i) a situation which threatens the integrity, liquidity or orderly liquidation of any contract; (ii) a situation which threatens the financial integrity of the market or its participants; iii) a manipulation, manipulative activity, attempted manipulation, corner or squeeze is threatening or is occurring; (iv) the liquidity of a contract or its orderly liquidation is threatened by the concentration of positions in the hands of individuals who are, or appear to be, unable or unwilling to make or take delivery in the ordinary course; or (v) an action of the Malaysian or any foreign government or authority being likely to have a direct and adverse impact on the integrity, liquidity, and orderly liquidation of any contract.
Instead, the price is based on a new price determined by the Exchange. In addition to this, for category (iv) and (v), the regulatory provisions do not provide a method for calculating the emergency settlement price. The following analyses the difference between the legal provisions for category (ii) and (iii) on the one hand and category (iv) and (v) on the other hand.

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In relation to category (ii) above, Rule 707.1(a) and (b) of Bursa Malaysia Derivatives Berhad Business Rules provide that the bids, offers, and traded prices agreed to by the parties must be within the prescribed price limits; namely:

"(a) The Exchange may stipulate in these Rules and/or in the Trading Procedures the maximum price ("upper limit") and the minimum price ("lower limit") at which an order in respect of a Contract may be entered;

(b) No order of a Contract shall be entered above the upper limit or below the lower limit."

The control of the price limit is governed by Schedule 13 of Bursa Malaysia Derivatives Berhad Business Rules which stipulates that:

"With the exception of trades in the current delivery month, trades for future delivery of Crude Palm Oil in any month, shall not be made, during any one Business Day, at prices varying more than 10% above or below the settlement prices of the preceding Business Day ("the 10% limit") except as provided in this Rule.

When the 10% limit is triggered (except for the current month), the Exchange shall announce a 10-minute cooling off period ("the Cooling Off Period") for all Contracts of quoted months (except the current month) during which trading shall only take place within the 10% Limit. Following the Cooling Off Period, Contracts of all quoted months shall be specified as interrupted pursuant to Rule 702B.2(a)(ii) for a period of 5 minutes, after which the prices traded for all quoted months (except the current month) shall not vary more than 15% above or below the settlement prices of the preceding Business Day ("the 15% Limit").

If the 10% Limit is triggered less than 30 minutes before the end of the first trading session, the following shall apply:-

(a) The quoted months shall not be specified as interrupted;

(b) The 10% Limit shall be applied to all quoted months (except the current month) for the rest of the first trading session; and

(c) The 15% Limit shall be applied for all quoted months (except the current month) for the rest of the Business Day."
For the purposes of this Rule, the 10% Limit shall be considered triggered in the manner as may be prescribed by the Exchange.”

In relation to category (iii) above, Rule 708 of Bursa Malaysia Derivatives Berhad Business Rules states that:

“If the Clearing House in consultation with the Exchange determines that the performance under a Contract or delivery of Instruments shall become impossible through the suspension of trading in the Instrument on the Underlying Market or for any reason that may be deemed appropriate by the Clearing House in consultation with the Exchange, the Contract may be cash settled according to a settlement price which shall be determined according to the procedures agreed upon by both the Exchange and the Clearing House. The Exchange shall calculate the average of the transactions taken above, after disregarding the highest and lowest price transacted. The average of the remaining prices rounded to the nearest whole sen shall be the settlement price. When the weighted average ends in 0.5, it shall be rounded upwards to the next whole sen.”

The clarity in the range of prices as well as the method of calculating the settlement price prescribed in Schedule 13 and Rule 708 is not evidenced in the legal provisions under category (iv) and (v). Rule 1102 of Bursa Malaysia Derivatives Clearing Business Rules provides for the emergency settlement procedure for category (iv) above. However, it is silent on the method of arriving at the emergency settlement price. It states that:

“1102 Substitute for Delivery

(a) If a Seller or a Buyer, as the case may be, to an Open Contract has failed to Deliver, pursuant to Rule 805(c) the Clearing House must:

(i) request the relevant Exchange to provide an emergency settlement price;

(ii) liquidate, by cash settlement pursuant to Rule 807 such Open Contract with reference to the emergency settlement price determined in accordance with Rule 1102(a).

(b) Pursuant to Rule 1102(a) the Seller or Buyer, as the case may be, to such Open Contract is also liable to pay to the Clearing House such sum as may be determined by the Clearing House as compensation and upon receipt of such sum the Clearing House must pay that sum to the Clearing Participant who was disadvantage by such failure to Deliver.”

147 Instead of providing for a clear method of calculating the settlement price in the case of emergency, rule 707.4(b)(x) of the Bursa Malaysia Derivatives Berhad Business Rules, merely provides for the Exchange to exercise its emergency power which includes, amongst others, recommending the emergency settlement price for the crude palm oil futures contracts. Even in Para 10 of the Bursa Malaysia Derivatives Berhad Trading Manual, which provides for the market emergency, is silent on the manner of calculating the emergency settlement price.
An equal treatment is found in rule 1101 of Bursa Malaysia Derivatives Clearing Business Rules, which stipulates only the emergency settlement procedure for category (v) above. It states:

"Rule 1101 Emergency Settlement

Pursuant to Rule 1002(c) and if the Clearing House in its absolute discretion considers that a fair and orderly market is not available or is not likely to be available, the Clearing House may:

(a) Request the relevant Exchange to provide an emergency settlement price;

(b) Liquidate, by cash settlement pursuant to Rule 807 all or any Open Contracts as may be determined by the Clearing House with reference to the emergency settlement price determined in accordance with Rule 1101(a)."

Notwithstanding the fact that these legal provisions fail to incorporate a clear method of calculation, legal frameworks from other jurisdiction are found to contain explicit methods of calculation. This disparity is conspicuously shown in the following legal provisions:

1) Rule 6.04 of ICE Futures U.S., Inc. Regulation provides for the determination of the settlement price in the case of physical emergencies. When a Physical Emergency is declared in accordance with rule 6.02, the following shall apply with respect to the determination of the settlement price:

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148 It is worthy mentioning Rule 6.52 of the NYMEX (New York Mercantile Exchange) Rule Guide which guides the method of fixing the settlement price of the crude oil futures contract. It is interesting to note that it provides for circumstances (i) if the settlement price, determined by its trading rules, is inconsistent with transactions that have occurred during the close range in other delivery months; or (ii) if the settlement price is inconsistent with the market information known to the committee. It follows that in either of these two circumstances, the committee may establish the settlement price at a level consistent with other transactions or market information. In such an event, the committee is required to prepare a written record of the basis for any settlement price so established. Given that the decisions of the committee have serious financial implications for traders and other users of the futures market, the settlement price determined must invariably reflect a consensus view of not only the committee members but also the majority traders. See also Kumar (1992: 459).

149 ICE Futures U.S. is a futures exchange which offers futures trading in soft commodities like sugar, cotton, coffee, cocoa and orange juice. It is also a trading venue for trading Russell 1000 and Russell 2000 index futures and options contracts as well as contracts based on the ICE U.S. Dollar Index (ICE U.S.)

150 "Physical Emergency" is referred to as fire or other casualty, bomb threat, substantial inclement weather, power failure, communication or transportation breakdown, computer malfunction, screen-based trading system break-down, malfunction of plumbing, heating, ventilation and air conditioning system, backlog or delay in clearing or in the processing of data related to clearing trades, floor occurrence which threatens an orderly market or other similar events.

151 Though Rule 707.5 of the Rules of the Bursa Malaysia Derivatives Berhad Business Rules provides for the physical emergency, it merely stipulates the power of the Exchange to take any action it deems fit. It is silent in providing any method of calculating the emergency settlement price.
(a) with respect to the on-exchange futures contracts that are listed for trading solely on the trading floor, if the market does not reopen, the settlement price will be calculated in accordance with Rule 4.28 using the prices traded during the last one (1) or two (2) minutes of trading, depending on the closing period specified in rule 4.06 for the contract.

(b) with respect to the on-exchange futures contracts that are solely listed for trading on the electronic trading platform,

(i) if the trading hours have been extended, the settlement price will be determined in accordance with Rule 4.28 using prices from the last one (1) or two (2) minutes of the extended trading hours, depending on the convention specified in rule 27.18(b) for the contract; or

(ii) if electronic trading does not resume, the settlement price will be determined in accordance with rule 4.28 using prices from the last one (1) or two (2) minutes, depending on the convention specified in rule 27.18(b) for the contract.

(2) Rule 4.16.4 of the LIFFE\textsuperscript{152} Rules provides for emergency\textsuperscript{153} settlement procedure which includes settlement through invoicing a back price. It prescribes that:

\begin{quote}
the price determined shall (in the absence of special reasons to the contrary) be within the Daily Settlement Prices established by the Exchange in respect of Six Business Days immediately preceding the date of determination. The Board may invite the CSP to be represented at any meeting of the Board at which an invoicing back price is to be determined under this LIFFE Rule and may consult the CSP before making its determination.
\end{quote}

(3) Rule 1.2 of the ICE Futures Europe\textsuperscript{154} (ICE Circular) provides for the emergency settlement procedure in the event of a system outage. This rule provides that, in the

\begin{footnotesize}
\begin{itemize}
  \item[152] This Rule took effect in November, 2011. NYSE Liffe comprises of five European derivatives markets, that of Amsterdam, Brussels, Lisbon, London and Paris. Hence, it is Europe’s largest exchange by value of business traded and the second largest globally (NYSE Liffe).
  \item[153] Emergency circumstances include excessive trading positions or unwarranted speculation; circumstances affecting the orderly conduct of business; a state of war or threatened hostility; the introduction of official control affecting the market or the performance of contracts or any change in such controls; any change in the legal provisions, administrative or financial practices affecting the market; the breakdown or failure of communications or equipment or facilities or the ATS central processing systems; the failure of any significant market infrastructure or service provider; or any other undesirable situation or practice.
\end{itemize}
\end{footnotesize}
event of a business interruption which leads to the market suspension, the exchange’s preferred approach is to determine prices by consulting market practitioners. In doing so, the exchange will conduct a poll of a representative sample of its members and will make an assessment of relevant values for the designated settlement period; namely, the value for the closing minute of the settlement period. In reaching this assessment, the exchange may consider other sources of price information: for example, the price assessors or reporters or values between other closely correlated contracts. Generally, an average of the assessment will be used, although the exchange may disregard trades which are at significant variance from the mean. Where the exchange is unable to obtain credible prices from the market, then it may take other courses of action to ensure that a viable settlement price is obtained. These other courses of action for deriving settlement prices might include, on a non-exclusive basis, the following:

(i) Using a previous day’s settlement price;
(ii) Using values obtained prior to the suspension of the ICE platform;
(iii) Using values obtained by restarting the ICE platform and settling the market from trades on the ICE platform albeit at a later time; and
(iv) Using values obtained by reference to over-the-counter markets or other markets which are not affected.

A clear provision in formulating an emergency settlement price is notably a fundamental aspect of commodity futures contract. The United States futures market legal framework enshrines its importance in Core Principle 6 of section 5(d) of the Commodity Exchange Act. It stipulates that a designated contract market or an exchange should have clear procedures and guidelines for the exchange’s decision-making during a period of emergency. This includes emergency intervention in the market as well as procedures and guidelines in avoiding conflicts of interest while carrying out such decision making.

Nonetheless, from a careful study of the regulatory framework of Malaysia as well as that of the United States, a clear criterion of arriving at the emergency settlement price is

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154 Relying on a circular (05/110) dated October 4, 2005. ICE Futures Europe (ICE Europe) is a regulated futures exchange for global energy market. It lists the leading global crude oil benchmarks and sees half of the trade in the world’s crude oil and refined product futures.
155 However it must be noted here that the exchange reserves the absolute discretion to determine settlement and market prices.
156 Procedures and guidelines should include notifying the Commission of the exercise of a contract market’s regulatory emergency authority, explaining how conflicts of interest are minimised, and documenting the contract market’s decision-making process and the reasons for using its emergency action authority.
absent. Due to the uncertainty and lack of knowledge in the method of calculation, it is not surprising that discontentment and disputes occur amongst the contractual parties. The following cases evidenced such scenarios.

*Ganda Oil Industries Sdn Bhd & Ors v The Kuala Lumpur Commodity Exchange & Anor.* This case involves an application made by a number of purchasers of the crude palm oil futures contract (Appellants) to cancel an emergency settlement price fixed by the Exchange; in this case, the Kuala Lumpur Commodity Exchange (KLCE). These Appellants were members of the Kuala Lumpur Commodities Clearing House (KLCCH) and KLCE, who at the same time, carried out business in palm oil processing and refining. This dispute arises from the default of one Matthes & Porton (M) Sdn. Bhd. (M&P). By the close of the trading on February 28, 1984, M&P (also a member of the KLCE and the KLCCH), purported to sell 761 March 1984 crude palm oil futures contracts on behalf of one Sun Edible Oil Industries (M) Sdn. Bhd (SEOI). SEOI was also a member of the KLCE and the KLCCH. However, the next morning on February 29th, the SEOI notified the KLCCH by telex that they had denied and rejected the said trades. In view of such a rejection, the KLCCH contacted the M&P on the fact that they would be required to pay the deposits in respect of the said contracts amounting to a total of RM7,610,000-00. However, the deposit was not forthcoming and the KLCCH decided not to register the said contracts.

Nonetheless, after receiving and considering various representations from relevant government agencies and other members of the palm oil industries, the KLCCH agreed to register the contracts for the purpose of protecting and maintaining the market and restoring confidence in the industry. The contracts were then registered on March 12, 1984 but the M&P still refused to pay the required deposit. In view of such a default, the KLCCH decided to liquidate all the aforementioned contracts at the price fixed by the KLCE. Therefore on March 16, 1984, the KLCCH was advised by KLCE that the price of the said contracts for the purpose of invoicing by way of a compulsory settlement was set at RM1,350-00 per tonne.

The Appellants, Ganda Oil Industries Sdn Bhd and others who purchased the defaulted 761 March 1984 crude palm oil futures contracts were not satisfied with the emergency

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157 The regulatory framework governing the Chicago Board of Trade and the Commodity Mercantile Exchange were examined in deciphering any explicit method of calculating the emergency settlement price.

158 [1988] 1 CLJ (Rep) 56.
settlement price quoted by the Exchange. They applied to the High Court, and later appealed to the Supreme Court, for an order of certiorari.\(^{159}\) The purpose of this application was to quash the decision of the KLCE made on March 15, 1984 which fixed the price of the crude palm oil futures contract at RM1,350-00 per metric ton. The Appellants cited two grounds for the said application; namely that the KLCE were in excess of jurisdiction and that it acted in bad faith. The Appellants compared the price fixed by the KLCE on the 14\(^{th}\) and 15\(^{th}\) March at RM1,520-00 per metric ton with that of other contracts and argued that KLCE had fixed a lower price for their contracts.

The KLCE on the other hand argued that they were empowered to declare the existence of a state of emergency by virtue of rule 300(2) of its emergency rule; namely, to take "such one or more steps as it sees fit and proper". The KLCE also argued that regulation 11 of the General Regulation gives a wider discretion to the KLCE to fix a settlement price. Hence, by virtue of this regulation 11, the KLCE argued that the fixed price was based on the price as of February 28, being the actual trading date, and was included in the price of the element of compensation.\(^{160}\) Despite the KLCE's frail argument, the court gave a judgement in favour of the KLCE.

Similar facts transpired in the case of Palmco Holdings Bhd v Sakapp Commodities (M) Sdn Bhd & Ors.\(^{161}\) The purchasers of the crude palm oil futures contracts challenged the emergency settlement price fixed by the KLCE. These purchasers, Palmco Holdings Bhd and other purchasers, sued seven sellers who defaulted on their crude palm oil futures contracts, as well as the KLCCH and the KLCE. The purchasers and the seven defendants were all members of the KLCCH and KLCE. The purchasers were injured by KLCCH and KLCE’s default declaration of the March 13 and March 14 crude palm oil futures contracts. The total amount of the crude palm oil futures contracts which were owned and defaulted by the Defendants was 5,150. The facts of the default are as follows:

\(^{159}\) Certiorari is a prerogative order obtained by an application for a judicial review in which the High Court orders decisions of inferior courts, tribunals and administrative authorities to be brought before it and quashes them if they are ultra vires or show an error of law (Law and Martin, 2009: 446).

\(^{160}\) In this case, the issue was whether the decision of the KLCE is subject to a judicial review. The Supreme Court of Kuala Lumpur held that the act of KLCE was not amenable to judicial review. This is because the relationship between the parties, namely, the members of the Exchange, is governed by contracts. It follows that the power exercised by the KLCE under regulation 11 also derived from the contract between KLCE and the members of the Exchange and as such, action taken by the Exchange based on these contracts is to be adhered to and honoured by the members of the Exchange.

\(^{161}\) Suit No. C2324 of 1984

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On March 13, 1984, a total of 5,150 futures contracts, valued at approximately RM160,000,000-00, registered under the name of the first, second, third, fourth and fifth defendants, were declared to be in default by the KLCCH. On March 14, 1984, the remaining contracts which were registered under the name of the sixth defendant were also declared to be in default by the KLCCH. Due to this default the KLCCH, in exercising its powers under KLCCH regulations, decided to liquidate all these contracts by invoicing back and accordingly requested the KLCE to fix the price for the compulsory settlement for all these contracts.

By its letter dated March 14, 1984, the KLCE was purported to have fixed the following prices for the compulsory settlement of the contracts declared to be in default on March 13, 1984 as follows:

March – RM1,520; April – RM1,410; May – RM1,305; June – RM1,160; and July – RM1,030.

The KLCE also fixed the following prices for the compulsory settlement of the contracts declared to be in default on March 14, 1984 as follows:

March – RM1,520; April – RM1,500; May – RM1,405; June – RM1,268; and July – RM1,030.

The purchasers alleged that, in so fixing the compulsory settlement price, the KLCE failed to comply with the KLCE rules when it neglected to take into account a sum reasonably sufficient to compensate the purchasers for their losses suffered from the default. Hence, the KLCE revised its compulsory settlement price to also include the compensation, in which a new list of settlement prices was then issued as follows:

"(a) In respect of the contracts declared to have been in default on the 13th day of March 1984 - $ March Invoice Back Price 1,520.00 Compensation 104.50 Settlement Price 1,624.50 April Invoice Back Price 1,410.00 Compensation 139.50 Settlement Price 1,549.50 May Invoice Back Price 1,305.00 Compensation 176.50

162 Under Rule 1102 of Bursa Malaysia Derivatives Clearing Berhad Business Rules, upon such a default, the Exchange, besides exercising its power to determine the emergency settlement price, must also determine the compensation sum payable by the defaulted party to the party who was disadvantaged by the failure to deliver.

163 According to one of the witnesses, Ahmad Habib who testified for the KLCE, the compensation element is the difference between the full settlement price and the invoice back price.
Based on the revised settlement price, the purchasers claimed that the KLCCH had only paid them the invoice back price excluding the compensation price. Hence, they argued that, until the purchasers received the full payment of the settlement price, including the compensation, the crude palm oil futures contracts remained unliquidated and all the defendants, including KLCE and KLCCH, were to continue remaining liable for these contracts.

These two cases show the repercussion of the absence in the trading regulation of a clear method of calculation of an emergency settlement price. The facts in Ganda Oil v KLCE demonstrate that the purchasers were discontent with the emergency settlement price determined for March 14, 1984 contract. While in Palmco Holdings v Sakapp Commodities, the emergency settlement price for March 14, 1984 was fixed at RM1,520 (excluding the compensation price), in Ganda Oil v KLCE, the price for March 14 and March 15, 1984 was fixed at only RM1,350.164 The discontentment is sensible as these two prices were fixed by the same Exchange on the same default date, namely March 14. The wide gap between the price fixed at RM1,520 and RM1,350 accentuates the risk of not having a clear method of determining an emergency settlement price. In fact, these law suits and recriminations have undermined confidence in the market. The reputation of the Exchange, the world’s only palm oil futures trading market, was perniciously tarnished. The Malaysian government and exchange officials spent much of the year looking for ways to rebuild market confidence and lure traders back (Rieger, 1986: 16).

Similar quandary is shown in an American case, In Crowley, Alien Property Custodian v Commodity Exchange, Inc. et. al.165 This case involved a Plaintiff, a Japanese company named Mitsui & Co. Ltd. disputing the U.S. Commodity Exchange’s emergency settlement

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164 It is not reported whether the amount of RM1,350 is to include compensation.
165 141 F. 2d 182; 1944 U.S. App. LEXIS 3625. This action was first commenced by Mitsui & Co, Ltd., a Japanese corporation and later due to the war, Mitsui became an alien company. By an order issued on August, 17, 1942, all its properties and assets in the United States were vested in the Alien Property Custodian, who was thereupon substituted as the plaintiff in this action.
price. The facts are as follows: On July 25, 1941, the Plaintiff was short (selling) 418 raw silk contracts. On July 26, 1941 (on Saturday), the exchange received a request from the Price Administrator in Washington to suspend all trading in silk. Hence, on July 28, the exchange’s Board of Governors (the Board) voted unanimously for the suspension of the trading of raw silk futures and their following deliveries.

On August 2, the Office of Price Administrator and Civilian Supply issued Price Schedule 14, fixing the ceiling price for raw silk at $3.08 per pound. This price reflects a considerable drop from the last trading price on the exchange; namely, $3.55 to $3.65 on 25 July, depending on the month of delivery. On August 11, an investigation was ordered to investigate the open position and to hold hearings with interested members. This investigation came back with a report that liquidation should be based on the closing prices of July 25. However, on October 15, 1941, the Board met again and decided, by a vote of thirteen to four, that the settlement price should be pegged at $3.08 per pound.

The Board’s decision caused huge financial damage to the Plaintiff. This is because its short raw silk futures contracts were originally purchased at an average price of $2.88 per pound and had to be liquidated at prices between the ranges of $3.55 to $3.65 per pound. The plaintiff was also left with physical raw silk which could only be sold to the Government at the ceiling price of $3.08. Though the Plaintiff was able to eventually liquidate by private settlement, it was still left with 180 outstanding short contracts. Due to this, the Plaintiff sued the exchange and the Commodity Exchange Silk Clearing Association, challenging the validity of the Board’s resolution on October, 15, 1941.

In deciding this issue, the United States Court of Appeals for the Second Circuit referred to the relevant minutes of the Board. The minutes on October 15 showed that the only dispute was not whether liquidation should be ordered but as to which of the two prices in dispute should be made the settlement price.166 In dismissing the Plaintiff’s claim, the court held that the decision of the Board to choose either one of the prices was justified under the rules. The court viewed that, under the rules, the Board is empowered to take any step, or

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166 It was also shown that the Board accepted the suggestion by the investigation committee to peg the settlement price as of the closing price of July 25. Despite that acceptance, the Board resolved to peg the settlement price based on the Government’s ceiling price.
fix any terms as the Board may deem necessary and desirable whenever there exists a
situation which may endanger or jeopardise the normal functioning of the market.\footnote{In this case, the court explicates the condition of the market which led to the two conflicting Board decisions. It states,}

However in \textit{Elmer A. Kent et. al., Respondents v E.B. Miltenberger, Appellant},\footnote{15 Mo. App. 480; 1884 Mo. App. LEXIS 74.} the issue was whether the quoted market price in the St. Louis market (the exchange) for No. 2 red winter wheat for August delivery was artificial\footnote{To discern whether an act of a trader would lead to artificial price for the commodity, Friedman \citeyear{1990} argued that this could be done by inferring the trader's true motivation from the circumstances. In making that inference, a historically unusual price pattern can be relied on. In doing so, one could ask whether the price of the commodity futures was abnormally high either absolutely or in comparison to other prices – of other contract months or commodities. See also Manipulation of Commodity Futures Prices: The Great Western Case \citeyear{n.n(f), 1953}.} hence was in far excess of its true value. The purchasers of the wheat futures contracts questioned the contract value fixed by the exchange for No. 2 red wheat and alleged that it was not based on its real value. The St Louis Circuit Court found that, though the price was based on the ruling market at the end of that month, the evidence showed that this wheat market was forced up to a fictitious point by a combination of dealers in what is called a "corner". Hence, the deal which was settled by the purchasers was not upon a legitimate market, as required by the above rules, but upon a fictitious and manipulated market.

However, the Court of Appeals of Missouri, St. Louis dismissed this part of the ruling. The question adjudicated by the court was "whether the price of No. 2 red winter wheat, which had, during the last days of August, been forced up some eight or nine cents beyond its natural value, had been so forced by 'manipulation' and that it was a 'fictitious market'". In addressing this question, the court referred to the recorded evidence which showed that during the month of August, 1880, the price of No. 2 red winter wheat rose from about 90 cents a bushel on the first day of the month to 99 cents a bushel on the last day of the month. The evidence also showed that the price of No. 2 red winter wheat and No. 3 red winter wheat on the exchange would differ by about 7 cents, though, on the last day of August, the difference expanded to about 16 cents. It also appeared that on the last day of
August, No. 2 red winter wheat rose to 99 cents and dropped to 90 cents on the following day.\(^\text{170}\)

The abnormal and temporary movement of the wheat price was held not to be necessarily fictitious. The court argued that there was no evidence to show that this price movement was the result of manipulation.\(^\text{171}\) Instead, the evidence found that there were lesser supplies of No. 2 red winter wheat for delivery in the elevators in the exchange during the month of August, 1880 than the sellers had to deliver. The sellers were forced to buy such wheat for delivery and those who had it to sell, aware of the necessities of these sellers who were obliged to buy, charged as much as they could. Thus, by ordinary competition, the market rose to an abnormal point. Relying on the general rule that there is nothing unlawful in a person having a commodity to sell and charging as much for it as he can get, whatever he can get and does get for his commodity. Hence, the court held that the value of the No. 2 red winter wheat was its real value and not a fictitious value.

This case raises an important point as to the issue of price artificiality. The question now is how assuring is the emergency settlement price, fixed by the Exchange, not an artificial or fictitious price, but a legitimate price, relying on a legitimate force of supply and demand.\(^\text{172}\) This expectation is emboldened by section 11 of the Capital Market Services Act 2007 which imposes a duty on the Exchange to:

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\(^{170}\) The record also showed that millers could sell their No. 2 red winter wheat in sacks, on the exchange, on the last day of August at 90 to 94 cents but due to the inspection and elevator process, an extra 1 1/2 cents to 2 cents would have to be incurred.

\(^{171}\) Manipulation in a way that:

"certain powerful dealers, having purchased largely of No. 2 red winter wheat for August delivery in St. Louis, had then combined for the purpose of depleting the market by exportation, or by preventing importations from the country, and by this means, has forced the market to an unnatural price, we suppose that such a market would be what the merchants of the exchange meant by manipulated or fictitious market when they framed the rules above quoted.” (Ibid., at 86)

\(^{172}\) It is basic economics that where markets are manipulated, supply and demand are distorted. And one distortion creates the needs for a further distortion and so on. The longer the distortions continue the greater the possibility of total market failure (Robins, 2010: n.p.). Similarly, Newman (n.d.:24) argues that corner and squeeze violates the basic force of supply and demand in a commodity futures market. According to Kyle and Viswanathan (2008: 277), due to corner and manipulation, a price becomes artificial hence making prices inaccurate and reducing market liquidity. To establish price artificiality, it is necessary to accumulate evidence that prices do not follow legitimate economic forces. One way to do this is to establish what the level of price or price relationships would or should have been had the suspected manipulator not illegitimately interfered with the normal process of price formation. In the cash market for commodity assets, for example, one must consider supply factors such as the deliverable supply of a commodity as specified in the derivatives market; any “seasonality” that may factor in its supply; all relevant production and marketing trends; and owners of deliverable supply. Likewise, one has to identify demand factors such as the major users of a commodity; the location of the users relative to the delivery points of the commodity; changes in economic factors affecting the demand; and demand at the delivery points. On the derivatives side, one must examine all aspects of open contracts, such as the group composition of the market (market shares of largest traders); those who have held derivatives positions of a size sufficient enough to affect prices; and those who

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"ensure, so far as reasonably practicable, an orderly and fair market in the securities and futures contracts that are traded through its facilities."

The phrase "fair market" is defined in section 27 of the same Act as "a market that reflects the forces of supply and demand." However the artificiality of the price detaches it from the legitimate force of supply and demand (International Organisation of Securities Commission, 2000: 13).

The question on price artificiality is vital as manipulations or corners tend to erupt in the delivery month, and when this occurs, the underlying commodity is priced at an artificial value, as opposed to its real value. This condition is exacerbated by Schedule 13 of Bursa Malaysia Derivatives Berhad Business Rules exempting the current delivery month from any price limit. The impact of the artificial commodity price on the futures market is precarious. According to Easterbrook (1986: S107), manipulation causes economic loss as it creates a wedge between the futures price and the anticipated price of the cash commodity. This gap - needed to compensate the participants for risk - also makes futures contracts less valuable as a tool of hedging. The divergence between the closing price of a futures contract and the price of the cash commodity immediately before and after results in the futures price becoming inaccurate. Hence a decrease in price accuracy is an economic loss. Although the market has a corrective mechanism, this disruption impairs the success of the market operation.

According to Gorton and Rouwenhorst, (2006: 48), in order to determine a fair futures price, the market participants compare the current futures price with the spot price that can be expected to prevail at the maturity of the futures contract. If the spot prices are expected to be much higher at the maturity of the futures than they are today, the current futures price will be set at a high level relative to the current spot price. Lower expected spot prices in the future will be reflected in a low current futures price. Peck (1976: 409) views that these futures prices are, in actual fact, determined directly by the hedgers and speculators demand for, and supply of, futures contracts.

Netz (1995: 190) carried out a study on the 38 corners or attempted corners identified through historical accounts in CBOT during the period September 1865-September 1888. It discovered that from the 38 corners, 7 had significant impacts on spot prices and 7 had significant impacts on storage. It is also found that during the two weeks at the end of the corner month, the corner would increase the spot price by an average of 9.7% of the mean price. During the two weeks following the corner or attempted corner, the spot price would fall an average of 7.3% of the mean spot price. Thus manipulation contributes to price volatility on both the up and down side. The spot price not falling significantly afterwards can be explained by either the manipulator managing to slowly sell off the inventory over time or, in the case of a squeeze, there simply being a low deliverable supply.

When the futures market in wheat and other grains was developed at the Chicago Board of Trade in the 1860s, many people especially farmers, complained that the futures market, facilitated by speculative trading, increased the volatility of the cash market. Studies have shown that it was not the futures market per se which led to the volatility but manipulation. Manipulation and corner may have discouraged potential hedgers.
The impact on society is also colossal. Whether intentionally or unintentionally caused, price fluctuations can cause considerable harm to society as hedgers will pass the burden on to consumers in the form of higher prices (n.n.(d), 1963: 176). Pirrong (1993:363) posits that manipulation distorts not only the price by the shorts utilising real resources to make excessive deliveries, but also consumption, which forces shorts to pay high prices to acquire the commodity. He appositely describes the loss suffered from futures market manipulation as "deadweight losses". These "dead weight losses" include temporal and spatial distortion in consumption, production, storage, and transportation; and a reduction in hedging effectiveness, increase in futures prices volatility, reduction in the informativeness of futures prices, and a decline in market liquidity (Pirrong, 2001: 222).

The Technical Committee of the International Organisation of Securities Commission reports that:

"Market manipulation harms the integrity and undermines public confidence in derivatives markets by distorting prices, harming the hedging functions of these markets and creating an artificial appearance of market activity." (2000: 1)

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176 By demanding excessive deliveries, a long induces distortions in the distribution of consumption, transportation, and storage. Shorts must pay current owners of the commodity increasingly higher prices in order to compensate current owners of the commodity for the surplus forgone as a result of this distortion. This causes the marginal cost of delivery to increase with the number of deliveries. The shorts must pay a higher transport charge when they go to more distant markets to obtain the commodity. Finally due to the transportation costs, prices are higher in some markets and shorts must purchase in these more expensive locations when supplies in cheaper markets are exhausted. These factors cause the marginal cost of delivery to rise (Pirrong, 1993: 345).

177 As it is inefficient to return all units delivered to their original owners, the shorts must pay super-competitive and rising prices for the commodities. When the shorts exhaust supplies at low price locations, they must travel to higher price locations to obtain the commodity. Thus transport cost contributes to an increasing marginal cost of delivery (Pirrong, 1993: 347).

178 The dead weight losses further includes traditional monopoly-power welfare losses - huge gains for those on the right side of the market and imposes potential ruinous losses on those on the wrong side (Pirrong, 1995: 254).

179 Although manipulation and corner are a statutory offence in most commodity futures markets, the court litigations and literature have shown that they have not been able to deter manipulation and corner absolutely from the market. See International Organisation of Securities Commission (2000) which enumerates the manipulation statutory provisions for a number of global commodity futures exchanges. See also Hatch and Mahlum (2011) on the investigation by the U.S. Commodity Futures Trading Commission (CFTC) on numerous manipulation and corner incidents in the American commodity futures market. Also Brimmer (1989) depicts in detail the Hunt silver manipulation in 1979 where, at that time, he was the appointed Chairman of the Special Silver Committee, established under the COMEX Board of Governors. See also the latest civil enforcement action filed in 2011 by the CFTC against Pamon Energy Inc. of California, Arcadia Petroleum Ltd. of the United Kingdom, Arcadia Energy (Suisse) SA of Switzerland, James T. Dyer of Australia and Nicholas J. Wildgoose of California for manipulating and attempting to manipulate the New York Mercantile Exchange's crude oil futures prices from January 2008 to April, 2008 (Commodity Online, 2011).
The court in *Kohen v Pac. Inv. Mgmt. Co. LLC* (quoted in *In Re: Dairy Farmers of America, Inc. Cheese Antitrust Litigation*\(^{180}\)) aptly states:

"A person who owns a substantial portion of the long interest near the contract’s expiration date also obtains control over the supply that the shorts need to meet their obligations. Then the long demands delivery, and the price of the commodity skyrockets. It takes time and money to bring additional supplies to the delivery point, and the long can exploit these costs to force the shorts to pay through the nose."

The next section deals with the remaining issue of contract settlement, namely the default of the physical delivery of the underlying commodity. This issue will be discussed in two separate scenarios: namely, when the supply of the underlying commodity is unavailable, and when the delivered underlying commodity is not of the deliverable grade.

### 4.3.2 The Default in the Delivery

The failure of the seller to deliver or the purchaser to take delivery of crude palm oil is a breach or a default of the crude palm oil futures contract. Rule 805 of Bursa Malaysia Derivatives Clearing Berhad Business Rules provides that:

"805 Failure to Deliver or Pay Settlement Amount

(a) A Clearing Participant, directed to Deliver in accordance with Rule 801 or 802 who fails to make such Delivery within the time prescribed by the Clearing House is in default of its obligations.

(b) A Clearing Participant who fails to accept Delivery or pay a settlement amount in accordance with Rule 801 or 802 is in default of its obligations.

(c) If the Clearing House is unable to Deliver or effect Delivery due to the failure of a Clearing Participant to meet its obligations under an Open Contract the Clearing House will be under no obligation to Deliver or to effect Delivery but may effect settlement in accordance with Rule 1102."

Based on a careful study of the case laws, the failure of the delivery of the underlying commodity hinges on the following two scenarios: (i) the non-availability of the supply of the commodity; and (ii) the non-fulfilment of the commodity’s deliverable grade.

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\(^{180}\) 767 F. Supp. 2d 880; 2011 U.S. Dist. LEXIS 13307
This section will be divided into two parts. The first part will analyse the issues surrounding the lack or the non-availability of supply of the underlying commodities. This section will show that, despite the modern and sophisticated agriculture industry, sellers are still faced with a supply problem. This section will also exhibit that despite the fact that manipulation is a statutory offence meted with heavy punishment, unscrupulous members of futures markets continue to find ways to gain windfall profits by manipulating the commodity futures market at the expense of others. The second part will deal with the issues relating to the default in complying with the regulated contract grade of crude palm oil. This section will highlight the insufficient description of the "good merchantable quality" of crude palm oil in its contract specification.

4.3.2.1 The Non-availability of the Supply of the Underlying Commodity

Sufficient supply of underlying commodities projects an image of an efficient commodity futures market. Hence, a lack in the supply of underlying commodities impinges not only the reliability and worthiness of this market but also the welfare of its society. Its ramification is exacerbated when a manipulation or corner is the cause. The following cases depict manipulation in world's important commodities.

In *Peto v Howell*, a grain dealer living in Kansas City bought on the Chicago Board of Trade corn futures contracts to be delivered in July, 1931. The grain dealer alleged that the defendant, a grain trader who was also a member of the Chicago Board of Trade, monopolised the corn market in Chicago by purchasing a large amount of July corn futures contracts. The grain trader began his large purchase of July corn futures contract in April, 1931, and progressively purchased additional large amounts of the July corn futures contracts in May and June, 1931. In April, 1931, the price of corn fell to the lowest it had been in the past eight years. The price continued to fall, and by end of May, the price had declined to 54 ¼ cents. Hence, on July 1, 1931, the trader owned a total amount of 8,500,000 bushels of July corn. This amount exceeded the supply of corn available for delivery in Chicago in July. Based on these facts, the grain dealer claimed that these purchases were made by the grain trader with the intent to withhold the commodity from the market. By doing so, he had caused a sharp increase in the price of the corn.
As part of the trading procedure, the corn would be delivered to the purchasers of corn futures contracts by way of delivering the warehouse receipts.\(^\text{181}\) Hence, on July 30, 1931, in performance of his long July corn futures contract, the grain trader received warehouse receipts which covered all deliverable July corn held in public warehouses in Chicago. There were, in storage, 5,650,000 bushels of deliverable corn in Chicago, all of which have been delivered to the grain trader. The grain trader also received an additional 1,500,000 bushels of corn which he thereafter sold and delivered to countries outside the United States. By removing this supply of corn from the United States, he reduced the availability of corn from the July corn market. Hence, the total amount of corn delivered to the grain trader under his July corn futures contract was around 7,000,000 bushels.

By July 30, 1931, he was still owed contracts for a delivery of about 1,500,000 bushels of July corn. However, there was no corn of a deliverable grade in Chicago to be delivered to the grain trader. Therefore, those who were contracted to deliver July corn were not able to procure corn in Chicago or elsewhere due to the lack of time. As a result these parties defaulted in performing the delivery of July corn to the grain trader. In default of delivering the July contract, these parties had to pay an excessive settlement price to the grain trader. This was because the corn price was raised artificially to about 25\(\frac{1}{2}\) cents per bushel. The grain dealer was among those who were forced to pay a large amount of settlement money for such a default.\(^\text{182}\) As a result, the grain dealer took legal action against the grain trader for the injury and damages caused by the grain trader's monopoly of the July corn market.

The grain dealer relied on the Grain Futures Act, Title 7, Chapter 1, Section 5, U.S.C.A., which stipulates that:

> "Transactions in grain involving the sale thereof for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest; that such transactions are carried on in large volume by the public generally...; that the transactions and prices of grain on such boards of trade are susceptible to speculation, manipulation, and control, and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and

\(^{181}\) Corn which is deliverable on futures contracts is kept in public warehouses in the Chicago district in which warehouses are designated as "regular".

\(^{182}\) The cash settlement is in effect purchasing the commodity from the long (buyer). Hence if the long acquires substantial long positions relative to the deliverable supply held by others, the shorts (sellers) will probably have to pay more than the competitive price for the commodity to satisfy their obligations to the long (or pay more than the competitive price for long's futures contracts to offset their short positions) (Fischel and Ross, 1991: 543).
the persons handling grain and products and by products thereof in interstate commerce, and that such fluctuations in the prices are an obstruction to and a burden upon interstate commerce in grain and the products and by-products thereof and render regulation imperative for the protection of such commerce and the national public interest."184

The United States Court of Appeals for the Seventh Circuit held that the grain dealer had proved that the grain trader had monopolised and controlled, by way of a corner, all July corn futures contracts – waiting to be delivered in July, 1913. Not only had he acquired almost all of the July corn futures contracts but he had also purchased, in the Chicago cash corn market, over 300,000 bushels. The court referred to the case of United States v Patten where the court in this case commented that:

"The corner was to be conducted on the Cotton Exchange in New York city, but by means which would enable the conspirators to obtain control of the available supply and to enhance the price to all buyers in every market of the country. This control and the enhancement of the price were features of the conspiracy upon the attainment of which it is conceded its success depended. Upon the corner become effective, there could be no trading in the commodity save at the will of the conspirators and at such price as their interests might prompt them to exact. And so, the conspiracy was to reach and to bring within its dominating influence the entire cotton trade of the country... It well may be that running a corner tends for a time to stimulate competition; but this does not prevent it from being a forbidden restraint, for it also operates to thwart the usual operation of the laws of supply and demand, to withdraw the commodity from the normal current of trade, to enhance the price artificially, to hamper users and consumers in satisfying their needs, and to produce practically the same evils as does the suppression of competition."185

This decision is in contrast with Volkart Brothers, Inc., Volkart Brothers, Company, Alfred Boedtiker and Kurt Muller v Orville L. Freeman, Secretary of Agriculture, and Thomas J. Flavin, Judicial Officer by Appointment of the Secretary of Agriculture.186 In this case, the petitioners, who were members of the New York Cotton Exchange (NYCE) and the New Orleans Cotton Exchange (NOCE), were suspended from trading on these Exchanges by the order of the respondent, the Secretary of Agriculture.187 The Judicial Officer, acting on behalf of the Secretary of Agriculture found that the petitioners were guilty of

183 Ibid., at 355. The word "interstate commerce" in this regulation is interpreted as "a transaction in respect of any article shall be considered to be in interstate commerce if such article is part of that current of commerce usual in grain trade whereby grain and grain products and by-products thereof are sent from one state with the expectation that they will end their transit, after purchase, in another..."
184 Ibid. at 355.
185 Ibid., at 359.
186 311 F. 2d 52; 1962 U.S. App. LEXIS 3405.
187 Trading of commodities futures contracts on exchange markets were then regulated by the Secretary of Agriculture pursuant to the provisions of the CEA, 7 U.S.C. § 1 et. seq.
manipulating and attempting to manipulate the price of the October 1957 cotton futures contract on the NYCE and the NOCE. The petitioners were found to be in violation of Sections 6(b) and 9 of the CEA based on the following facts:

On October, 1957, at the opening of the trading session, there were a total of 13,400 open interests on both exchanges. The records shows that on the long (purchaser) side, the petitioners had 12,100 bales and the other longs had 1,300 bales. Accordingly, there were a total of 13,400 bales on the short (seller) side that needed to be covered before the end of the October 15, 1957 trading. Out of these 13,400 bales, there were only about 5,000 bales of certificated cotton owned by persons other than the petitioners. To meet the demand of the 13,400 cotton bales, 7,100 were met out of the petitioners' supply of long contracts and out of whatever cotton was still in the process of certification.\(^\text{188}\)

In challenging the award of the Secretary of Agriculture which suspended them from trading, the petitioners argued that there was no artificiality in the October cotton futures prices on the last day of trading, namely, October 15, 1957 as there were large stocks of non-certificated cotton. On the other hand, the respondents argued that though there were large stocks of non-certificated cotton, these were not deliverable under the trading rules nor were readily available to the shorts, particularly the non-merchants shorts, on the last day of trading. Therefore, there was no practical alternative available for a short on the last day of trading, who did not have the cotton to deliver to the party with whom he had made the futures contract, other than to default on delivery or pay the price to get out.

On this basis, the respondents claimed that the alleged manipulation or attempt to manipulate occurred solely on the last day of the trading on these two exchanges. They alleged that the petitioners had manipulated the market price of the October 1957 cotton futures contract by means of (i) their controlling of long positions in these exchanges; (ii) the insufficient and non-available supply of eligible cotton for the shorts to deliver during the period of manipulation; and (iii) the establishment of an abnormal or artificially high price when liquidating the futures contract.

The petitioners counter-argued these claims by stating that, in response to (i), though they admitted that their long position on these two cotton exchanges on the last day of trading

\(^{188}\) It is important to note that the cotton deliverable under these cotton futures contracts must be of the duly certificated cotton or cotton which was still under the process of certification.
was a dominant position, they denied that their dominant position was "controlling," meaning capable of being used for manipulative purposes. In response to (ii), the petitioners disputed the date of 15\textsuperscript{th} October as the proper time factor to be considered on this issue. The petitioners contended that there were millions of bales of cotton available in the country, of which 1,250,000 bales were stored in port warehouses designated as the delivery points for certified cotton. Therefore, the shorts, through their brokers, would still be able to procure the cotton there and place this cotton for certification on October 13\textsuperscript{th} and 14\textsuperscript{th}. In allegation (iii), they denied that they had established abnormal or artificially high prices. If this was so, they argued that the Control Committee of the New York Exchange would be able to detect and advise their members of the price abnormality when the October cotton futures contract was liquidated.

After considering the arguments of both parties, the United States’ Court of Appeal of Fifth Circuit dismissed the respondents' argument of manipulation. Instead, the court argued that the conduct of the petitioners amounted to an unplanned or unintentional squeeze. The court referred to the Report of the Federal Trade Commission on the Grain Trade (1926) which recognises that a squeeze from which a long purchaser profits is not necessarily illegal. The report states that:

"A 'squeeze' suggests a much milder situation than a corner. It means that there is too large a line of short sales out and that the short sellers have been somewhat obstinate in carrying their trades into the delivery month, or possibly that the various long interests are unduly or unexpectedly obstinate in reducing their lines during the delivery month. A squeeze does not imply one long holder nor conspiracy among the long interests to enhance the price. A large long interest may exist which has not been built up for manipulative or even speculative purposes, but as a hedge, and maybe a hedge on which the buyer expects to take delivery to meet cash grain commitment.\textsuperscript{189}

On this basis, the court found that the petitioners did not manipulate, or attempt to manipulate, as was charged by the State of Secretary. Hence the order of the Secretary of State against the petitioners was set aside.

However, this case was overruled by a later case, \textit{Cargill, Incorporated, et. al., v Clifford M. Hardin, Secretary of Agriculture, Thomas J. Flavin, Judicial Officer by Appointment of}

\textsuperscript{189}Ibid, at 59.
the Secretary of Agriculture, and the United States Department of Agriculture. This case involved an application by the petitioners, Cargill and others, to set aside the order of the respondent, the Secretary of Agriculture. The Secretary of Agriculture has found that the petitioners were guilty of manipulating the market price of May 1963 wheat futures contracts on the CBOT, hence violating the CEA, 7 U.S.C. §§ 9 and 13. The facts of this case are as follows:

In early 1963, the petitioners forecasted that there would be an ample supply of soft red winter wheat at the end of the crop year, May 1963. It therefore hedged its inventory by selling May 1963 wheat futures contract on the CBOT. By early March, 1963 it held 8,000,000 May wheat short positions. In the same month, the petitioners learnt that the Spanish government was interested in purchasing large quantities of soft red winter wheat and that the petitioners wanted to get some of this business. Based on this development, the petitioners decided that the wheat supplies would be tight in May and the wheat price might rise instead of fall. Therefore, the petitioners began to liquidate its short hedges and then established a long position in March 1963 wheat futures. By May, 15, Cargill had accumulated 1,930,000 speculative May wheat long positions.

On April 12, 1963, the United States Department of Agriculture published figures showing that there were 2,804,000 bushels of deliverable grade wheat stored in the Chicago warehouses. From this amount, the petitioners owned 2,471,000 bushels. On May, 11 the Spanish government offered to purchase 50 tons (40 bushels to a ton) of soft red winter wheat to be delivered by June 10. The petitioner managed to get the Spanish government to buy its wheat. Hence, by May 18, the Spanish government purchased 770,000 bushels of

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191 Cargill is one of the largest grain merchandisers and exporters in the United States. It owns an elevator and warehouse in Chicago which is a designated regular for the delivery of grain on the Chicago Board of Trade. When a wheat futures contract is settled by way of physical delivery, the delivery is effectuated by the tender on the part of the seller and the acceptance on the part of the buyer of a warehouse receipt or receipts. The warehouse receipt or receipts cover a specified quantity of deliverable grade wheat stored in a designated warehouse in Chicago area as approved by the Chicago Board of Trade as a regular for delivery. There is no delivery point outside of the Chicago area. Under the rules of the Board of Trade, during the last three business days of a delivery month, the seller may also affect delivery by tendering deliverable grade wheat loaded in railroad cars on track in the Chicago switching district. These cars are consigned to an approved Chicago warehouse or elevator.
192 Soft red winter wheat is one of the various classes of wheat produced in the United States and Chicago is one of the principal markets of such wheat. The Chicago wheat futures contract is essentially a soft red winter wheat contract because No. 2 soft red winter is the cheapest grade and class deliverable at par in satisfaction of the contract. Due to this, the price of the Chicago wheat winter futures generally tends to reflect the value of No. 2 soft red winter wheat.
193 The United States Department of Agriculture published figures every week, indicating the quantities of deliverable grade wheat located at various market areas around the country. However, these figures do not publish the ownership of such supplies.
wheat from the petitioners.\textsuperscript{194} This sale, together with other commitments, left the petitioners with approximately 50,000 bushels of wheat. This constituted all of the wheat in the Chicago warehouses available for delivery under the May wheat futures contract.

On the last day of trading, May 21, though the trading had ended, there were still 420,000 bushels remaining outstanding. From this number, the petitioners held 365,000 bushels. Shortly after the trading closed, the Acting Chairman of the Business Committee of the CBOT visited and requested the petitioners to orderly liquidate or offset its remaining long positions. The request was made in response to the apparent short supply of soft red winter wheat in the Chicago area. The Acting Chairman suggested that the petitioners offer to sell their warehouse receipts to the unresolved shorts in order to clear up the outstanding May wheat futures contracts. The petitioners replied that it had only approximately 35,000 bushels of uncommitted wheat available for sale but would be able to offer more warehouse receipts at the price of $2.28 \frac{\text{Y}4}{\text{per bushel}} and an assurance of it getting back these receipts (as these receipts were actually needed for delivery on prior commitments).

Upon getting such an assurance from the CBOT, the petitioners sold 100,000 bushels of warehouse receipts to various commission houses for $2.28 \frac{\text{Y}4}{\text{per bushel}} (approximately 75,000 bushels of this wheat were already committed under prior sales). These receipts were then tendered to the petitioners in satisfaction of the shorts' delivery obligations, resold by the petitioners, and redelivered back to the petitioners and other longs in satisfaction of their contracts.\textsuperscript{195} This process continued until 420,000 bushels of the unresolved open interest were liquidated by this method.\textsuperscript{196}

The Secretary of Agriculture alleged that the petitioners manipulated the market price of the May 1963 wheat futures contract by means of a squeeze when (i) it acquired and held a controlling position of the May 1963 wheat futures contract, (ii) there was an insufficient supply of wheat available to be delivered by the shorts under their futures contract as the supply was controlled by the petitioners, (iii) it exacted an artificially high price in

\textsuperscript{194} Cargill offered to sell to Spain 12,500 tons of wheat at a price which equalled $2.13 \frac{1}{2} \text{ per bushel or 10 \frac{1}{2} cents over the May futures. On the next day, Cargill offered 15,000 tons at a price which equaled $2.09 per bushel or 5 \frac{1}{2} cents over the May futures. Upon acceptance of the offer, Cargill loaded out 770,000 bushels of wheat from its Chicago elevators and shipped them to Spain.}

\textsuperscript{195} This process of continuous selling and repurchasing (in other words, recirculation) of the warehouse receipts amongst Cargill and other shorts and longs raised doubt as to the actual sufficiency of the quantity of wheat represented by these warehouse receipts.

\textsuperscript{196} In summary, Cargill received 315,000 bushels of its own warehouse receipts plus 50,000 bushels of wheat from other sources. Other longs received 55,000 bushels of Cargill warehouse receipts. All of these warehouse receipts were sold at a price of $2.28 \frac{\text{Y}4}{\text{per bushel}}.
liquidation of its futures contracts, and (iv) the squeeze was intentionally caused by the petitioners. In defence, the petitioners argued that, (i) a trader must commit an "uneconomic act"\textsuperscript{197} in order to be guilty of manipulation under the Act; and (ii) a squeeze is not a form of manipulation prohibited by the Act.

In determining this case, the court adjudicated on the issue of whether there was an insufficient supply of wheat from other sources than the petitioners, for the purpose of delivery under the May wheat futures contract. In addressing this issue, the Eighth Circuit first referred to the delivery rules of the CBOT. According to the delivery rules, the wheat which was subjected to delivery must be stored in any one of the designated warehouses located in the Chicago area. In addition to that, during the last three business days of the delivery month, the railroad cars on track in the Chicago switching district, in which cars are consigned to any one of the designated warehouses, can also be the approved delivery point. The No. 2 soft red winter wheat was the standard or grade of wheat acceptable as a fulfilment of the wheat futures contract. Hard wheat could also be delivered under such a contract. However, hard wheat is of a more expensive grade of wheat and no premium was allowed to the short for delivering such wheat under the futures contract.

Applying this requirement to the facts of this case, the petitioners practically owned all the designated warehouses for the wheat in Chicago. From the evidence tendered in court, it appeared that no supplies of No. 2 soft red winter wheat were located within shipping distance from Chicago, by the close of trading. However, the evidence showed that there were ample supplies of hard wheat in the surrounding areas that could be shipped into Chicago in time for delivery. This evidence was followed by the next question, whether this hard wheat would satisfy the requirements of the standard of deliverable grade under the delivery rules.

The Eighth Circuit referred to the case of \textit{Great Western Food Distributors, Inc. v Brannan}.\textsuperscript{198} This case relates to the default in the physical delivery of eggs under the December 1947 eggs futures contract. The issue of the logistic supply of eggs deliverable under the December 1947 eggs futures contracts was discussed. The grade of eggs, deliverable under this contract, was comprised of refrigerator eggs, graded U.S. No. 2

\textsuperscript{197} Cargill did not specifically define the term "uneconomic act", but from its argument, it referred to an act which does not make profit for the party involved.

\textsuperscript{198} 201 F. 2d 476; 1953 U.S. App. LEXIS 2315.
Extras and stored in approved warehouses in Chicago. Nonetheless, the rules of the CME allowed the sellers to deliver eggs of other grades, namely, fresh eggs, or those of the same grade as refrigerator eggs but stored in approved, out-of-town warehouses.

Based on the evidence tendered in that case, it was shown that customarily the price of the fresh eggs range higher than the price of refrigerator eggs. Despite the higher price, the sellers would not get any premium for the delivery of such eggs. It was also shown that the out-of-town refrigerator eggs presented a slightly different problem. Under the CME rules, if these eggs were tendered in satisfaction of his contract, the seller would be required to pay to the purchaser an equalising factor of $135 per carlot, plus freight charges to Chicago. Hence, an average cost of $315 per carlot was charged on the seller. In view of these "economic impediments" attached to their delivery, the court agreed to exclude fresh eggs and out-of-town refrigerator eggs from available supply when determining the elements of a corner.

Based on the court's finding in the case of Great Western Food Distributors, Inc. v Brannan, the Eighth Circuit referred to the evidence tendered in its court which showed that the hard wheat was more expensive than the No. 2 soft red winter wheat due to its higher quality. Despite its higher quality and price, no premium was allowed for its delivery. In addition to this, the cost of its shipment into Chicago would further escalate the cost of its delivery. In comparison, the No. 2 soft red winter wheat, were grown mainly in farm areas surrounding the Chicago market and this type of wheat were primarily consumed there. Therefore it was more economical to pay the purchaser a premium than to pay the additional charges for premium wheat plus the shipping and handling charges in the case of the hard wheat.

Relying on this evidence and the decision of the eggs futures case, the Eighth Circuit held that out-of-town wheat should be excluded from the available supply. Therefore, as the petitioner was in control of No. 2 soft red winter wheat, his source of supply was the only one readily available to the sellers. Hence, the court held that there was a corner. As a result of this corner, the sellers who had to fulfil their delivery obligation were left with the

199 The trading unit of the December eggs futures is one carlot, which consists of 600 cases of 30 dozen eggs or equivalent to 18,000 dozen eggs.
unfavourable choice of either having to offset their contracts or purchase warehouse receipts at a higher price fixed by the petitioners.\textsuperscript{200}

The following cases are drawn from the major physical default of the Maine potatoes futures contracts in the United States. In the words of the District Judge, MacMohan, in \textit{National Super Spuds, Inc., et. al. v New York Mercantile Exchange et. al.}, it is "perhaps one of the major defaults in the history of the New York Mercantile Exchange, namely, the failure to deliver on some 1,000 open futures contracts for Maine potatoes in May, 1976."

The effect of the sellers' refusal to deliver potatoes spawned a long list of court battles in the United States. The huge number of parties involved in these cases depicts the severe magnitude of the issue it brought to the futures market as well as the cash market.\textsuperscript{201}

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\textsuperscript{200} This decision, as well as the decision of \textit{Great Western Food Distributors, Inc. v Brannan}, clearly contradicts the decision of \textit{Volkart Brothers, Inc. v Secretary of Agriculture}. All these three cases dealt with the question of whether there existed a manipulative squeeze or corner in the commodities market. In addition to that, these courts had also considered the question of the logistics of the supply of cornered commodities within the surrounding area. The purpose of addressing this question is to establish that there was no other supply than the supply of the manipulators from whom the sellers would have to procure the commodities. The court in \textit{Volkart Brothers, Inc. v Secretary of Agriculture} addressed the issue of whether the non-certificated cotton should also be considered as part of the available supply of cotton for delivery under the cotton futures contracts. The Secretary of Agriculture contended that it should be excluded from the available supply and also that the certificated cotton was the only acceptable standard for delivery under the cotton futures contracts. However, the court disagreed. Although the court was shown that, at the close of trading, the non-certified cotton was not able to be certified in time for delivery, the court still viewed that the shorts could still procure the cotton and place them for certification prior to the close of trading.

\textsuperscript{201} See also \textit{Kent Gneiting, R. Von Walker, Oscar Ellsworth and Ronald Ball v Peter J. Taggares, James Minor, Harold Abend, Robert Abend, Kenneth Ramm, Modie J. Spiegel, Arthur Spiegel, John Coleman, Charles M. Cohen, Reddy-Chef Foods Corp., Agri-Empire, Inc., San Jacinto Packing Co., Idaho Potato Packers Corp. of Idaho, Idaho Potato Packers Corp. of New York, Universal Land Corp., Freehling & Co., Steinberg Bros. Co., and S. Friedman & Sons, Inc. (62 F.R.D. 405; 1973 U.S. Dist. LEXIS 14770; 17 Fed. R. Serv. 2d. (Callaghan) 311; 1973-1 Trade Cas. (CCH) P74,440}. This case involved a claim by the plaintiffs, sellers of May 1971 Idaho Russet potatoes for damages incurred as a result of the defendants' alleged conspiracy in manipulating supply and demand. Due to this conspiracy, the sellers had to fulfill their contracts by settling at manipulated and artificially set prices even though they had on hand stocks of fresh potatoes which they were forced to sell at low prices.
In this case, the Plaintiff, Joseph Stobl, claimed that he had suffered huge losses as a result of the defendants' manipulation of the 1976 Maine potatoes futures market. Plaintiff's loss started from his purchase of long May 1976 Maine potato futures contracts made in September and October, 1975. At this time, his average cost for the aforementioned purchase was approximately $18.30 per hundredweight (cwt). However, in May 4, 1976, he liquidated his entire long contract at an average price between $9.12 and $9.76 per cwt. Plaintiff's alleged that the defendants, Simplot and Taggares, two of the largest competitors in the purchase and processing of potatoes, conspired to manipulate the futures price of these potatoes.

The evidence revealed that the Maine potato futures price was indeed unusually high in 1976. This was due to the high demand for, and low supply of, Maine potatoes. The increase in the potato futures price tended to drive up the price of the cash potatoes. The high price of the potatoes adversely affected the need of the defendant to purchase large quantities of potatoes. Therefore the defendants planned to push the price to the lowest possible. To serve this agenda, the defendants purchased vast amounts of short futures contracts. By purchasing heavily on the short side, the defendants artificially inflated the perceived supply of Maine potatoes. Hence, cash and futures prices went down. Despite owning a vast amount of short futures contracts, the defendants did not attempt to obtain the potatoes that they were obligated to deliver, nor did they offset their short positions. With so many short positions remaining open, there was a surplus of sellers which effectively caused the price of Maine potatoes commodities contracts to plummet. So when the plaintiff sold his long May 1976 Maine potato futures contracts, he suffered a significant loss. The jury found that the defendants did conspire to depress the price of the 1976 Maine potatoes futures contracts.

768 F. 2d. 22; 1985 U.S. App. LEXIS 20438; 1985-2 Trade Cas. (CCH) P66, 692.
Sam Wong v New York Mercantile Exchange

This case relates to the default in the delivery of the March, April and May Maine 1979 potato futures contracts. The facts of this case will be discussed in the later part of this chapter.

Merrill Lynch, Pierce, Fenner & Smith, Inc. v Curran et. al. This case is decided together with New York Mercantile Exchange et. al. v Leist et. al., Clayton Brokerage Co. of St Louis and Inc. v Leist et. al.; Heinold Commodities, Inc., et. al. v Leist et. al.)

In consequence to the default of the May 1976 Maine potato futures contracts, the buyers of the futures contracts sued the NYME, its officials, and the firms of futures commission merchants (who acted on behalf of the short conspirators), seeking damages under the CEA. Their basis was that the NYME had failed to prevent unlawful conspiracies of manipulating the price of the Maine potato market and that the futures commission merchants had failed to report such a violation to the NYME. The United State Supreme Court allowed the buyers to claim damages from the defendants, in violation of CEA.


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203 735 F. 2d 653; 1984 U.S. App. LEXIS 22544.
204 456 U.S. 353; 102 S. Ct. 1825; 72 L. Ed. 2d 182; 1982 U.S. LEXIS 100; 50 U.S.L.W. 4457.
205 FCM is defined in § 2(a)(1), 7U.S.C. §2 CEA as individuals or association “engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery...on...any contract market...”
In this case, the buyers claimed damages from the defendants for the default under the May 1976 Maine potato futures contract. The defendants, Simplot and Taggares were potato entrepreneurs. During the trading period of the Maine potato futures contracts, namely, May 7, 1975 till May 7, 1976, the Department of Agriculture issued reports which disclosed information on the low stock of potatoes, particularly the Maine potato stocks, relative to the previous year. The consequence of this report was that it induced investors to purchase May Maine potato futures contracts (on the expectation that they would profit from a shortage of potatoes in May) and that farmers would demand a higher price for their potatoes on the cash market. To counteract the anticipated price increase, Simplot, Taggares and other entrepreneurs formed a conspiracy to depress the price of the May Maine potato futures contract.207

The conspirators agreed (i) to accumulate massive large short positions in the May Maine potato futures contract; (ii) to make no offsetting purchases of long contracts at a price higher than that agreed among themselves; and (iii) to default, if necessary, on their short commitments. As part of the conspiracy plan, they shipped large quantities of unsold Idaho potatoes to Maine markets. This multifaceted
strategy was designed to give the Idaho Potato Growers Association (IPGA) the impression that the supply of Maine potatoes was plentiful. On the final trading day, these short sellers had accumulated a net short position of almost 1,900 contracts, notwithstanding a Commission regulation limiting their lawful net position to 150 contracts. However, they did, in fact, default on their short commitments.

At the same time, the May Maine potato futures price was also manipulated by a separate group described as the “long conspirators”. The long conspirators were potato merchants and traders in the Maine futures market. Aware of the short conspiracy, they determined that they could not only counteract its effects but could also enhance the price. The purpose of this was to penalise the short conspirators when they liquidated their large massive short positions. They also created an artificial shortage of railroad cars during the contract delivery period. This was done by tying up all the railroad cars, hence preventing the owner of the warehoused potatoes from making deliveries to persons desiring to perform short contracts. At the close of trading on May 7, the longs controlled 911 open long positions and the shorts controlled 1893 open short positions.

The Plaintiffs were caught in the middle of these two competing conspiracies. All the plaintiffs invested heavily in the long believing that the price of the long position would have gone up due to the shortage. One of the plaintiffs, Incomco accepted 1,500,000 pounds of Maine potatoes delivered to it pursuant to the March futures contracts. It planned to sell these potatoes to those shorts that needed them to satisfy their delivery obligations. Anticipating a cash market shortage, Incomco was expected to sell its potatoes at a handsome premium. Because of the conspiracy, however, Incomco was not able to deliver its warehoused potatoes to shorts seeking delivery as the long conspirators had successfully tied up all the freight cars. As a result, Incomco and all other plaintiffs suffered massive losses due to the unnatural fall in the price.

The above cases evidenced the inadequacy of the trading regulation in overcoming manipulation in their commodity futures market. They also reinforce the effect of manipulation on the economy. The massive default in delivering underlying commodities deprives society of the consumption of basic commodities. In addition to that, any type of
manipulation would cause commodity prices to derail from their fair and real value as the price trends on the cash market are related to the price trends on the futures market. As a result, the general public have to pay prices for the processed commodity not warranted by real supply and demand (n.n.(g), 1955: 909). The next chapter will explicate more the devastating impact of this derailment.

As described earlier, the default of the delivery transpires in two scenarios. This section demonstrates how the non-availability of the supply of the underlying commodities and the economic loss due to the artificially inflated price of the commodity causes sellers to default. The following section will display the default by failure to deliver the required quality of the underlying commodities.

4.3.2.2 Non-fulfilment of Good Merchantable Quality

This section discusses the failure of the seller to deliver crude palm oil in accordance with the contract specification. This failure is discussed in the context of the insufficient description of the phrase “crude unbleached palm oil of good merchantable quality”, in its legal framework. A clear and sufficient description is vital as a buyer can only examine the quality of the oil when he/she receives its physical delivery.208

Besides the Malaysian case, Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal, reference could also be made to other American cases which also involve defaults in the deliverable quality of futures commodities. White v Barber; Same v Same208 relates to the default in July wheat futures contracts. In April, 1882, the customer, through his broker bought one short 100,000 bushels of wheat for July delivery. As there was a corner in the July wheat market, the price of wheat was forced up to ten or twelve cents. The customer was advised by his broker to make a tender of No. 2 red winter wheat as the No. 2 red winter wheat was intrinsically more valuable than the No. 2 spring. Hence, the customer tendered for No. 2 red winter wheat as advised. The broker then informed his customer that he had borrowed warehouse receipts for the ten thousand bushels for No. 2 red winter wheat and tendered the same to several parties to whom he had sold the wheat. However, these tenders were declined by all the purchasers. They were declined as the quality of No. 2 red winter wheat was not of the kind and grade to be delivered under the No. 2 red winter wheat futures contract. The wheat was also not in compliance with the rules of the Chicago Board of Trade (CBOT), which states:

"On contracts for grain for future delivery the tender of the higher grade of the same kind of grain as the one contracted for shall be deemed sufficient, provided the higher grade of grain tendered shall not be of a colour or quality that will depreciate the value of the other, if mixed."208

Hence, the customer defaulted in performing his short No. 2 red winter wheat futures contracts. As a result, the parties with whom he had made the contracts, and whom he had the right to call for delivery, made a large damages claim against the customer. The claims for damages were made on the basis that the tender was irregular and insufficient. Due to these claims, on September 11, 1882, the broker, on behalf of his customer sued the Chicago Board of Trade (CBOT). The customer alleged that the Board of the CBOT had unlawfully combined the wheat so as to prevent sellers like him from fulfilling their short wheat contract. Although the Supreme Court did not adjudicate on the issue of compliance with the required grade and
Rule 1303B.2 of Bursa Malaysia Derivatives Berhad Business Rules emphasises that delivery of crude palm oil must be made in accordance with the Business Rules. It states:

"Where settlement of the Crude Palm Oil Futures Contracts has been determined to be by physical delivery, the tendering and delivery process shall be done in the manner prescribed by the Exchange and the Clearing House."

Rule 1304 of the aforementioned Business Rules further stipulates that the condition and quality of the tendered crude palm oil must be:

"Each tender shall consist of twenty-five (25) metric tons of Crude Palm Oil in bulk unbleached of good merchantable quality as specified in these Rules and stored at a Port Tank Installation located, at the option of the seller, in Penang/Butterworth, Port Klang, Pasir Gudang and such other ports to be declared by the Exchange from time to time."

The quality of crude palm oil is further described in Rule 1317. Under this Rule, crude palm oil must meet the following criteria:

"The contract grade shall be for crude unbleached palm oil of good merchantable quality, in bulk, in approved Port Tank Installations."

In this regard, the following specifications shall be conformed to:

quality, the facts of this case serve as a proof that the purchasers were injured when coerced to settle by cash instead of physical delivery. The injury is exacerbated by the corner in the July wheat market which caused the wheat price to inflate.

In another case, John A. Dussault v Geldermann & Co., Inc., Chicago Mercantile Exchange, et al, the customer, John A. Dussault, through his broker entered into a "feeder cattle" futures contract with Gelderman & Co, a futures commission merchant cum member of the Chicago Mercantile Exchange (CME). The feeder cattle futures contract specified the future delivery dates to be in May and October of 1974. However, at the time of delivering the feeder cattle, the customer alleged that the tendered cattle were inferior and not merchantable. As a consequence, the customer only accepted several lots of cattle outright, later accepting some with reservation of right as to their quality, and finally refusing to accept delivery upon the rest. Upon these allegations, the customer pleaded, amongst others, that there was negligence, intentional misrepresentation, and fraudulent conduct by the futures commission merchant in violation of the United States' Commodity Exchange Act. The customer also pleaded that the CME had breached its fiduciary duty to the customer by promulgating vague rules. The District Court of Utah, unfortunately, did not discuss the issue of default in the physical delivery. Instead it dealt with the issue on the personal jurisdiction of the customer over the CME. On this issue, the court held that CME was only liable to its members and since the customer was not its member, the CME was not liable to any losses suffered by the customer.

The term "tender" is defined in Rule 201 of the said Business Rules as "the exchange of documents through the Clearing House in fulfilment of a Contract of future delivery of Crude Palm Oil and Crude Palm Kernel Oil."

The phrase "Port Tank Installation" is defined in Rule 201 of Bursa Malaysia Derivatives Berhad Business Rules as "the port installations approved by the Exchange as points of delivery for Crude Palm Oil and Crude Palm Kernel Oil tendered in fulfilment of Futures Contracts."
a) the Free Fatty Acid (FFA) content (as Palmitic-molecular weight 256) of palm oil delivered into Port Tank Installations shall not exceed 4% and of palm oil delivered from Port Tank Installations shall not exceed 5%;211

b) the Moisture and Impurities (M&I) content shall not exceed 0.25%;212 and

c) the Deterioration of Bleachability Index (DOBI) value of palm oil delivered into Port Tank Installations shall be at a minimum of 2.5 and of palm oil delivered from Port Tank Installations shall be at a minimum of 2.31,

or such other grades to be declared by the Exchange from time to time, in accordance with sample(s) drawn and analysed on delivery into Port Tank Installations and from Port Tank Installations in accordance with procedures governing sampling and analysis as laid down by the Exchange.”

Similar provisions are also incorporated in the contract specification of crude palm oil futures contract, namely in Schedule 13 of Bursa Malaysia Derivatives Berhad Business Rules.

The quality of the tendered crude palm oil is also guaranteed by the issuance of a Certificate of Quality.213 The Port Tank Installation Owner issues this Certificate of Quality together with a Negotiable Storage Receipt (NSR). Rule 1306 of the Bursa Malaysia Derivatives Berhad Business Rules describes the NSR as follows:

“Rule 1306  Negotiable Storage Receipt

Upon completion of Appraisal of the Crude Palm Oil, the Port Tank Installation Owner shall issue a Negotiable Storage Receipt in the form as approved by the Exchange from time to time, for all Crude Palm Oil, which is deliverable. Such document shall show the name of the Port Tank Installation Owner, the date of appraisal and shall state that the oil in question meets the needs of the Exchange’s specifications for delivery. A separate Negotiable Storage Receipt shall be issued for each lot of twenty-five (25) metric tons of Crude Palm Oil.”

211 According to Khera (1976: 7), most of the palm oil may contain the same fatty acids found in other vegetable oils and fats. The main difference between palm oil and vegetable oil lies in the proportions of saturated and unsaturated acids. The higher the FFA content the lower the usefulness of the oil content. A low FFA is easier to refine and bleach. The refining of poor quality oil involves considerable losses, and even when the FFA content is reduced, the chemical composition of the oil is not as desirable as a good quality oil.

212 The effect of moisture on the FFA is also of importance. If fats are exposed to enzymes in the presence of moisture, partial hydrolysis occurs, thus producing FFA. The presence of more moisture would result in a greater possible extent of hydrolysis: hence, detracting from the quality of the products of palm oil (Khera, 1976: 7).

213 See Rule 201 and 1307 of Bursa Malaysia Derivatives Berhad Business Rules. The validity of the Certificate of Quality is till the midnight of the last day of the appraisal month. This means that the validity period of the Certificate of Quality would practically be in the range of four weeks or so as the tender for the oil would commence from the first business day to the twentieth business day of the delivery month.
Although these provisions expressly stipulate the oil to be of “crude unbleached palm oil in bulk of good merchantable quality,” this phrase is not defined in the crude palm oil futures legal framework. In order to understand the meaning of this phrase, reference is made to a Malaysian case, Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal. This case discusses and interprets the phrase “crude unbleached palm oil of good merchantable quality, in bulk” and, more importantly, the resulting interpretation has been affirmed and upheld by the highest court in Malaysia, the Federal Court.

Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal involves a dispute over the quality of the crude palm oil tendered under the crude palm oil futures contract. This case involved a port tank owner, Fima Palmbulk Services Sdn Bhd (“FIMA”), who was sued by the purchaser of the crude palm oil futures contract, Federal Flour Mills Bhd (“FFM”), for damages incurred as a result of the default in delivering the prescribed quality of crude palm oil. In brief, FIMA was one of the few port tank owners approved by the Commodity & Monetary Exchange of Malaysia (“COMMEX”) to become a point of delivery for crude palm oil traded in COMMEX. Under the trading procedure, when a seller wants to discharge his delivery obligations, the seller will deliver the crude palm oil to any of the COMMEX’s duly approved port tank installations. Before taking delivery of the crude palm oil, the port tank owner must ensure that the delivered crude palm oil is duly appraised.

Upon the completion and satisfaction of the result of the appraisal, the port tank owner will issue the NSR to the seller. The NSR certifies that the crude palm oil has been appraised and that its weight and quality are in conformity with the specifications regulated by the COMMEX rules. The relevant part of the NSR reads as follows:

“1. The said Crude Palm Oil has been duly appraised and is hereby certified, as regards the weight and quality, to be in conformity with the specifications laid down by the Rules and Regulations of the Kuala Lumpur Commodity Exchange (hereinafter referred to as “Exchange Company”).”

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214 The term “merchantable quality” merely means that the goods must satisfy the description in the contract. This is to enable goods tendered under such a description to be of a good tender (n.n.(e), 1922: 377).
215 [2005] 4 CLJ.
216 The matter was first heard by the Arbitration Tribunal, then later in the Kuala Lumpur High Court, followed by the Court of Appeal, and finally the Federal Court.
217 Section 201 of Bursa Malaysia Derivatives Berhad Business Rules define “appraisal” as the weighting, sampling and analysis of crude palm oil.
The seller will then surrender the NSR to the Clearing House for payment of his crude palm oil. The Clearing House would then pass on the NSR to any buyers who had paid for the amount of crude palm oil represented by the NSR.

Returning to the facts of this case, from 30.10.1998 to 19.11.1998, 700 m/t of crude palm oil were delivered by its seller, Guan Soon Heng Edible Oil Sdn Bhd ("GSHE"), to FIMA’s port tank installation for appraisal. Upon completion and satisfaction of the appraisal test, FIMA issued 28 NSRs to GSHE. GSHE then surrendered 28 NSRs to the Malaysian Derivatives Clearing House²¹⁸ (MDCH) for payment. FFM paid for and received the 28 NSRs from MDCH. On 20.11.1998, FFM informed FIMA that they had in their possession 28 NSRs and wished to take delivery of the crude palm oil from FIMA’s port tank installation. Before taking delivery of the said crude palm oil, FFM conducted a test on the oil which resulted in FFM not being satisfied with the oil’s quality.

On 23.11.1998, FFM informed FIMA that the crude palm oil was not of the prescribed contract grade and hence refused to take delivery of the crude palm oil. FFM alleged that the Iodine Value (IV), which forms part of the crude palm oil, was below 50. As a result, FFM brought this matter to the arbitration tribunal to seek damages of RM1,622,250.00. The arbitrators found in favour of FFM and ruled that the crude palm oil was not of the contract grade required under Rule 1409 of COMMEX’s Rules and Regulations and awarded the sum claimed to FFM.

Nonetheless, when the FFM brought the matter to the High Court to enforce the arbitration award against FIMA, the High Court dismissed its application and instead allowed the application by FIMA to set aside the award. The High Court’s decision was based on the following grounds, amongst others: that (i) the arbitrators did not objectively determine the evidence based on market practices; (ii) the IV range between 50 to 55 was not a necessary requirement under the Rules; (iii) FIMA was not responsible for the quality of the crude palm oil as it was merely a bailee and not a seller; and (iv) the crude palm oil was of good merchantable quality because it was proven to be saleable. Dissatisfied, FFM appealed to the Court of Appeal.

²¹⁸ The Malaysian Derivatives Clearing House is now known as Bursa Malaysia Derivatives Clearing Berhad.
After considering the judgements of the High Court and the award of the arbitrators, the Court of Appeal decided only to address the question as to whether the crude palm oil had satisfied the criteria set out in rule 1409. Rule 1409 stipulates that:

“(a) the contract shall be for Crude unbleached Palm Oil of good merchantable quality in bulk, in approved Port Tank Installations.

(b) the free fatty acid content (as Palmitic-molecular weight 256) of Palm Oil delivered into Port Tank installations shall not exceed 4% and of Palm Oil delivered from Port Tank Installation shall not exceed 5% and the moisture and impurities content shall not exceed 0.25%, in accordance with sample(s) drawn and analysed on delivery into Port Tank Installations and from Port Tank Installations in accordance with procedures governing sampling and analysis as laid down by the Exchange Company.”

In addressing this issue, the judges of the Court of Appeal have unanimously approved and adopted the approach taken by the arbitrators in interpreting the phrase “crude unbleached palm oil of good merchantable quality, in bulk”. The arbitrators based their interpretation on the following arguments:

i- The arbitrators contended that rule 1409 must be read disjunctively as it represents two distinct provisions; namely, rule 1409(a) and 1409(b). According to the arbitrators, rule 1409 should be read as follows:

(a) The oil delivered under the contract to be crude unbleached palm oil of good merchantable quality, in bulk, and

(b) The free fatty acid and moisture and impurities must be within the stipulated levels; namely, the free fatty acid content (as Palmitic-molecular weight 256) of Palm Oil delivered into Port Tank installations shall not exceed 4% and of Palm Oil delivered from Port Tank Installation shall not exceed 5% and the moisture and impurities content shall not exceed 0.25%, in accordance with sample(s) drawn and analysed on delivery into Port Tank Installations and from Port Tank Installations in accordance with procedures governing sampling and analysis as laid down by the Exchange Company.219

Based on this method of reading, the arbitrators set aside FIMA’s argument that rule 1409 was to be read conjunctively, which would result in FIMA having met the contract grade specification by meeting the requirement of FFA and M&l.

219 Ibid., at 56.
After determining the disjunctive reading of rule 1409, the arbitrators then attempted to define the meaning of the phrase "crude unbleached palm oil of good merchantable quality, in bulk". The arbitrators dissected the phrase into two limbs. One is that the oil must be crude unbleached palm oil in bulk. Second, the crude palm oil must be of a good merchantable quality.

In interpreting the phrases "crude unbleached palm oil in bulk" and "good merchantable quality", the arbitrators took note of the fact that the buyers who were given the NSR would not have the opportunity to negotiate the quality of the crude palm oil in order to meet their need or purpose of usage of the oil. In addition to that, the arbitrators found it important that the phrase "good merchantable quality" be objectively determined by reference to the established practices and generally accepted market quality. In achieving this, a number of expert witnesses from the crude palm oil industry were called to adduce evidence as to what constituted the quality of crude unbleached palm oil. Six experts were called to testify and the relevant parts of their testimonies are as follows:

a- FFM's first expert witness, Tang Thin Sue had been a chemist in the Palm Oil Research Institute of Malaysia (PORIM) for twelve years. He stated that the characteristics of crude palm oil can be broadly divided into two categories. The first category is referred to as the inherent characteristic of crude palm oil and the other category is the variable characteristic of crude palm oil. The inherent characteristic is important, as without this characteristic, crude palm oil cannot be sold under the description "crude unbleached palm oil in bulk". The inherent characteristic consists of elements such as the IV and Slip Melting Point (SMP). The other category, namely the variable characteristic, involves elements such as FFA and M&I. The FFA and the M&I only affect the quality of the crude palm oil and not its identity as crude palm oil. On the testimony of Tang Thin Sue, the arbitrators made the following findings:

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220 Ibid., at p56.
221 The lower the level of crude palm oil’s melting point, the more solid it will be at a room temperature (Belai, Boakye, Vrakas and Wasswa, 2011: 21).
We accept Mr Tang’s testimony that the IV is an inherent chemical property of CPO and therefore is an inherent characteristic of CPO. The IV value of unbleached CPO in bulk is between the range 50-55. Mr Tang stated unequivocally that commercially produced CPO (crude palm oil), that is CPO produced in bulk from naturally occurring oil palm fresh fruit bunches in Malaysia always has an IV range between 50 and 55. If the IV drops below 50 it could only be because the oil has been contaminated, adulterated or blended.\textsuperscript{222}

b- FFM’s second expert witness, Khoo Yok Lian, testified that if the IV level was less than 50, the buyer may not take delivery. She also stated that if the IV level is 48.7, the quality of the crude palm oil is considered to be below general market expectations.

c- FFM’s third expert witness, Richard Tan Kee Hock,\textsuperscript{223} gave evidence that if the crude palm oil is not in the range of 50 to 55, the oil is not of “good merchantable quality”. He further testified that, because the phrase “good merchantable quality” is not defined in the COMMEX rules, the normal practice is that if this standard is not met, the parties would, via negotiation, adjust for the price difference.

d- FFM’s fourth expert witness, Ong Hai Ching, testified that if the IV level of the crude palm oil is less than 50, the oil may not be Malaysian crude palm oil or it could either be contaminated, adulterated, blended, or from a different geographical region.

e- FIMA’s expert witness, COMMEX general manager, Rajbir Singh, testified that the words “crude unbleached palm oil” and “good merchantable quality” are not defined in the COMMEX rules. This witness conceded that IV indicates a good merchantable quality if it is generally accepted by the traders in the cash market.

\textsuperscript{iv-} Relying on these evidences, the arbitrators found that the IV value in crude palm oil is an important factor in determining whether the crude palm oil would fall within the description of “unbleached crude palm oil of good merchantable

\textsuperscript{222} Ibid, at 56

\textsuperscript{223} Mr Richard Tan Kee Hock claimed that he had 19 years of trade experience, including trading crude palm oil both on the Exchange as well as at the cash or physical market.
quality”. As the IV level found in the 700 metric tons of crude palm oil was below 50, the arbitrators ruled that the crude palm oil had failed to satisfy the first limb of rule 1409, namely that, “the contract shall be for Crude unbleached Palm Oil of good merchantable quality in bulk, in approved Port Tank Installations”.

In this case, FIMA also raised another important point as part of their contention that the crude palm oil had attained a standard of good merchantable quality. They relied on the fact that that the crude palm oil was still saleable. This is because the crude palm oil was later sold to a successful bidder at RM885-00 per mt. although the price was much lesser than what FFM had paid for, at RM2,317-00 per mt. This contention was rejected by the Court of Appeal. The Court of Appeal opined that the saleability of the crude palm oil has no bearing on the question of whether it is of good merchantability quality as the crude palm oil may be saleable with a different grade and a different price. The court referred and applied the observation of Lord Reid in the case of Henry Kendall & Sons (A Firm) v William Lillico & Sons Ltd. And Ors.\(^{225}\) where the judge states that:

"But there are many cases in which different qualities of a particular kind of goods are commonly sold under different descriptions. Suppose goods are sold under the description commonly used to denote a high quality and the goods delivered are not of that high quality but of a lower quality, which is commonly sold under a different description, then it could not possibly be said that the goods in the form in which they were tendered were of no use for any purpose for which those goods would normally be used. They would be readily saleable under the appropriate description for the lower quality. But surely Lord Wright did not mean to say that therefore they were merchantable under the description which was appropriate for the higher quality. They plainly were not.\(^{226}\)

The judges\(^{227}\) also referred to the view of Dixon J in Australian Knitting Mills Ltd v Grant where he said:

\(^{224}\) IV indicates the degree of saturation of an oil or fat. A decrease in IV is generally associated with an increase in melting point (Yusoff, 2000: 801; Corley and Tinker, 2003: 446).

\(^{225}\) [1969] 2 AC 31 at 77.

\(^{226}\) ibid., at 64.

\(^{227}\) The court also referred to the view of Viscount Dilhorne in B.S. Brown & Son v Craiks Ltd. where he states,

"In Hardwick Game Fair v Suffolk Agricultural Poultry Producers Association [1969] 2 AC 3; 31, 75, Lord Reid said that 'Merchantable can only mean commercially saleable'. In the same case Lord Pearce said at p. 118:

'The suggestion, without more, that goods are merchantable unless they are no use for any purpose for which they would normally be used and hence would be unsaleable under that description may be misleading, if it contains no reference to price. One could not say that a new carpet which
"The condition that goods are of merchantable quality requires that they should be in such an actual state that a buyer is fully acquainted with the facts, and therefore knowing what hidden defects exist and not being limited to their apparent conditions, would buy them without abatement of the price obtainable for such goods if in reasonably sound order and condition and without special terms." 228

Hence, relying on these cases, the court of appeal held that, although the crude palm oil was sold at a lower price than the price paid for by the FFM, it only verified the fact that the crude palm oil was of an inferior grade. Hence, the court concluded that the saleability of crude palm oil was no proof that the oil was of a good merchantable quality within the meaning of rule 1409. The Court of Appeal restored the award of the arbitrators. FIMA appealed to the Federal Court but in August 20, 2009, their leave to appeal was rejected and instead the Federal Court upheld the award of the arbitrators.

Following this case, FIMA sued the Exchange. In this case, *Fima Palmbulk Services Sdn Bhd v Bursa Malaysia Derivatives Berhad*, 229 FIMA claimed from the Exchange a sum of RM2,962,800-52 together with interest and cost. FIMA alleged that the Exchange owed them such an amount, as the Exchange had breached its duty to ensure that its crude palm oil contract specifications and requirements under its trading rules were free from any liability. In order to understand this legal duty, it is important to briefly explain the relationship between FIMA and the Exchange. The Exchange operates and provides a trading platform for crude palm oil futures contracts. As part of the crude palm oil futures trading procedure, the Exchange appointed and approved delivery points or designated port tank installations for crude palm oil. These delivery points or port tank installations were authorised to handle and store crude palm oil upon the terms and conditions contained in the Exchange’s standard letter of undertaking. The port tank installation owners undertook with the Exchange that:

"The specification of CPO (crude palm oil) are to be in accordance with the COMMEX’s Rule 1409 CONTRACT GRADE which provides the specifications of CPO of tenderable quality are, (a) The CPO shall be unbleached CPO of good merchantable quality, in bulk; and (b) The free fatty acid content (as Palmitic-molecular weight 256) of Palm Oil delivered into Port Tank installations shall not exceed 4% and of Palm Oil delivered from Port Tank Installation shall not exceed happens to have a hole in it or a car with its wings buckled are of no use for their normal purposes and hence would be unsaleable under that description. They would no doubt, if their price was reduced, find a ready market." 227

228 Ibid, at 65.
5% and the moisture and impurities content shall not exceed 0.25%, in accordance with sample(s) drawn and analysed on delivery into Port Tank Installations and from Port Tank Installations in accordance with procedures governing sampling and analysis as laid down by the exchange company.

Nonetheless, FIMA argued that this provision is not adequate. It relied on the award given by the Arbitration Tribunal which decided that the crude palm oil in FIMA’s port tank installation was not of good merchantable quality as they failed to contain the three desirable levels of specifications; namely, the IV, Slip Melting Point C (“SMP”), and Deterioration of Bleachability Index (“DOBI”). As this decision was upheld by the Federal Court, FIMA claimed that the Exchange had failed to adequately describe in their rules, letter of undertaking and contract grade specifications these three desirable levels of specifications.

On that basis, FIMA claimed that the Exchange owed a duty to FIMA and all other port tank owners that its contract specifications, regulations, and rules were adequate. Furthermore FIMA claimed that these rules should not only be adequate but its compliance must be free from any liability. Based on this argument and the decision of the Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal, FIMA claimed that the Exchange is duty bound to ensure that the IV, the SMP and the DOBI are incorporated as part of the crude palm oil’s standard merchantable quality. By excluding these in its legal framework, the Exchange had breached its duty towards FIMA and the Exchange’s negligence had caused FIMA to suffer loss. FIMA quantified that its damages amounted to RM2,962,800-52. This amount accounted for the FFM’s refusal to take delivery of the crude palm oil from its port tank installation and its losses in the legal suit against the

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230 Ibid., at 5
231 As decided in the case of Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal[2005] 4 CLJ.
232 The melting point is a characteristic property of oil. When a figure for melting point is quoted, it usually refers to “slip point”, indicating the temperature at which melting starts. The melting behaviour is important in determining their suitability for particular uses (Corley and Tinker, 2003: 470). Equally, Yusoff (2000: 801) adds that the melting point is a good parameter to ensure the consistency and quality of the oil’s final product.
233 Corley and Tinker (2003: 460) discuss the characteristics which good quality palm oil must contain: a low FFA content, a low level of contamination with water and other impurities, and a good bleachability. These characteristics interact. For example, a high level of water is likely to increase the FFA and a higher level of FFA leads to a proportionately lower oil yield after neutralisation. Bleachability depends on the carotene content but is more affected by the oxidation of the state of oil, the level of antioxidants, and the contaminations present. High temperatures encourage oxidation, and should be avoided as far as is compatible with storage and shipping requirement. Table A in Appendix II depicts the palm oil products based on the Malaysian standard specifications. Comparison could be made to Table B in the same Appendix where it shows the fatty acid composition of typical Malaysian palm oil and some of the fractioned products.
234 Though FIMA acknowledged the fact that, in 2005, the Exchange rectified the contract to include DOBI, which is one of the three desirable specifications in its crude palm oil futures Contract Specification.
FFM. FIMA’s claim against the Exchange was dismissed by the court on the basis that FIMA’s claim was statute-barred as the cause of action had accrued more than six years. Due to this reason, the issue pertaining to the contract grade specification of the crude palm oil was not dealt with.

On the basis of these two cases, Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal and Fima Palmbulk Services Sdn Bhd v Bursa Malaysia Derivatives Berhad, it is submitted that Rules 1304, 1306, 1317 and Schedule 13 of the Bursa Malaysia Derivatives Berhad Business Rules are not adequate. These provisions do not sufficiently describe the phrase “crude unbleached palm oil of good merchantable quality, in bulk”. To attain this description, a good quality of crude unbleached palm oil must have the desirable levels of namely, the FFA, I&M, IV, SMP and DOBI incorporated. However, currently Rule 1317 and Schedule 13 only contain FFA, I&M, and DOBI.

The importance of a clear contract specification is underscored by the role it plays in determining the futures-spot price relation well before the delivery date (Kamara and Siegel, 1987: 1008). Moreover, according to an interview with two crude palm futures traders in Malaysia on 7th December 2011, the requirement of IV and SMP in the contract specification is to distinguish Malaysian-produced crude palm oil from the Indonesian produced version. The reason is that the quality of Malaysian-produced crude palm oil is higher than its Indonesian counterpart. According to Koswanage (2011: 17), China, the world’s second-largest edible oil shopper, imports Malaysian-refined palm oil as it is of a higher quality and its delivery can be guaranteed. China will only switch to Indonesia if there are shortages in Malaysia. Hence, it follows that to eliminate the element of gharar, the contract specification must clearly provide a “sufficient description of quality, quantity and special requirements of the present as well as future goods” (Zahraa and Mahmor, 2002: 384).

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235 Though IV and SMP are not used to measure the quality of the oil (nonetheless Let (2011: 649) views that IV and SMP form part of palm oil quality), their establishment is fundamental as they determine the authenticity and purity of the oil as well as its uses in edible and non-edible products (Kuntom, 2004: 8). Gorton and Rouwenhorst (2006: 63) rightly argue that the commodity futures contract is different from other financial assets in several aspects. Amongst them, financial assets are held for investment purposes, whereas commodities are produced for use, and derive their value from, ultimate consumption or inputs into the production of finished goods. Hence, their usage in the downstream or finished products makes it more imperative for the crude palm oil to contain the adequate quality which would eventually result in stable and preserved refined oil (Let, 2000: 806).

236 The contract specification is important to any participants in the futures market even though he may never make or take delivery.
To substantiate the above submission, rules 1317 and Schedule 13 also empower the Exchange to modify its contract specification. Pursuant to this power, on June 9, 2005, a circular was issued by the Exchange. This circular had the effect of incorporating DOBI as part of the crude palm oil's contract grade in Rule 1319 of Bursa Malaysia Derivatives Berhad Business Rules. On March 16, 2007, the Exchange yet again revised the crude palm oil contract specification. However this revision only increased the position limits, changed the price limits, and introduced six other contract months into Rule 1302, Para 3.1.1.5 of Schedule 3 and Schedule 13, respectively, in the Bursa Malaysia Derivatives Berhad Business Rules. On November 18, 2009, the Exchange again revised Schedule 13 by incorporating a new provision relating to the settlement of weight differences in the delivered oil. At present, however, there has been no circular issued by the Exchange to the effect of incorporating the other two fundamental elements; namely, the IV and the SMP as part of the "good quality of crude unbleached palm oil".


This case deals with the issue of default in the delivery of quality potatoes on the New York Mercantile Exchange (NYME) on November 1978. From November 6 till

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237 At current, the relevant provision is Rule 1317.
239 See Bursa Malaysia Derivatives Berhad Trading Participant Circular 38/2009.
241 According to the NYME rules, the Maine potatoes must be of grade U.S. No. 1 for par delivery, except that for the April and May contracts "commercial" which are deliverable at a 25% discount from the settlement price for the last trading day of the delivery month. The contract requires two inspections – one by
November 20, 1978, fifty deliveries of potatoes were tendered. All these fifty deliveries passed the inspection in Maine but fifteen failed to pass the inspection at the Hunt Points Terminal Market in New York. Eleven loads failed because of the apparent deterioration since their inspection in Maine. The potatoes reached Hunt Points with high percentages of sunken and discoloured areas that exceeded the Department of Agriculture's (USDA) specifications for U.S. No. 1 grade. Similar defaults took place during the week of March 5 till March 8, 1979. Twenty-nine out of thirty-two loads failed the inspection at the Hunt Points where similar symptoms were discovered in the potatoes.

On March 8, 1979, after numerous meetings held between the NYME and USDA on the matter, the NYME became convinced that the real problem was with the quality of the crop and not with inspection inconsistencies (which was their initial primary concern). Hence, in consequence of the large numbers of potatoes failing to meet delivery standards at the Hunts Point, the Board of NYME declared a market emergency. Due to this, trading halted and contracts were ordered to be liquidated at a certain settlement price. The appellants, being commodities traders, brought this action against the NYME, its governors and officers for certain actions and inactions in relation to the defaulted March, April and May 1979 Maine potatoes futures contracts.

One of the appellants, Wong, claimed that the NYME had failed to amend the Maine potatoes futures contract between the periods of mass default in the delivery of potatoes, namely November 1978 to March 1979. His claim was set aside on technical grounds as the United States Court of Appeal for the Second Circuit found that he had no right to sue the NYME. Nonetheless, it is interesting to note the argument of Wong in support of his application. Wong claimed that the defect in the Maine potatoes futures contract was in the

The potatoes which failed to meet the Exchange specifications suffered from pressure bruises and discolouration. Such defects resulted from conditions during the growing and harvesting season in Maine, the subsequent storage in Maine, as well as the transportation of the potatoes to New York. The longer the potatoes were kept in storage, the more their condition deteriorated. Such deterioration plus the warm weather in the spring was very likely to cause more delivery problems in April and May. The USDA confirmed that the potatoes deteriorated while in transit from Maine to New York. Meanwhile the cash market potatoes, of which cash and futures prices would normally converge to a certain extent, did not rise. This is because the cash market price was based on potatoes from all sources, not just Maine potatoes. Hence, it was marginally affected by the information concerning a potential shortfall in the supply of top-quality Maine potatoes. By the close of trading on March 8, the price of the April and May contracts had reached respectively $7.60 and $8.14 per hundredweight ($3,800 and $4,070 per contract).
contract grade. The prescribed contract grade for the potatoes futures contract is the Maine-grown U.S. No. 1. Notwithstanding the massive default in delivery between the period November 1978 and March 1979, the NYME failed to amend the futures contract by inserting potatoes of other qualities.

In his application, Wong referred to § 5a(10) of the Commodity Exchange Act which allows the exchange to permit the delivery:

"of such grade or grades at such point or points and at such quality and locational price differentials as will tend to prevent or diminish price manipulation, market congestion, or the abnormal movement of such commodity in interstate commerce".244

Wong compared the difficulties in procuring potatoes of grade U.S. No. 1 for the delivery in the futures market, during that default period, with the cash market. In the later market, potatoes could come from many sources and not just Maine-grown U.S. No. 1s.245 The mass failure of delivery also resulted in higher prices for the April and May contracts as news of a possibility of a shortage of deliverable Maine potatoes spread in the market. By the close of trading on March 8, the price of the April and May contracts reached respectively $7.60 and $8.14 per hundredweight ($3,800 and $4,070 per contract). This condition was anticipated as the shorts were faced with difficulties in procuring the gradable Maine potatoes needed to meet their delivery commitments.

In dismissing Wong’s contention, the court states that these sections do not expressly stipulate the duty of the NYME towards the public as to include that of amending the terms of a contract. The court also opined that revision of contractual terms is a matter for the Commodity Futures Trading Commission (CFTC) and the NYME and not for the courts in private litigation.246 In other words, the power to amend lies with these authorities and

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244 In fact, to promote compliance with §5(a), Congress in 1974 empowered the CFTC to order changes in delivery points and to direct changes in price differentials based upon the commodity’s quality or location.

245 Reference was made to the following provisions: (i) § 5(a) of the Commodity Exchange Act which provides that unless otherwise approved by the CFTC, the board of trade shall be “located at a terminal market where any cash commodity of the kind specified in the contracts of sale of commodity for future delivery to be executed on such board is sold in sufficient volumes and under such conditions as fairly to reflect the general value of the commodity and the difference in value between the various grades of such commodity, and where there is available to such board of trade, official inspection service approved by the Secretary of Agriculture or the Commission for the purpose.”; (ii) § 5(g) of the Commodity Exchange Act which states that the board of trade "demonstrates that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest.”

246 The court referred to the CFTC regulation 13.2, 17 C.F.R. § 13.2 which provides that “any person may file a petition with [the CFTC] for the issuance, amendment or repeal of a rule of general application.” Similarly, § 8a(7) empowers CFTC to “alter or supplement the rules of the contract market”, specifically including “terms or conditions in contracts of sale to be executed on or subject to the rules of such contract market.”
even if they proposed for amendments in the futures contracts, there will be certain administrative procedures under the rules which need to be accomplished.

Nonetheless, the infamous mass default of Maine potato futures contract in the midst of 1976 had damaged the NYME’s integrity and reputation. The trading of potato futures contracts was later terminated from the NYME. However on September 1996, potato futures contracts resumed trading on the NYME (AllBusiness.com, 17 September, 1996). This time, contract specification of the deliverable potatoes had been amended. The potato futures contracts were now based on the delivery of 85,000 lbs. of U.S. No. 1 Russet Burbank potatoes, for delivery in Idaho with 2/3rds non-size “A” potatoes packed in 10lb mesh bags, and 1/3rd 70 or 80 count potatoes packed in 50lb cartons (Battley, 2000: 107).

4.4 Conclusion

This chapter has analysed the elements of uncertainty arising from the legal provisions of crude palm oil futures contract settlement. This element of uncertainty is based on the concept of *gharar* as discussed in the earlier *gharar* chapter. This chapter has found that the following elements of uncertainty are central to the disputes relating to contract settlement of commodity futures contracts. The elements are: (i) the lack of knowledge in the attributes of the emergency settlement price; (ii) the failure of the seller to deliver the underlying commodity; (iii) the underlying commodity being incapable of delivery; and (iv) the quality of the underlying commodity being insufficiently described. Based on the examination of these issues, this chapter reaffirms the finding of the earlier chapter that, inconsistent with the stance of the SAC, *gharar* permeates through crude palm oil futures contract and that it has not been eliminated by the legal framework of crude palm oil futures contract.

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247 When acting within § 5a(10), the Commission must first notify the exchange of its concern and afford the exchange an opportunity to make appropriate changes. If the exchange, after such notification, fails to act, the statute authorises the Commission to change or supplement the contract rules, but only after granting the contract market an opportunity to be heard. Ibid., at 668.
CHAPTER FIVE

Reasons for *Maysir* in the Futures Margin System, Offsetting Transaction, and Futures Speculation

5.1 Introduction

This chapter sets out to investigate the element of *maysir* in the crude palm oil futures margin system, offsetting transaction, and futures speculative trading. *Maysir*, or gambling, is one of the foremost prohibitions in any contractual dealings in Islam. The SAC have resolved that the crude palm oil futures contract is free from any elements of gambling. This position is inconsistent with the IFAM and the AAOIFI, both of which have resolved otherwise. The debates on *maysir* in these resolutions centre around two important apparatus in the commodity futures contract, the futures margin and the offsetting transaction.

On this basis, this chapter will analyse the operation of the futures margin system and the offsetting transaction. The futures margin system is comprised of the initial margin, maintenance margin, variation margin, margin call, as well as marking to market. The futures margin system and the offsetting transaction serve as the vehicles for speculative trading in the crude palm oil futures market. Hence, speculators and their speculative trading will also be examined. The thrust of this analysis is premised on the notion that Shari'a scholars are not against the commodity futures contract being utilised as a risk management tool but only when it is used as a gambling tool. As gambling is strictly prohibited, so is any form of *maysir*-tainted business activities.

This chapter will examine whether the elements of *maysir* - namely, betting, chance, gain of one party at the loss of the other party, unlawful acquisition of wealth, as well as hatred and enmity - are to be found in the futures margin system, the offsetting transaction and futures speculation. This research adopts a similar method of analysis, as applied in the *gharar* chapter. Finally, this chapter seeks to establish that, inconsistent with the stance of the SAC, the futures margin system, the offsetting transaction, as well as futures speculation, are contaminated with *maysir* elements, and hence are forbidden.
Maysir is explicitly prohibited in the Qur'an. Chapter Al-Baqarah (Hereafter), verse 219 warns that:

“They ask thee concerning wine and gambling. Say: In them is great sin, and some profit, for men; but the sin is greater than the profit.” They ask thee how much they are to spend, say: “What is beyond your needs.” Thus doth God make clear to you His Signs: in order that ye may consider.”

This verse was revealed at a time when the game of chance called *al-maysir* was prevalent in society. It is said that *al-maysir* envisaged an element of charity whereby proceeds gained from *al-maysir* were distributed amongst the poor. However, this charity spirit was gradually forgotten when *al-maysir* became a means of business without any consideration of munificence. The people then began to gamble with all their property and hence this resulted in people becoming destitute and penniless (Siddiqi, 1981: 137).

Chapter Al-Māïda (The Table), verses 93 and 94 promulgate the *maysir* injunction. Allāh says:

“O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by), arrows, are an abomination of Satan’s handiwork: eschew such (abomination), that ye may prosper.”

“Satan’s plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of God, and from prayer: Will ye not then abstain?”

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248 This game involved the slaughtering of numerous beasts, generally camel. The beast was cut into ten parts, of which the parts consisted of the thighs and shins of both the fore and rear legs plus two shoulders. The head and feet were given back to the butcher and the remaining inferior pieces were distributed proportionately into these ten parts. These parts were then represented by seven arrows and, by taking turns, the player inserted his left hand into the quiver containing these arrows till the arrows representing these ten parts were diminished. The arrows that were used in this game of chance were of two types:

1. Seven winning arrows (*anšibā‘*), each bearing a name and with notches (*fard* or *hazz*), by which they were identified; and

2. Three or four white arrows (*ghulf, aghfāl*), neither winning nor losing. The white arrows bore no notches and their purpose consisted in slowing the game and making it more difficult. This is because every time one of the white arrows was drawn, it was immediately replaced back into the quiver, making the chances of drawing the winning arrows consistently more difficult.

This game consisted of seven players, no less or no more. If the number was fewer than seven, the players had to buy the remaining parts in order for the game to take place. The player who bought the remaining parts was called *al-Tamīm*, “he who completes”. When he won twice in succession, he was called *mutammin*, generously donating his winning to his entourage. This act of charity was also carried out by any players who purchased the parts that had not been won and gave them to the poor (Bosworth, et al., 923).
The mentioning of *al-maysir* together with other sinful conducts - namely, intoxicants (*al-khamr*), idolatry (*al-anṣāb*), fortune telling, and divining arrows (*al-azlām*) - are evidence for *Shari‘a* scholars to view all forms of *al-maysir*, conducted through card games, dice, games that involves risk, as strictly forbidden (McAuliffe, 2002: 281). Though *maysir* elements are conspicuous in these kinds of games, they may not be so in a pseudo sale transaction. The commodity futures contract is one of those instances. The next section adumbrates the divergence between the SAC on the one hand, and the IFAM and AAOIFI on the other, on the existence of *maysir* issues in commodity futures contract.

5.3 Divergence on the Issue of *Maysir* in the Commodity Futures Contract

The SAC resolves that the crude palm oil futures contract is free from any elements of gambling. In arguing that this is so, the SAC refers to the deposit or the initial margin payment imposed on a futures market trader before the start of a trading. Notwithstanding the fact that others view this initial margin payment as a form of prohibited bet, the SAC views it otherwise, as:

"... the fluctuation of the value occurs due to the change in demand in the crude palm oil futures markets. It is also a common phenomenon in the trading world. It is not appropriate to judge a contract whose value fluctuates due to the changing demands for crude palm oil futures market as a gambling activity. This is because gambling activities depend solely on luck and are not related to demand and offer." (2006: 76)

In contrast, the IFAM resolves that the commodity futures contract is tainted with elements of gambling, exploitation, and unlawful devouring of the property of others. The IFAM reasons that commodity futures contracts are, by and large, paper transactions and are not genuine purchases as they do not involve real delivery and/or possession of the underlying commodities. It is also because the parties in the futures contract gain profit by giving and taking the price difference, similar to gamblers who undertake risk in a zero sum game.

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249 A similar note of abhorrence is shown in Aristotle's categorisation of gamblers where gamblers were held at the same level as thieves and robbers. The only difference is that thieves and robbers took great risks in their trade but the gamblers instead took money from their friend whom they should be helping (as cited in Jones, 1973: 16). This is the reason why in Islam, gambling is seen as a means to gain property from others easily and unfairly.

250 A similar position is taken by the IFAJ, though its resolution is not particularly on the commodity futures contract but on indices trading. Index trading involves the sale and purchase of an index of stocks or bonds or commodities market. The IFAJ resolves that index trading is not permissible as it is pure gambling and it constitutes the sale of something fictitious (something that does not exists) (Islamic Research and Training Institute, 2000: 133). Likewise, the AAOIFI (2010: 487) resolves that *Shari‘a* prohibits trading in indices or
Likewise, the AAOIFI (2010: 372) prohibits the commodity futures contract as it transgresses the contract requirement, and it results in procuring the property of others unjustly.

These two opposing views implicate two fundamental trading mechanics in the commodity futures contract or, for that matter, the crude palm oil futures contract. They are the futures margin system and the offsetting transaction. For this reason, this chapter will analyse whether these two apparatus contain any elements of *maysir*. To do so, the notion of *maysir* needs to be understood. Hence, the next section discusses its definitions and concept.

### 5.4 Maysir: Its Definition and Concept

Literally defined, *maysir* refers to an ancient Arabian game of chance played with arrows without heads and feathering, for the stakes of slaughtered and quartered camels (Cowan, 1979: 1107). According to Al-Shawkānī, by playing this game, the winner gets an easy gain, by means of gambling, in the meat of this slaughtered animal (as cited in McAuliffe, 2002: 280). The nature of this game is reflected in its root word, *yasira*, which means to be or become easy, to live in an easy circumstance, or to be or to become rich, lucky, and or fortunate (Cowan, 1979: 1107). Al-Zamakhsharī denotes the word *al-yasar* to *al-ghina* (meaning wealth) which reflects "gambling (is) to grab someone's property" (as cited in McAuliffe, 2002: 280). According to Ibn Sīrīn, *maysir* applies to every practice in which there is an element of chance (Houtsma, et. al., 1987: 156).

Taking or receiving money on the mere occurrence of certain readings of the index. Such dealings are prohibited even if it is practiced for the sake of hedging against potential risk. The basis for such a prohibition is that the dealing is done without the selling or buying of real assets, which the index represents, or any other type of asset. It is nothing more than the payment or receipt of money for the mere existence of a certain reading or figure. It is a form of gambling and an illegal act of gaining money.

251 This notion is based on the Qur'ānic verse 29, chapter 4 (*al-Nisa*), in which Allāh says, "Eat not up your property among yourself with injustice, but let there be amongst you traffic and trade by mutual consent." The AAOIFI (2010: 365) also invalidates the determination of the commodity futures contract in any of its modes of settlement; namely, by way of liquidation between the parties or a cash settlement or through a counter-contract.

252 The meaning of *yasira* perhaps could be argued to connote the nature of humans which is impatient with delays of regular work. It wants to acquire earnings in one stroke, without trouble, and without the laborious accumulation of gradual earnings (Hastings, 1971a: 164).
Apart from *maysir*, a game of chance is also referred to as “*al-qimar*”. *Al-qimar*\(^2\) literally means gambling, bet or wager (Cowan, 1979: 1107). Technically, it connotes the taking of ownership by way of a wager (ISRA, 2010: 276). Al-Jurjānī defines *qimār* as “taking one thing after the other from one’s partner in a game” or “a game with the condition that the winner (*ghālib*) of two contestants gets some thing from the loser (*maghlūb*)” (as cited in Rosenthal, 1975: 3). Ibn al-ʿArabī describes *qimār* as “Each one of two (contestants) seek to defeat his partner in an action or statement in order to take over property set aside for the winner” (as cited in Rosenthal, 1975: 3). Abu Habib defines it as “every game over property which the winner takes from the loser” (as cited in Kamali, 2002: 152). Ibn Manzūr says that it also refers to *al-murāhanah*, which is equivalent to *mukhātarah*, meaning “the taking of risk” (as cited in Hashim, 2003: 310).

Though *qimār* and *maysir* have their own independent definitions, they are used interchangeably in the literature to describe gambling activities. For the purpose of this study, the term *maysir* will be used throughout this chapter. This is based on the views of Ibn Sirīn, Mujāhid, and ‘Atā’ that, “everything involving a stake (*khatar*) belongs to *maysir*, even the walnut game of children…” While Ash-Shāfiʿi says: “…*maysir* is something that necessitates paying out or obtaining property.” (as cited in Rosenthal, 1975: 77).

The classical interpretation of *maysir* is echoed in the contemporary work. *Maysir* or gambling is described by Kamali as:

> “a combative relationship between two contracting parties, each of whom undertakes the risk of loss and the loss of one means gain for the other…Gambling also consists of an appeal to chance, and making chance the arbiter of one’s conduct is to subvert the moral order and stability of life.” (2000: 151).

Similarly, Rahman (1979: 115) describes gambling as a game of chance because it is based on the principle that the gain acquired or the loss suffered by the player is dependent upon luck or chance unless there is fraud. But even if there is no fraud, the player’s gain is unearned and the player’s loss is by a mere chance. El-Din and Hassan refers to gambling as a:

\(^2\) The Arabic noun *al-qimār* derives from the word *qamar* (the moon) which increases at times and decreases at other times. It has been given this name due to the possibility that gamblers may at one time lose their wealth and, at the other time, gain wealth from their counterparties (Ahmad, 2010: 100).
two or more person game of chance which ends up in redistributing the total stakes committed by these players. It is purely a competitive zero sum game amongst the parties. Although it is a game of chance, it has one sure outcome, excitement for one party and displeasure and vexation for the other.” (2007: 246)

Likewise Salamon denotes gambling as:

“the betting of something of value, with unnecessary risk, hope of gain based on the elements of chance and uncertain events that involves to a certain extent economic manipulation and on occasion, loss of context of economic reality.” (1998: 221)

Equally, the SAC (2006: 104) defines gambling as:

“any activities which involve betting, whereby the winner will take the entire bet and the loser will lose his bet...Gambling activities … depend solely on luck and are not related to demand and offer” (Securities Commission, 2006: 104).

The International Shari’ah Research Academy (2011: 183) defines gambling as any activity which involves betting whereby the winner will take the entire bet and the loser will lose his bet.

Based on the above definitions, maysir can be discerned by the following elements: betting, chance, unlawful gain of one party at the expense of the other party and unlawful misappropriation of one’s property. Additionally, as expressly stipulated in the Qur’ān, namely, Chapter Al-Māida (The Table) verse 94, maysir spurs the element of hatred or enmity between the contesting parties. Therefore, the question now is whether these elements exist in the crude palm oil futures margin system and the offsetting transaction. If it does, the futures margin system as well as the offsetting transaction are maysir transactions and hence are religiously condemned. Otherwise they are not. The following section attempts to address this critical question.

5.5 The Elements of Maysir in Crude Palm Oil Futures Contract

This section is divided into two parts. The first part examines the futures margin system which is then followed by the identification of maysir elements in this system. The second part of this section deals with the offsetting transaction and, accordingly, the identification of maysir elements in this transaction.
5.5.1 Futures Margin System

Rule 1 of Bursa Malaysia Derivatives Berhad Business Rules defines margin\textsuperscript{254} as:

"initial margin, being payment or deposit from a Clearing Participant\textsuperscript{255} as security for non-performance by that Clearing Participant of obligations under all Open Contracts\textsuperscript{256} to which that Clearing Participant is a party."

This initial margin must be paid by each and every contractual party prior to trading. Rule 614.1(b) of Bursa Malaysia Derivatives Berhad Business Rules stipulates that:

"A Trading Participant\textsuperscript{257} or Associate Participant\textsuperscript{258} shall not accept orders for new Contracts from a Client\textsuperscript{259} unless the minimum initial margin for the Contracts is on deposit or is forthcoming within such period as may be prescribed by the Exchange from time to time after a call for initial margin has been made by the Trading Participant or Associate Participant."

The initial margin amount must be maintained throughout the party holding a futures position in the crude palm oil futures contract. Rule 614.1(a) of Bursa Malaysia Derivatives Berhad Business Rules requires that:

"Every Trading Participant or Associate Participant shall obtain from its Clients a minimum initial margin and maintain the amount of minimum margins on all Open Contracts."

\textsuperscript{254} Rule 614.2 of Bursa Malaysia Derivatives Berhad Business Rules and Rule 613(c) of Bursa Malaysia Derivatives Clearing Berhad provide that the margin payment may be in the form of cash, letters of credit, bank guarantees and any other approved securities, and forms as the Exchange and Clearing House may from time to time prescribe.

\textsuperscript{255} Clearing Participant means “a Trading Participant or an Associate Participant who is a participant of the Clearing House for the closing, settlement and exercise of Contracts”. See Rule 201 of Bursa Malaysia Derivatives Berhad Business Rules.

\textsuperscript{256} Open Contract means “a Future Contract or Option between a Clearing Participant and the Clearing House which has not been extinguished or terminated in accordance with the Rules.” See Rule 1 of Bursa Malaysia Derivatives Clearing Berhad Business Rules.

\textsuperscript{257} Trading Participant means “a Corporation holding any or all Preference Shares which shall be referred to as Equity Participant, a Non-Equity Financial participant or a Commodity Participant (as the case may be) and has been admitted as a trading Participant in accordance with these rules and has not ceased for any reason to be a Trading Participant.” See Rule 201 of Bursa Malaysia Derivatives Berhad Business Rules.

\textsuperscript{258} Associate Participant means “a Corporation which has been admitted as an Associate Participant in accordance with these Rules and has not ceased for any reason to be an Associate Participant.” See Rule 201 of Bursa Malaysia Derivatives Berhad Business Rules.

\textsuperscript{259} Client means “...a person on whose behalf the Trading Participant trades or proposes to trade, or from whom the Trading Participant accepts instructions to trade in Contracts.” See Rule 201 of Bursa Malaysia Derivatives Berhad Business Rules.
Positions and these margins shall be at least equivalent to the amount of margins required by the Clearing House. In addition to this initial margin payment, contractual parties are required to make additional margin payments, namely the variation margin payment, upon them receiving a margin call from the Clearing House. In order to do that, Rule 614.1(c) of Bursa Malaysia Derivatives Berhad Business Rules provides that:

"Each Client's Open Position must be marked to market daily and additional call for margins must be made if necessary."

The method of marking to market is made daily by marking or assigning each of the outstanding futures positions to the daily settlement price. According to Rule 611 of Bursa Malaysia Derivatives Clearing Berhad Business Rules, the daily settlement price is the price in which:

"The Clearing House will determine the Daily Settlement Price for each open Contract in accordance with its procedure. Such procedure must provide for consideration to be given to any bids, offers and traded prices quoted by an Exchange and such other information as may be deemed relevant by the Clearing House."

The marking to market is the lynchpin of the futures margin system. King explains that:

"Marking-to-market means that a futures contract can, in effect, be seen as a series of one-day forward contracts, each one having the previous business day's future settlement price as its maturity value. For each day, a party loses money through its variation margin if the settlement price has moved against it since the day before, and it gains if it has moved in its favour." (1999: 155)

The fluctuation of the crude palm oil futures price and the marking to market is what triggers the Clearing House to make a margin call. This call is, in an actual sense, a demand by the Clearing House to the affected contractual parties to make the variation margin payment, this being the difference between the current daily settlement price and the previous day settlement price. In order to make this call, Rule 614 (a) and (b) of Bursa Malaysia Derivatives Clearing Berhad Business Rules prescribes that:

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260 Open Position means "the position of a party under a Contract whose rights or obligations have not expired or been discharged or where the rights and/or obligations under that Contract are yet to be fulfilled." See Rule 201 of Bursa Malaysia Derivatives Berhad Business Rules.

261 Similar to the purpose of the margin payable to the Exchange, the Clearing House's margin is also to be held as security against the non-performance of the contractual obligation of its clearing participants or members. See Rule 613 of Bursa Malaysia Derivatives Berhad Business Rules.
“(a) On each Business Day, the Clearing House must make available to each Clearing Participant a statement advising the Clearing Participant of funds (if any) which must be paid to the Clearing House on the same day and showing the Margin which must be lodged with the Clearing House…”

(b) The Clearing House is entitled to set off any amount due from a Clearing Participant to the Clearing House against any amount due from the Clearing House to the Clearing Participant.”

It is important to note that this margin call is only exacted to the contractual party whose amount of initial margin has gone lower than the prescribed level. This level is known as the maintenance margin.262 This may happen on two occasions. First, when the current daily settlement price is determined to be lower than the previous days. The Clearing House will then extract the difference between the current and previous settlement price from the amount of the initial margin of the buyer and transfer this difference amount to the account of the seller. Second, when the current settlement price is determined to be higher than the price of the previous day, the Clearing House will extract the difference from the initial margin of the seller and transfer this difference amount to the account of the buyer.263

5.5.1.1 Maysir Elements in the Futures Margin System

From the examination of the futures margin operation system, maysir could be located in the following areas:

(i) At the time of making the initial margin payment, both contractual parties do not know the future daily settlement price or the direction of the crude palm oil futures

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262 The level of the maintenance margin is in fact lower than the initial margin.
263 Hull (1997: 20) illustrates the process and effect of marking to market to the parties’ account, “At the end of each trading day, the margin account is adjusted to reflect the investor’s gain or loss. This is known as marking to market the account. Suppose for example, that by the end of trading June 3, the futures price has dropped from $400 to $397. The investor (who goes long) has lost $600 (200 ounce of gold x $3 the amount of loss). This is because the 200 ounces of December gold, which he or she contracted to buy at $400, can now be sold for only $397. The balance in the margin account would be reduced by $600. Similarly if the price of December gold rose to $403 by the end of the first day, the balance in the margin account would be increased by $600. A trade is first marked to market at the close of the day on which it takes place. It is then marked to market at the close of trading on each subsequent day... When there is a $600 decrease in the futures price so that the margin account of an investor with a long position is reduced by $600, the investor’s broker has to pay the exchange $600 and the exchange passes the money on to the broker of an investor with a short position. Similarly when there is an increase in the futures price, brokers for parties with short positions pay money to the exchange, and brokers for parties with long positions receive money from the exchange.” In other words, the clearing house acts as a conduit to enable the flow of cash from one party to the other.
price. Due to this uncertainty, the initial margin payment signifies as bets, placed by both parties, on the future daily settlement price or the direction of the crude palm oil futures price.

(ii) The next day’s daily settlement price is the determining factor on who is to receive the variation margin, namely the differential amount, from the other contractual party via the Clearing House. As a result, this payment, known only on the following day, arises purely out of chance and or luck.

(iii) The variation margin payment which the loser has to pay is exactly the same amount of money which the winner gets. This payment is made not for the delivery of crude palm oil or any counter values but merely on the changes in the price of the crude palm oil futures contract. Hence, the basis for gaining money from the loser is unlawful as the winner’s gain is made at the loss of the loser;

(iv) The variation margin payment which is paid by the loser to the winner is based on chance. Therefore the payment which the winner receives amounts to unlawful misappropriation of the loser’s wealth;

(v) The loss suffered by the loser on the basis of chance and luck engenders hatred and enmity in the loser towards the winner.

The following section examines the offsetting transaction and its modus operandi. This examination will accentuate the maysir elements contained in the transaction.

5.5.2 Offsetting Transaction

As described in Chapter three, the eligible delivery agreement allows parties to discharge their contractual obligations prior to the expiry of the contract. This can be done by a process known as offsetting. Rule 608 of Bursa Malaysia Derivatives Clearing Berhad Business Rules stipulates the manner of offsetting as follows:

"608 Liquidation by offset

a) A Clearing Participant who is Buyer to an Open Contract and a Seller to another Open Contract the terms of which are identical in all aspects but not necessarily price and contract date, and both Open Contracts are recorded in
either the Unsegregated Account\(^{264}\) and in the same Sub-Account\(^{265}\), of that Clearing Participant, may request the Clearing House to liquidate by offsetting the rights and obligations under those two Open Contracts.

b) Upon two Open Contracts being off-set pursuant to Rule 608(a), any settlement difference, as calculated by the Clearing House, becomes immediately due by the Clearing Participant or the Clearing House, as the case may be.

c) Requests for liquidation by off-set in accordance with this Rule 608 must be submitted to the Clearing House in such manner and on such terms as may be determined by the Clearing House, from time to time."

Offsetting entails the discharge or liquidation of one’s futures obligation. This is done by the party entering into a new eligible delivery agreement with a new party, taking an opposite position to his/her current position. In addition to that, this mode of settlement essentially causes one party to pay the other contractual party, via the clearing house, the difference between the current and previous settlement price of the crude palm oil futures contract. The obligation to pay the differential payment depends on the futures position of the parties. The buyer will make a profit or receive the differential payment if the futures price rises. The seller, on the other hand, will make a profit if the futures price falls (Blake, 2000: 240).

5.5.2.1 Maysir Elements in the Offsetting Transaction

Similar elements of maysir, as recognised in the futures margin system, are found in the offsetting transaction. They are as follows:

(i) The entry into a new eligible delivery agreement is not made to pursue a real sale and purchase of crude palm oil but is in fact to accommodate the remittance of betting proceeds from the loser to the winner;

(ii) The differential payment received by the winner from the loser via the Clearing House is not made on the basis of an exchange of counter values, namely the delivery of the crude palm oil and its purchase payment. Instead it is made purely

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\(^{264}\) Unsegregated Account means an account maintained by the Clearing House in the name of a Clearing Participant and established under Rule 604. See Rule 1 of Bursa Malaysia Derivatives Clearing Berhad Business Rules.

\(^{265}\) Sub-Account is defined as an account maintained by the Clearing House within the Segregated Account of a Clearing Participant bearing such identification as advised by that Clearing Participant. See Rule 1 of Bursa Malaysia Derivatives Clearing Berhad Business Rules.
on the basis of the winner’s bet on the direction of the daily settlement price of the crude palm oil futures contract. Hence, the payment received by the winner amounts to an unlawful misappropriation of the loser’s wealth;

(iii) The differential amount received by the winner is exactly the same amount of money which the loser has lost to the winner. Hence, the winner’s gain is unlawful as it is made at the loss of the loser;

(iv) The loss suffered by the loser is purely based on chance and or luck. This kind of winning engenders hatred and enmity in the loser against the winner.

The discovery of the above element of *maysir* in the futures margin system and the offsetting transaction is further distilled in the following section.

5.6 *Maysir* Elements in the Futures Margin System and the Offsetting Transaction

The ensuing analysis is predicated on the premise that the objection of *Shari'a* scholars towards the futures contract is not because it is being used as a tool of risk management but because it is being used as a tool of gambling (Obaidullah, 2005: 34). It is also premised on the fact that gambling, in all its forms, is forbidden; hence any business activities which contain any elements of gambling are prohibited (Algaoud and Lewis, 2007: 39).

5.6.1 Betting

The New Palgrave Dictionary of Money & Finance describes betting as:

"the process whereby individuals voluntarily wager a sum of money or item of value on the uncertain outcome of an event. This process frequently arises to resolve differences of opinion, among various parties, concerning the likelihood of a probabilistic event. There are two principal types of betting: (i) bets against nature; and (ii) bets based on subjective probabilities. Examples of the first type include various casino games (roulette, twenty-one) in which the winning probabilities are known *a priori*. The second type refers to wagers in which the

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266 Probability is the expedient devised to overcome the insufficiency of coarse logical classification. Hence subjective probabilities overcome the unquestionable gap between the certain and impossible, the dubious taking into account of the continuous range of degrees of doubts and degrees of beliefs. It is, in fact, a daily psychological experience. The theories under subjective probability characterise human physiological, consistent, and rational behaviour under uncertainty (Sills, 1972b: 499).
winning probabilities are unknown – for example, bets on professional sporting events. For this form of betting, individuals face both risk and uncertainty. Since the winning probability is unknown, the betters assume the risk if they determine that the odds offered understate the true probability of winning. Bets against nature offer no opportunity for improved payoffs even if the better acquires additional information. However, bets based on the subjective probabilities may yield improved earnings if the better can obtain and utilise relevant information.” (1992: 195)

This definition underlies a critical question - whether payment of an initial margin assimilates betting on an uncertain outcome of an event – the future price of the crude palm oil futures contract – in which the probability of winning is unknown?

According to the SAC, the initial margin payment is not a prohibited bet as:

“... the fluctuation of the value occurs due to the change in demand in the crude palm oil futures markets. It is also a common phenomenon in the trading world. It is not appropriate to judge a contract whose value fluctuates due to the changing demands for crude palm oil futures market as a gambling activity. This is because gambling activities depend solely on luck and are not related to demand and offer.” (2006: 76)

Similarly, Kamali (2000: 176) contends that margin payment is allowed as it represents a margin deposit, an equivalent to a good faith deposit. This margin, which is deposited in the broker's account, is to ensure the integrity of the transaction is protected. Correspondingly, the previous Chief Executive of the Kuala Lumpur Commodity Exchange, Syed Abdul Jabbar Shahabudin (1994: 3) maintains that the futures margin system assures contract integrity and financial stability in the market place. Rule 1 of Bursa Malaysia Derivatives Berhad Business Rules amplified the role of the initial margin as a security against the non-performance of contractual parties. To attain this, marking to market is executed to indicate to the contracting parties, whether their account is in their favour (in the money) or not in their favour (out of money) (Khorshid, 2009: 257). This begs one to question the position of such a deposit in the Shari‘a.

5.6.1.2 Hamish jiddiyah

Kunhibava (2009: 243) posits that in Islamic commercial law, the futures margin payment is analogous to hamish jiddiyah. 267 Hamish jiddiyah is referred to as:

267 The suggestion of the futures margin to be similar with hamish jiddiyah is based on her interview with one of the Shari‘a advisors, though she does not expound on the area of hamish jiddiyah in her thesis.
“margin reflecting firm intention of the promisee – earnest money taken from a person who intends to purchase a commodity from or enters into a contract with anyone to confirm its sincerity to actually purchase the commodity when offered. In the case of breach of promise, the promisee has the right to recover his actual loss incurred due to the breach.” (Ayub, 2007: 488)

In the current practice of Islamic finance, financial institutions hold this token money as a form of trust and adjust it with the sale price, at the time when the sale is executed. *Hamish jiddiya* is paid before the execution of a sale agreement but it does not form part of the object price. The whole purpose of having *hamish jiddiyah* is for the victimised party to recover any actual loss, excluding losses with respect to the cost of funds, incurred in honouring the promise to purchase the sale of the object. Any excess after such a deduction will be returned back to the promisee (Ayub, 2007: 116). A similar description is given by the AAOIFFI (2000: 18). *Hamish jiddiyah* is applied in the case of a binding promise. Hence, in the event of default, the promisor need not demand compensation from the promisee as this may then be charged against the account of *hamish jiddiyah*. With the consent of the promisee, *hamish jiddiyah* can be invested as an investment trust on the basis of *mudarābah* between the promisor and the promisee.

Although initial margin and *hamish jiddiyah* play a significant role as risk management tools in securing the performance of contractual obligations, they inevitably bear dissimilarities. It is submitted that this dissimilarity presents the futures margin system as a tool for betting. Firstly, the amount of initial margin fluctuates relative to the movement of the crude palm oil futures price while the amount of *hamish jiddiyah* remains fixed. Secondly, initial margin is paid out not as a compensation payment for a default in the buyer failing to purchase the crude palm oil but because the buyer or the seller, as the case may be, has bet on the wrong side of the price movement.

Thirdly, *hamish jiddiyah* relates to the real purchase of the subject matter of the contract - to compensate and reinstate the party’s position to his original status quo before the purchase. However, in reality, only five per cent of crude palm oil futures trading ends with a real purchase of the oil. In this circumstance, it is obvious that initial margin is not actually meant to cover losses due to a default in the actual purchase of crude palm oil. Finally, the affiliation of the initial margin with marking to market and the variation margin, with daily paying into and paying out, of the account of contractual parties, accentuate the dissimilarities between the futures margin deposit and that of *hamish jiddiyah*.
Although initial margin is said to be a security tool for an efficient futures market, it is submitted that it is also being used as a betting mechanism to wager on the future direction of the crude palm oil futures price. This may not have been the case if the initial margin operated independently and solely on securing the contractual parties from any default of delivery. Instead, initial margin operates together with marking to market, margin call and variation margin. This framework alludes to betting on the future course of the crude palm oil futures price. Syed Abdul Jabbar Shahabudin clearly elucidates the ramifications of the futures margin system on the parties’ gains and losses. He says:

"Futures contracts are marked-to-market daily by the clearing house and the winners are paid for the paper profits and the losers have to pay for the paper losses in the form of variation margins. To ensure that losers have the money, the clearing house requires that they pay initial margins or earnest money when they establish positions. The combination of initial margins and variation margins ensures that players in the market have sufficient funds to meet their obligations." (1994: 3)

This explanation falls squarely within the IFAM’s resolution on the commodity futures contract. The IFAM resolves that the commodity futures contract is tainted with elements of gambling as they are, by and large, paper transactions. They are also not genuine purchases as they do not involve the real delivery and taking possession of the underlying commodities (as cited in al-Amine, 2008: 14).

According to Blake, the daily system of marking to market, which results in the gains and losses of the contractual parties, is an express demonstration that:

"Futures trading is exactly like betting with a bookmaker²⁶⁸ (in this case the clearing house) on the price of the underlying good, with daily clearing bets." (2000, 241)

Similarly, Gorton and Rouwenhorst maintain that:

"A futures contract is thus a bet on the futures spot price, and by entering into a futures contract, an investor assumes the risk of unexpected movements in the futures spot price." (2006: 48)

²⁶⁸ In this situation, Chen (2006: 3) argues that a bookmaker is like a market maker in the betting market. It can at the same time be a bridge between two punters.
Likewise, the International Encyclopedia of the Social Sciences states that:

"Elements closely parallel to gambling appear in conjunction with economic activities, especially those in which risk and uncertainty are prominent. In effect, speculators on the commodity markets bet against each other about the rise or fall of commodity prices." (Sills, 1972a: 53)

Similarly, Stout articulates that:

“These sorts of commercial wagers are neither new nor particularly innovative...Originally, most commercial derivatives were bets on the future prices of agricultural commodities, like the rice derivatives traded in Japan in the fifteenth century or the corn and wheat futures still traded on the Chicago Mercantile Exchange today. To use the language of derivatives traders, the ‘underlying’ - that is the thing being bet upon - was the future market price of rice, wheat or corn.” (2009: 5)

This position is echoed by a well-known Shari’a scholar, Yusuf Talal DeLorenzo who states:

“Generally speaking, a futures contract is a bet on which way prices will move. The attraction of such contracts to investors is that they, like short-selling and buying on margin, promise big profits. On the downside, however, the possibility of significant losses cannot be ignored...none of this even remotely resembles the way envisioned by the Shari’a for the proper conduct of business.” (2004: 23)

5.6.2 The Element of Chance

The word “chance” derives from the Latin verb cadere, meaning to fall, which is a possible reference to the fall of a dice. Therefore, in the throwing of a dice, the result in every instance is due to chance in the sense that no uniformity of sequence between the antecedent and consequent can possibly be discovered however carefully and patiently one may experiment with the various conditions involved (Hastings, 1971b: 355). The Encyclopaedia of Religion and Ethics Encyclopaedia describes “chance” as:

“a complex of causal elements, in which indefinitely various combinations are possible, and each distinct combination yields a distinct result. Inasmuch as there is no possibility of knowing what particular combination may occur, there is no possibility of forecasting the precise effect which may follow....Consequently there

269 Again, Stout maintains that derivatives are essentially betting contracts. They are, “often described by the short word “bets.” (Readers who prefer polysyllabic nouns can call derivatives “wagers.”)...Derivatives are literally bets – agreements between parties that one will pay the other a sum of money that is determined by whether or not a particular event occurs in the future...This is exactly why derivatives are called derivatives. The value of a derivatives agreement is “derived” from the performance of the underlying financial phenomenon, just as the value of a betting ticket at the racetrack is “derived” from the performance of a horse in a race.” (2011: 6)
is no basis whatsoever for the definite calculation of any future event. But, while definite calculation is impossible, an estimate of general tendencies is quite within the scope of our capabilities...Chance happenings become immoral solely in consequence of the uses to which they may be put...No evil principle can lurk in the simple fact itself of a chance event, whether it be the casting of the lot, the fall of dice, a hand at cards or the turn of a wheel..." (1971: 355)

As explained above, chance by itself is not immoral. It becomes immoral depending on the way it is used. This notion is in parallel with the Shari'a. In this respect, Imam Malik demarcates the game of chance into two categories: (1) games of chance that are partaken for sport or fun purposes hence making this type of game of chance not considered gambling; and (2) games of chance which involve people making bets, hence such bets qualify these games of chance as gambling or maysir (as cited in Siddiqi, 1981: 131). The latter category is condemned as the gain acquired or loss suffered by the player is dependent on luck or chance (Rahman, 1979: 115).

It follows that in a situation where parties are betting on an uncertain event, at the point of making a payment to initiate the contract, the parties are not actually interested with what they are actually transacting but rather with what they may gain or lose.270 Hence by relying on chance, one is betting that luck will be on one’s side. However, chance is not an acceptable object in an exchange contract as it is not a material object (Elgari, 235). This is gambling in essence. The mere reliance on chance or hope is an irrational behaviour as chance and hope are not natural means in achieving the desired outcome (Al-Suwailem, 2002: 24).

5.6.2.1 Game of Chance in Variation Margin and Offsetting Transaction

According to Al-Suwailem (2002: 25), a game of chance is prohibited as it involves a zero sum exchange with an uncertain payoff (he referred to the zero sum game not as merely the gain of one party is the loss of the other party, but strictly to the payoff of a player being unable to increase without also reducing the other player's payoff).271 He postulates that a

270 When a future uncertain event is identified, players bid on chances based on whether they think the event is likely or unlikely to occur. The price at any point in time represents the players' collective consensus on the likelihood of the outcome (McCarthy, 2007: 750).

271 It is a competitive game where preference of each party is diametrically opposed to the other, so one party can win only if the other loses (Al-Suwailem, 2000: 62). Al-Suwailem (2006: 74) explains that "eating wealth for nothing" is equivalent to a zero sum game and amongst the characteristics of a zero sum game is uncertainty at the time of the contract and gain and loss being determined bilaterally between the two contractual parties.
game of chance is characterised by: (i) each party relying on pure chance to win; (ii) chance favouring only one player – the winner; and (iii) the risk involved in the game being uncontrollable with none of the players being able to influence the likelihood of his payoff. Hence, the question now is whether the winning, in the form of the differential payment received via the variation margin and the offsetting transaction, results from a mere chance or luck.

In reality and as explained earlier, the determination of who, under the eligible delivery agreement, is to be receiving or paying the differential amount very much depends on the following day’s daily price settlement and the position of the parties in the agreement. The contract price agreed to by the parties at the time of entering into such agreement varies with the next day’s daily settlement or the next minute after the parties have entered into the agreement. Rule 611 of Bursa Malaysia Derivatives Clearing Berhad Business Rules provides for the nature of the daily settlement price. This price is determined daily by the Clearing House with reference to:

“...any bids, offers and traded prices quoted by an Exchange and such other information as may be deemed relevant by the Clearing House.”

This provision shows that the daily settlement price, which determines which party is to pay the difference, is not the decision of the parties concerned. The parties will not even be able to negotiate or do anything to influence the likelihood of their payoffs. The price is determined by the bids, offers and price quoted by the Exchange. Hence, if luck is on their side, the price will move in correspondence with their bet. This condition is exacerbated further by the constant change in the anticipated future price of the underlying commodity. According to Edwards and Ma (1992: 10), price fluctuation is one of the hallmarks of the commodity futures contract which affects contractual parties on whether they gain or lose.

Dubosfky and Miller (2003: 5) view all futures contracts as zero sum games. In view of this, it is inevitable that one party will bet for the price to move in a direction which is totally opposite to the other party’s bet. As a result, in each contract, there can only be one party that is likely to win. It is the element of chance that yields the outcome of the parties’ bet. Taking into consideration the fact that the parties neither exchange any counter values nor have control over the influence of the movement of the crude palm oil futures price, chance is the arbiter on the parties’ gain and loss.
The SAC, on the other hand views that:

"It is not appropriate to judge a contract whose value fluctuates due to the changing demands for crude palm oil futures market as a gambling activity. This is because gambling activities depend solely on luck and are not related to demand and offer."

(2006: 76)

It is submitted that price fluctuation or volatility fits a gambling environment. It is the basis for betting the future movement of the crude palm oil futures price. It follows that when the resulting gain and loss is absolutely dependent on the movement of prices, of which movement is determined by factors wholly independent of one’s control, the activity therefore is connotative of gambling (Thomas, 1995: 21). This is regardless of whether the value of the crude palm oil futures price is a reflection of supply and demand.

5.6.3 Unlawful Gain of One Party is at the Expense of Another

The International Encyclopedia of the Social Sciences defines gambling as:

"a form of activity in which the parties involved, who are known as betters or players, voluntarily engage to make the transfer of money or something else of value amongst themselves contingent upon the outcome of some future or uncertain event.” (Sills, 1972a: 53)

The word gambling is defined by Rosenthal as:

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272 Gambling is the derivative of a game. According to Rosenthal (1975: 2), the term “gambling” was a recent coinage into the English language despite gambling activities having been played from the days of antiquity. The earliest form of gambling involved man-to-man games such as: contests of strength like wrestling and weight-lifting, followed by contests of speed, and competitions involving a degree of skill. These games involved players throwing spears or stones at a target or tossing a stone, shell, or bone into the air and guessing where it would fall (Jones, 1973: 13). These rudimentary features of games have evolved over the centuries. Hence, the later forms of gambling were extended to include activities or games which involve elements of pure hazard like betting and guessing games (games of pure chance); games of “pure adresse” (games of true skills) such as chess; board games involving dicing (games of a mix of chance and skill); and a variety of other types of activities that used both human and animal skills in the sport (such as horse racing and pigeon racing) (Rosenthal, 1975: 26). Wager or stake is the striking element in this later version of these games.

273 It is also interesting to note the definition of gambling given by Borna and Lowry (1987: 219) who describe gambling as “reallocation of wealth on the basis of deliberate risk, involving gain to one party and loss to the other, usually without the introduction of productive work on either side.” While Werhane and Freeman refer to gambling as “putting something valuable at risk in a process the end of which cannot be known to those whose risk it is.” It also generally refers to “any activity in which there is risk (something valuable may be lost) and/or opportunity (something valuable may be gained) and the outcome is not knowable in advance.” (1998: 294).
"contract among two or more human beings which involve the exchange of money or other valuables depending upon the uncertain outcome of a staged event." (1975: 2).

The question then is whether the characteristic of transference of money from a loser to a winner upon the outcome of an uncertain event, is ingrained in the differential payment via the variation margin and the offsetting transaction?

5.6.3.1 Unlawful Gain of One Party is at the Expense of Another: the Variation Margin and the Offsetting Transaction

For variation margin, Rule 614 (a) and (b) of Bursa Malaysia Derivatives Clearing Berhad Business Rules stipulate that:

(a) On each Business Day, the Clearing House must make available to each Clearing Participant a statement advising the Clearing Participant of funds (if any) which must be paid to the Clearing House on the same day and showing the Margin which must be lodged with the Clearing House...

(b) The Clearing House is entitled to set off any amount due from a Clearing Participant to the Clearing House against any amount due from the Clearing House to the Clearing Participant.

Kolb elucidates the process of the variation margin as follows:

"Because futures prices change almost every day, each account will have frequent gains and losses. The losses can require a variation margin payment, and the gains may entitle the trader to withdraw cash...Any losses will be covered by the posting of additional variation margin." (2000: 19)

Equally, Dubofsky and Miller explain that:

"A trader is offsetting his position every day, and realising each day’s profit or loss. The profits and losses are based on the changes in the settlement price, or closing futures price, of the futures contract. All profits that increase the margin account balance above the initial margin amount can be withdrawn daily and spent by the trader. Losses deplete the equity in the account, until there is a margin call, at which time variation margin must be deposited to bring the account balance back to the initial margin level." (2003: 130)

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274 Staged event refers to all kinds of games and competitions of men and animals that are associated with the exchange of property, but not to events which are natural-based, for example whether it will or will not rain tomorrow.
A similar procedure for the transference of the differential payment in the offsetting transaction is prescribed in Rule 608(b) of Bursa Malaysia Derivatives Clearing Berhad Business Rules. It states:

“(b) Upon two Open Contracts being off-set pursuant to Rule 608(a), any settlement difference, as calculated by the Clearing House, becomes immediately due by the Clearing Participant or the Clearing House, as the case may be.”

For a clearer view, Table 1 illustrates the manner in which money from a loser is transferred to a winner by the use of marking to market. The gain by the winner is evidenced by the receipt of the differential payment via the variation margin as well as the offsetting transaction.

Table 1

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<td>+240</td>
<td>1,440</td>
<td>-240</td>
<td>960</td>
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<tr>
<td>2</td>
<td>97</td>
<td>+120</td>
<td>1,560</td>
<td>-120</td>
<td>840</td>
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<tr>
<td>3</td>
<td>98</td>
<td>-120</td>
<td>1,440</td>
<td>+120</td>
<td>960</td>
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<tr>
<td>4</td>
<td>96</td>
<td>+240</td>
<td>1,680</td>
<td>-240</td>
<td>720*</td>
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<td>95</td>
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<td>1,800</td>
<td>+480*</td>
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<td>-120</td>
<td>1,080</td>
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Source: Bacha (2007: 33)

The above table demonstrates how the initial margin, RM1,200, gets decreased or increased on a daily basis. The changes in the account results from the execution of marking to market which is influenced by the changes in the price of the crude palm oil. If the price of the crude palm oil increases, the farmer will get additional payment into his margin account, while the confectionary will lose his money in the margin account. The amount of money lost by the confectionary is equivalent to the amount of money that is paid into the farmer’s margin account. Table 1 also shows how, on day 4, the confectionary’s account is below the level of the maintenance margin where the account has only RM720. The confectionary then receives a margin call to top-up his margin account back to the level of initial margin which is shown in Day 5. An amount of RM480
is then added to the account. This example illustrates how the confectionary loses RM1080 in five days of trading, which is almost all the money he had initially paid into his margin account.

In economics, the gain of the farmer at the loss of the confectionary or vice versa is known as a zero sum game.\(^{275}\) A zero sum game is:

"one in which the payoffs of the two players add up to zero, no matter what strategy vector is played...Consequently, the incentives of the two players are diametrically opposed – one player wins if and only if the other player loses." (Dutta, 2000: 139).

All derivatives are zero sum games. Whatever the amount of money one party gains must equal the amount of money the other party loses (Dubofsky and Miller, 2003: 5). The zero sum game is unlawful as Shari‘a disallows one from benefitting at the expense of others, out of nothing, and in an unfair manner (Vemados, 2008: 106).

In addition to that, the zero sum game conflicts with the precepts of the law on exchange; namely, any transfer of money must be made with a corresponding transfer of counter-values between parties (‘iwad) (Qatar Financial Centre Authority, 2010: 135). ‘Iwad is the basic trait or condition sine qua non of a lawful sale, as a sale is necessarily an exchange of value against an equivalent value (Rosly, 2005: 30). Ayub (2002: 18) similarly argues that the absence of any ‘iwad recalls the case of ribā, or usury in Islam, where usury is marked up to the loan without any plausible reason. In Islam, money is not considered a commodity and money cannot generate money (Kotby, 1990: 68). This receipt of an additional payment by one of the contractual parties coincides with the literal meaning of maysir which is to gain something with ease and without paying an equivalent ‘iwad for it.

A similar position was found in English common law and American civil law in the seventeenth till the nineteenth century. A sale and purchase contract entered into without any intention of performing its contractual obligations but instead to settle by difference was considered a gaming or wagering contract. That was so as the contract was entered into for the sole purpose of gambling on the price difference. Nonetheless, at the dawn of the twentieth century, the contract for difference was no longer deemed a gaming or

\(^{275}\) It is also equivalent to a form of rent-seeking – trying to acquire wealth not by creating it but by taking existing wealth from someone else. Hence when rent-seeking exhausts valuable resources like time, money, or human ingenuity, the zero sum game becomes a negative sum game that reduces net social welfare (Stout, 2011: 9).
wagering contract. Instead they became valid and enforceable contracts so long as they were traded by members of an exchange on a formal exchange venue. The irony of this present law is that the contract for difference as it is today, as well as from previous centuries, is still innate with the element of wagering or gambling. Chapter six discusses in detail the development of the legality of the contract for difference.276

5.6.4 Unlawful Acquisition of Another’s Wealth

The notion of unlawful acquisition of another’s wealth encompasses any ways or means of acquiring wealth that violates the rights of Allâh, the contracting parties, or society at large (Iqbal, 2007: 13). This notion is clearly explicated in the Qur’ân, Chapter An-Nisâ’, verse 29:

“O ye who believe! Do not consume one another’s wealth in wrongful ways (such as theft, extortion, bribery, usury and gambling); except it be dealing by mutual agreement; and do not destroy yourselves (individually or collectively by following wrongful ways like extreme asceticism and idleness. Be ever mindful that) God has surely been All-Compassionate towards you (particularly as believers).”

Rosenthal aptly describes the importance of this notion when she states that:

“Islam, with its strong feelings and laws about how property should be acquired and distributed, was naturally inclined toward greater strictness in classifying gambling as everything where the acquisition and distribution of property took place outside the generally accepted categories (by way of gift, labour or exchange), but the specific character of gambling was well understood.” (1975: 3).

Ibn Taymiyyah (2000: 41) describes two ways in which property or wealth are gained unlawfully, namely, the properties themselves are unlawful and the manner in which the properties are acquired. He further postulates that:

“If a sale which partakes in gharar also involves devouring the property of others- akl al-mâl bi’l-bâtîl’, then it becomes indistinguishable from qimâr and maysir, which are clearly forbidden. If in one contract of sale one party receives what was

276 The differential contract resembles the offsetting transaction in the sense that, “on the ascertainment of the future price, one party must pay to the other an amount originally unfixed. Neither party has any interest in the contract beyond that amount, and since neither knows what the amount at stake is, it is impossible to say that either has any interest in the event such as may represent it.” (Street, 1937: 129)
due to him but the other does not and the latter's side of the bargain is open to risk-taking (mukhātarah) of a kind that frustrates and nullifies his right, then the sale partakes both in gharaar and gambling at the same time...God Most High has forbidden the unlawful devouring of the property of others, and it occurs in two ways, namely, usury and gambling (riba and maysir), and the Book of God is explicit in respect of both.” (as cited in Kamali, 2002: 155)

In Islam, an individual’s property is sacred. No property can be taken from him except through a lawful exchange or unless he gives it freely as a gift or a charity (Yusuf Al-Qaradawi, 2003: 281). Hence when one of the contractual parties takes what is due to him while the other contractual party face the risks of not getting what is due to him, an unlawful acquisition of property has occurred (Kamali, 2000: 151).

5.6.4.1 The Futures Margin System and the Offsetting Transaction: Unlawful Acquisition of Another’s Wealth

According to Kamali (2000: 176), the margin payment in a commodity futures contract is valid, as its purpose is to secure the contract’s integrity and the rights of contractual parties against excessive price fluctuations. Therefore there is no issue of unlawful gain. However, in reality, the futures margin system and the offsetting transaction entail one party to transfer his money to the other party without anything in return. In other words, one party gains while the other party loses. Hence, Coulson (1984: 11) argues that the gain earned by the winner is unearned as the gain results from speculative transactions and cannot be calculated in advance by the contracting parties.

Apart from that reason, Sharia strictly requires the exchange of counter-values in any transaction.277 Legally, a contract to transfer, as compared to a contract of exchange, lacks the balance of damān (liability or contractual liability). The receipt of payment by one party without any corresponding damān from the other party results in the contract being invalid as the damān is unjustified (Habil, 2010: 102). Additionally according to Sanhuri, the Islamic law of contract “has an altruistic moral role: to intervene in the contractual

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277 The exchange of real counter-values strikes at the very foundation of a balanced economy or equilibrium in society. The exchange of counter-values creates wealth. However, a gambling contract is not an exchange contract but is instead a transfer contract. It transfers wealth from the losers to the winners. It lacks the benefit which trade offers; for example, the sale of food enhancing man’s longevity and survival. Sale transactions also create wealth by virtue of the exchange of money and food, hence they benefit not only the buyer and the seller but society in general (El Diwany: 2003, 99).
content in order to create a just and balanced society” (as cited in Bechor, 2001: 189). As a result, an individual’s right to property or an individual’s self-interest is restricted to the social good or to the needs of the society (Bechor, 2001: 180).

5.6.5 Hatred and Enmity

In Chapter Al-Māīda (The Table) verse 94, Allāh says:

“Satan’s plan is (but) to excite enmity and hatred between you, with intoxicants and gambling, and hinder you from the remembrance of God, and from prayer: Will ye not then abstain?”

Yusuf Al-Qaradawi succinctly adduces the notion of enmity and hatred from the above verse where he says:

“3. It is therefore not surprising that gamblers develop hatred and enmity towards one another, although they may claim that losing does not trouble them. There is always a winner and a loser. The loser may seem composed but behind his composure is frustration, anger and regret: frustration due to disappointment, anger at the loss of money, and regret for not having played a winning game.

3. Gambling has its own compulsion. The loser plays again in hope of winning the next game in order to regain his earlier losses, while the winner plays again to enjoy the pleasure of winning, impelled by greed for more. Naturally luck changes hands, the loser becomes the winner and the winner becomes the loser, and the joy of winning changes into the bitterness of loss. Thus, the gamblers may persist at playing the game, unable to bring themselves to leave it; this is the secret of the addiction to gambling.278

5. Because of this addiction, gambling is a danger to the society as well as to the individual. This habit consumes gamblers’ time and energy, making them non-productive idlers and parasites on society, who take but do not give, who consume but do not produce. Moreover, due to his absorption with gambling, the gambler neglects his obligations towards his Creator and his duties towards his community. It often happens that a gambling addict sells his honour, religion and country for 278 Similarly, Statman views that “Hope and fear may be the strongest emotions that drive lottery players and stock traders, but regret is not so far behind. Regret is the pain we feel when we find, too late, that a different choice would have led to a better outcome...the wide array of securities advice and research tools enhances the play value of securities trading. Illusion of control leads people to act as if they have control in situations that are in fact determined by chance. The illusion of control leads stock traders to believe that their chosen stocks have better odds than stock chosen by darts thrown at stock tables.” (2002: 17). Based on this premise, it is not surprising to find a survey by Ross (1975) on 558 customers of a large Chicago-based commodity house with branch offices throughout the country. The survey has shown that almost all of the customers of the commodity house lost their money in futures trading.
the sake of the gaming table, since his devotion to this table dulls his sense of values and kills all other devotions.” (2003: 281-282).

Likewise, Ibn Taymiyyah argues that, though the primary purpose of gambling may originally be to gain property and for the pleasure of play, the resulting loss and the pain and harm caused by playing were greater. For these reasons, *maysir* was not prohibited mainly because of the frivolous exchange of property attendant upon gambling but more because of its effects on the mind and heart. (as cited in Rosenthal, 1975: 80). The harm of gambling affects not only the individual player, but also society as a whole. Hence, by prohibiting gambling, Islam negates these few benefits and wards off the harms (Al-Raysuni, 2005: 228). Chapter six evidences this vexatious situation. Through case laws, this chapter demonstrates how the parties in the commodity futures contract wage legal battles against one another over the claims of betting proceeds.

The next part of the chapter discusses another fundamental component of the crude palm oil futures contract - futures speculation or speculative trading. The question that this part will attempt to address is whether futures speculation is contaminated with elements of *maysir*. If this question is answered in the affirmative, futures speculation is deemed prohibited. Otherwise, it is not. Similar to the analysis on the futures margin system and the offsetting transaction, the analysis on futures speculation is premised on the fact that speculation in commodity futures contract is condemned if it is being used as a tool of gambling and that any business activities which contain elements of gambling are hence prohibited.

5.7 Speculation in the Commodity Futures Contract

Kaldor defines speculation as:

“the purchase (or sale) of goods with a view to resale (repurchase) at a later date, where the motive behind such action is the expectation of a change in the relevant prices relatively to the ruling price and not a gain accruing through their use, or any kind of transformation effected in them, or their transfer between markets.” (as cited in Feiger, 1976: 677).

Hence, in the futures market: 279

279 According to Blake, speculation in the futures market is where:

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"Speculators have no intention of making or taking delivery of the commodity. They don’t even have any connection with the production or use of the commodity. Speculators enter the market anticipating that prices are going to change. In doing so, they take futures positions with the intention of making a profit.” (Chicago Mercantile Exchange, 2006: 54).

The speculators buy futures contracts when they believe the price of goods will rise and sell futures contracts when they believe the price will fall (Dubofsky and Miller, 2003: 126). To speculate, they use techniques called fundamental analysis;\(^{280}\) namely, the study of supply and demand; and or technical analysis,\(^{281}\) which is the study of price and volumes charts. These analyses aid in forecasting the movement of the underlying commodity price. Due to the typical volatility of the prices of the underlying commodity as well as the high leverage of futures trading, large profits can be earned and large losses can be suffered.

\(^{280}\) Fundamental analysis – it uses supply and demand information to interpret and determine its anticipated impact on prices. In hoping to predict which way prices will move, they are interested in identifying factors that are likely to affect the supply and demand of the respective underlying commodity. When the supply of a commodity increases and demand decreases or stays the same, the price falls. When supply decreases and demand increases or stays the same, the price of that commodity rises. If supply stays the same, changes in demand will cause prices to rise or fall. Fundamentalists also study how and when events change the value of the commodity – whether it becomes more valuable or less valuable as a result of an event – and whether prices can be expected to increase or decrease because of such an event. In addition to the above studies, fundamentalists also study psychology effects of various kinds of information on other market traders to see how and when these traders respond to a certain type of event or release of information. By analysing this response, fundamentalists hope to trade before information is incorporated into the price. The time lag between an event and its resulting market response presents a trading opportunity (Chicago Mercantile Exchange, 2006: 69).

\(^{281}\) Technical analysis interprets historical price movements to predict prices in the future. Its basic goal is to determine the direction and strength of the current trend in the market and to identify when such a trend is about to change. If the technician identifies the trend as bullish, the forecast is to remain long and to keep buying until the trend is deemed to be over. The technical analysis places focus almost exclusively on past and current prices. The technicians believe that all economic supply/demand news and forecasts are built into current prices. Besides studying the price of the underlying commodities, technicians are also interested in the patterns of volume and open interest. These patterns help them to chart and identify the strength and direction of the market trends. Spotting trend is also another interest – to chart the bullish and bearish of the markets. If they see that on one day the market finishes on an upward note with high volume and open interest but it finishes down on a low volume and a similar or decreased open interest the next day, they would note that the market might be turning bullish as the sellers in the market were not as keen to sell as buyers had been keen to buy on the previous day. They also study the cyclical repetition of price patterns over time. This requires an in-depth analysis of market movements, ranging from relative high and low points which last for two or three years, integrated with those that last only for a few days. Like fundamentalists, technicians also look to complex computer programs for assistance in interpreting the behaviour of market players in order to identify trading opportunities (Chicago Mercantile Exchange, 2006: 76).
within a short time in the futures market (Securities Industry Development Corporation, 2007: 1-19).

The above description discerns two characteristics of futures speculation: namely, (i) the buying and selling of crude palm oil futures contract with the intention of gaining from the price difference, and not from the physical delivery of crude palm oil, and (ii) the gain by price difference, results in one gaining at the expense of others. These characteristics are fundamental to the issue on *maysir*. Hence, the next section examines whether the SAC resolution has resolved this big question.

5.8 The SAC's Position on Futures Speculation

The SAC (Securities Commission, 2006: 78) resolves that speculation in crude palm oil futures contract is permissible. This view is grounded on the basis that speculation exists in all forms of business and is not limited to futures transactions. The SAC further argues that making profit from price difference is not forbidden in Islam. This is due to the fact that Islam allows sale and purchase transactions, such as *bay‘ muzāyadah* and *murābahah*, which involve profiting from the difference between the original price and the selling price (Securities Commission, 2006: 109).

The SAC (Securities Commission, 2006: 111-112) further contends that speculation is different from gambling. The act of speculation can be distinguished from the act of gambling by checking the motives and conduct of the investors. Those investors who are well informed and invest with careful consideration are speculators while those who enter the market and invest solely on luck are gamblers. Hence in futures speculation, the issue is whether it is done excessively or moderately. This issue can be overcome by the monitoring and supervision of speculative activity to ensure fairness to market players as well as to minimise forbidden practices in Islam, for example fraud and manipulation.

Despite permitting futures speculation on the basis that it is analogous to ordinary commercial trading and not gambling, the SAC has not attended to two important issues inherent in futures speculation, namely: (i) buying and selling of crude palm oil futures contract with the intention of gaining only from the price difference and not from real

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282 *Bay‘ muzāyadah* is defined as sale by auction (Securities Commission, 2006: 171).
283 *Murābahah* is defined as cost plus profit sale (Securities Commission, 2006: 174).
delivery, and (ii) such gains results in one gaining at the expense of others. Although the SAC argues that Islam permits profiting from price difference, it is submitted that such permission is based on transactions involving real delivery of commodities or exchange of counter-values. It is further submitted that though speculators speculate responsibly and carefully, it does not extinguish the fact that, the gain from price difference at the expense of one’s losses, is a characteristic of a prohibited maysir activity.

The pursuing section will further distill the question as to whether futures speculation is an investment or a gambling. This section will be followed by the examination of issue (i) above under the following sub-headings: namely, short-term trading, disassociation from the real economy, the method of trading and the ramification of futures speculation. However, issue (ii) above will not be dealt with, as this issue has been examined in the earlier part of this chapter.

5.9 Futures Speculation – An Investment or Gambling?

The controversies surrounding futures speculation result from its activities being akin to gambling. However, Teweles, Harlow and Stone (1977: 4) view it differently. They argue that gambling involves the creation of risk for the sole purpose of someone taking it. Hence, horse races, poker games and roulette wheels are vehicles where risks are created that would not be present without them in the first place. A gambler willingly accepts this risk in return for an opportunity to win some money. On the other hand, speculation deals with risks that are necessarily present in the process of marketing goods in a free capitalist system. Therefore in the case of the commodity futures contract, the risk of price changes is inevitable. This risk exists regardless of whether there exists any futures market for the said commodities. Nonetheless, Stout (2011: 9) argues that the risks that speculators are exposed to are new risks which were not there before, namely the risk of losing their bet and the risk of their counter-party defaulting. Thus, instead of risk being shifted, risk is created hence becoming artificial risk. Similarly, Toutounchian (2009: 81) argues that this artificial risk is created by the futures market and by speculators, out of uncertainty. Uncertainty is an essential element in all speculative activities and its sole purpose is to make a suitable environment for a few speculators to make a “profit”.  

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284 In view of the involvement of risk in both of these professions, the gambler, as the risk-maker, and the speculator, as the risk-taker, share one motivation: namely, to willingly take relatively large risks in return for a chance to gain large profits. Both professions derive some pleasure and excitement from their activities – getting rich fast and the thrill of taking a risk (Teweles, Harlow and Stone, 1977: 4).
Naturally, futures speculation is distinct from commercial investment. An American court in the case of *Kirkpatrick v Bonsall*, aptly distinguishes commercial speculation from futures speculation, which is akin to gambling. It says (in deciding the legality of the 1870 futures contract to sell 5000 barrels of oil):

“We must not confound gambling, whether it be in corporation stocks or merchandise, with what is commonly termed speculation. Merchants speculate upon the future prices of that in which they deal, and buy and sell accordingly. In other words, they think of the weigh, that is speculate upon, the probabilities of the coming market, and act upon this lookout into the future, in their business transactions: and in this they often exhibit high mental grasp, and great knowledge of business, and of the affairs of the world...But when ventures are made upon the turn of prices alone, with no bona fide intent to deal in the article, but merely to risk the difference between the rise and fall of the price at a given time, the case is changed...Then the bargains represents not a transfer of property, but a mere stake or wager upon its future price. The difference requires the ownership of only a few hundred or thousands of dollars, while the capital to complete the entire purchase or sale may be hundreds of thousands or millions...such transactions are destructive of good morals and fair dealing, and of the best interest of the community.” (as cited in Tate, 2007: 111).

A similar view is echoed in The Encyclopedia of Religion and Ethics where it distinguishes futures speculation, which is betting on future price, from commercial speculation. It says:

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285 This notion is supported by the following views. Khan (1982: 240) views speculation as a purchase and sale of an asset, in the expectation of a gain from changes in the price of the assets. Investment, on the other hand, is the purchase of any asset or expenditure on capital goods. In speculation, the objective is to derive any gain from a shift in the price level without getting involved in the production process while in investment the purpose is to participate in the production activity. Chapra (1986: 96) explains that investors make purchase by making a full payment followed by a reciprocal delivery. The objective of investors is to seek an outlet for their savings, to earn an income, and to profit from any appreciation in the value of their stockholdings. The investors do not indulge in short-term transactions and their intention at the time of purchase is to hold the stock for a long period. The shorter the time of holding, the lesser the investment motive, though they may change their mind and sell off their stocks. This is in line with the requirements in Islamic investment. According to Levy (1999: 3) an investor is an individual who is willing to forgo consumption today to achieve the goal of a higher level of consumption in the future. When an investor invests, he uses financial capital in an effort to create more financial capital in the future. Investment also refers to a vehicle used to make more money. Some investments are speculative as they involve a high degree of risk. Seeto (2004: 38) describes an investor as one that actively researches financial instruments to be invested in, whether they are company shares, commodities, currencies, or derivatives of those instruments. On the basis of that analysis, an investment decision is formed. On the other hand, a speculator may know nothing of the instrument that is being invested in or has little to do with the underlying value of the company or commodity, but attempts to forecast current or future sentiment with no solid foundation or standard of measure with which a price can be stabilised. Similarly, Sardehi (2008: 50) argues that speculation, which is backed by proper risk assessment, analysis, and interpretation of relevant information, is not pure gambling and accordingly is not prohibited in Islam (Sardehi, 2008: 50). However, what is prohibited is the absence of these conditions and the excessive uncertainty that is akin to speculation in a game of chance (Obaidullah, n.d: 3).

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Men buy or sell cotton or corn for future delivery, without ever intending to handle or distribute the actual commodities, but merely with a view to closing the contract before it is due, and profiting by the fluctuation of prices...But there is also a commercial speculation which is necessary and legitimate. The merchant has to make provision for social need, and, in buying ahead, chance must inevitably enter into calculation. The gambler’s business is wholly self-centred; he subserves no need of the community. The merchant whole policy is to eliminate risk as far as possible. The gambler desires risk.” (Hastings, 1971a: 166).

A parallel illustration\textsuperscript{286} is given by Kamali where he states:

“If A buys a corn futures contract from a farmer and B sells a corn futures contract to a flour mill, A and B are speculating in the futures contract. However if the farmer sells a futures contract directly to the miller and A and B makes a bet with one another on the direction of the corn prices, they are gambling. They do not invest any capital labour or skill, but engage in a bet than a commercially beneficial endeavour or enterprise.” (2002: 147)

In this respect, Ahmad Muhyi al-Din (as cited in al-Amine, 2008: 147) explicates that in Islam, futures speculation is unlawful as it does not involve physical delivery of the underlying commodity. This contract, settled by way of difference, is an evidence of gambling. The mere fact that this contract is called a sale contract is just a form of \textit{hilah} (legal trick). Khan (1995: 46) similarly argues that earning an income from mere speculation on prices without having an implicit part in real activity is gambling.

Further, Toutouchchian (2009: 75) contends that speculation in stock and commodities functions as a medium for exchanging money with money “as if loan is taken and the stock or commodity is being used as collateral in this disguised loan contract”. The intention of a speculator is not to buy stocks or commodities for himself, or for trade, but is merely to exchange money with money and to make a gain from the difference between the selling and buying price. To understand Toutouchchian’s contention, it is worth noting the view of Abu Hamid Muhammad Al-Ghazali on money where he said, in Islam, money:

“...only reflects the value of goods... money should not be created just because its very existence should create a demand for it, but rather it should be used for the procurement of other goods...the money itself has no intrinsic values. Had it an intrinsic value, it could not have played its role as money and would have become like commodities” (as cited in Thomas, 2005: 9).

\textsuperscript{286} Stevens (1892: 421) likens an investor in a commercial or industrial line with a “bull operator”, who expects and intends to profit by making the property productive. Speculators, who are not investors, are ones who make profits from an increase in the value of the property rather than it being made productive.
This section discusses one of the two important issues inherent in futures speculation; namely, the buying and selling of crude palm oil futures contract with the intention of gaining only from the price difference and not from real delivery. This discussion is divided into four sub-headings: namely, short-term trading, disassociation from the real economy, the method of trading and the ramification of futures speculation.

5.10.1 A Short-Term Trading

Futures speculators are distinguishable by the type of futures position they hold. A position trader is a type of speculator who looks for long-term price trends. He takes on a position and may hold it over a period of days, weeks, or months and close his position when the price moves favourably (Securities Industries Development Corporation, 2007: 1-20). On the other hand, a day trader is a type of speculator who closes out his position on the same day. Thus, if a trader has taken a long position, the plan is to take an offsetting short position later in the day; and if the trader has taken a short position, the plan is to take an offsetting long position later in the day (Hull, 1997: 23). In view of the very short period held by day traders, often minutes or hours, day traders represent a major group of market traders which require high speed computer access and real-time market quotes to enable them to capitalise on small changes in the price (Seeto, 2004: 45). A scalper also trades like a day trader as a scalper rarely holds a position overnight.

The structure of commodity futures trading: namely the non-involvement of making and taking delivery of the underlying commodity; the high leverage; and price volatility, accentuate the appeal of quick gain trading. Naughton and Naughton (2000: 146) argue that speculative trading, which is purely for short-term gain and is executed on the basis of uncertainty in the market, embeds characteristic of qimār or gambling.

In reality, day trading has raised problems. The problem lies in predicting how fast or by how much prices will change. If the buying and selling is done at lightning speed, traders stand to lose as much money as traders would have gained, if not a lot more (Morris and Ingram, 2001: 33). Hence, Shapiro attests that day trading is:
a risky, speculative activity and even the most experienced day traders may suffer severe and unexpected financial losses, even beyond their initial investment.” (as cited in Kamal, 2001: 117)

Meanwhile, Skeel (2006: 3) labelled day trading as “gambling, pure and simple”. The US Permanent Subcommittee on Investigations has investigated day trading activity. Following eight months of investigation, the Subcommittee concluded that day trading is a highly speculative activity which is equivalent to a certain type of gambling. Day trading has even been called “gambling”²⁸⁷ by both the Chairman of the Securities of the Exchange Commission and the President of the North American Securities Administrators Association (NAASA). Evidence had shown that only a small fraction of novice traders were ever profitable. Traders who were novice and undercapitalised had almost no chance of success. The NAASA has also released a professional report based on a seven month investigation, which found that at least 70 per cent of day traders lose money and only 11.5 per cent show the ability to conduct profitable short-term trading (as cited in Seeto, 2004: 45).

The image of the day trader is further smeared by the shooting rampage of Mark Barton, the Atlanta day trader. As a result of this incident, Robert Bontempo²⁸⁸ hit out on day trading as:

“These people are not investors...Calling this investment is totally missing the point...It’s a casino.” (as cited in Statman, 2002: 19).

5.10.2 Disassociation from the Real Economy

According to Bacha (2007: 44), only five per cent of the total trading of crude palm oil futures contracts will eventually end with the real delivery and payment of crude palm oil. The rest of the contracts are settled by payment of difference. Jobst (2007: 25) argues that the difference settlement transforms the commodity futures contract into a paper transaction without any element of genuine sale. Mohamad and Tabatabaei (2008: 10) argue that the detachment of the futures contract from real economic activities distorts the supply and demand condition of real economy.

²⁸⁷ Skeel (2006: 3) labelled day trading as “gambling, pure and simple”.
²⁸⁸ An Associate Professor of Management at Columbia University Business School who gave an interview with Buckman and Simon.
Nonetheless, Kamali (2002: 7) argues that the detachment from the real economy allows for the “selling and buying of commodities” to take place indefinitely throughout the tenure of the contract. Unlike securities, where a company may offer a set number of stocks for sale, a commodity futures contract exists whenever there is a buyer and a seller. There is no limit to the number of futures contracts that can be created. The process of contract creation can theoretically go on as long as buyers find sellers and vice versa. In reality, the quantity of futures contracts exceeds the actual available commodity supply.\(^\text{289}\) That is why at the time of selling the commodity futures contract, there is no obligation on the seller to show that he has the capacity to supply the underlying commodity (Khan, 1995: 50). Hence, Alkaff (1986: 50) argues that in the commodity futures market, there is no real buyer and seller.

Based on these conditions, futures speculation is detached from the real economy (International Shari’ah Research Academy for Islamic Finance, 2011: 492). Hence, it breaches the fundamental precept that all trade must represent real economic transactions. Al-Suwailem (2006: 14) explicates that to profit, risk must not be separated from goods or services.\(^\text{290}\) Risk must be integrated with real activities so that it is naturally controlled by the real economy. This integration will eventually stimulate real economic activities and generate sufficient wealth. Hence it compensates such risk. This strategy creates value and minimises risk in any economic activity. However, futures speculation separates risk from its underlying asset. It unbundles risk from real economy activity and trades it separately as the “underlying” commodity.\(^\text{291}\) It transforms risk into a commodity which is bad and toxic. Equally Shahid and Rahman (2005: 170) argue that the severance of risk from its

\(^{289}\)Hence, offsetting transactions are not real sales (n.n.(h), 1942: 507). Hutcheon (1992: 302) argues that, from the business point of view, an excess of speculative transaction relative to the actual delivery demonstrates that speculative transaction is a bet on the future price of the commodities.

\(^{290}\) Risk is divided into three categories. The first is entrepreneurial risk where the risk of losing is part of the normal course of gaining profit in any business dealings. Every economic activity involves risks of uncertainty and the need to indulge in such risk is what society cannot do without. The second category of risk is from natural disasters or calamities which are part of human life. People throughout history have no choice but to seek ways and means to protect themselves from the fear of personal and collateral damage caused by natural disasters. The final category is risk that is self-created from gambling activities. This risk is unnecessary as the individuals can choose not to indulge in these risky activities nor do these activities create any wealth or bring benefit to society (Molyneux and Iqbal, 2005: 160, Iqbal, 2007: 17). On the other hand, Ibn Taymiyyah (as cited in Al-Suwailem: 2006: 55), categorises risk into two types. The first is commercial risk, where one would buy a commodity in order to sell it for a profit and to rely on Allah for that. This risk is necessary for the merchant and although one might occasionally lose, that is but the nature of commerce. This type of risk is acceptable in a normal economic transaction as it is a value-added and wealth creating activity. The second type is gambling risk which implies eating money for nothing. This risk is proscribed in Islam. This risk does not add any value and create any wealth.
underlying commodity and the creation of a contract to transfer such risks results in it being a zero sum game which is strictly prohibited in Islam.

5.10.3 Method of Futures Speculation - Technical Analysis and Fundamental Analysis

Most speculators adopt technical analysis in predicting the future price of underlying commodities. They believe that in doing so they can consistently make money in a simple buy-and-hold strategy. The difference between technical analysis and fundamental analysis is that fundamental analysis attempts to predict future prices by finding out what the underlying commodity is really worth - its intrinsic value - which may have little to do with its current quoted price. On the other hand, technical analysis does not look at fundamental information such as political events or industrial data but instead focuses on studying the changes in the value of the underlying commodities. They believe that market price contains all the relevant information, whether it be rational or irrational, and therefore the trader does not need to go behind the price (the fundamentals) to forecast its future path (Hallwood and MacDonald: 2000: 280).

One of the best known patterns used in technical analysis, and one regarded as having good predictive powers, is the "head and shoulders reversal pattern". Hence when the price movements produce a pattern resembling a head and a pair of shoulders, it signals that the price has reached the "top" (the head) and will start declining. Many technical analysts believe that the psychology of investors' en masse causes this pattern. Gough (1997: 120) maintains that technical analysis encourages trading as speculator respond to the "buy" or "sell" signals indicated in the chart. However, Pepper raises concern on this method of speculation when he states:

"Market participants detect that following a trend tends to be a profitable course of action. The herd instinct then prevails. Crowd psychology becomes more important than the behaviour of investors acting as rational individuals. Technical analysis (chartism) which is based on crowd psychology becomes more important than fundamental analysis." (as cited in El Diwany, 2003: 114).

Similarly, Keynes (as cited in El-Din and Hassan, 2007: 244) argues that market participants based their investment decisions on expected movements in stock markets

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291 Similarly, Stout (1995: 66) argues that by adding risk to the market place and diverting scarce resources from more productive forms of investment as well as the highly leveraged derivatives trading may actually do much harm.
prices rather than on real economic information. These players try to predict what other players believe is the right decision. They are trained in mass psychology to guess better than the crowd about how the crowd behaves, in the same manner as judges in a beauty contest base their valuations on what they expect other judges to do.

As a result of this imaginative mode of speculating – rumours and the market trend - Salamon (1998: 225) argues that it breeds element of betting. He distinguishes the conduct of real investors who buy shares based on the real analysis of the economic fundamentals of a company with speculators who buy shares based on the sentiment of the market and detach themselves from the economic reality. The deliberate spreading of rumours, made to influence the market price, aggravate the fluctuation of the futures price unrelated to the spot market price. Although the market has corrective mechanisms, this disruption impairs the successful operation of the market (n.n.(d), 1963: 174). Nonetheless, Kamal (2001: 120) maintains that there is nothing wrong with technical analysis when it is used simultaneously with fundamental analysis. It is undesirable when it fuels the instability of the market. The instability which is caused by high speculative activities will eventually cause harm to other market participants.

5.11 The Ramification of Futures Speculation

The discussion on the ramification of futures speculation will be divided into two subheadings: firstly, the impact of speculation on the price of commodities hence affecting the social-wellbeing of community, and secondly, its contagious destabilising effect on the global economy.

292 Tilburg and Stichele (2011: 30) raise concerns about the emergence of increasing numbers of speculators, sometimes with very large positions, who do not trade based on fundamental supply and demand relationships, in the commodity futures market, but who nonetheless influence commodity price development. Coming from gigantic financial institutional backgrounds, these financial speculators may be looking more for financial data, which they are used to dealing with, rather than the real development in the physical agricultural market. They may also be less able to interpret (and therefore debunk) misleading rumours about certain supply and demand developments. This increases the possibility of herd behaviour, not only when prices increase but also when they decline. Several empirical studies have found that, in the last decade, commodity futures prices became ever more detached from real factors and have started to move in line with the position held by these financial speculators and other developments in the financial market. Dema (2009: 10) also view that when these financial institutional speculators decide to allocate one percent to the commodity futures contract, they come to the market with a set of money. They are not concerned with the price per unit and they will buy as many futures contracts as they need, at whatever price is necessary, until all their money has been put to work. Their insensitiveness to commodities prices multiplies their impact on commodity markets.
5.11.1 The Inflation of the Price of Commodities

In 2008, the Minnesota-based Institute of Agriculture and Trade Policy issued a report which analysed the increment of commodity prices from the period of 2006 to July 2008. Due to these high prices, the total developing country food import bill rose from about $191 billion in 2006 to $254 billion in 2007. This was despite the fact that developing countries consume less food as a result of higher prices. The number of those undernourished and food insecure in the world has increased along with the prices. The report suggests that speculation contributes to extreme price volatility which distorts the agriculture market. This distortion becomes excessive relative to the actual value of the commodity as determined by real supply and demand and other fundamental factors.

The report refers to the United Nation’s Food and Agricultural Organisation (FAO) which stipulates that, as of April 2008, corn volatility was recorded at 30 per cent and soybean volatility was at 40 per cent, beyond what could be accounted for by supply and demand or market fundamentals. Prices are particularly vulnerable as they are being moved by big speculative “bets” when a commodity’s supply and demand relationship is “tight” due to production failures, high demand, and/or a lack of supply management mechanisms. Though a number of studies negate the influence of price increases by speculative activities, the report contends that these studies do not take into account the over-the-counter trades that dominate commodities speculation. These studies are also being limited by the quantity and quality of the United States Commodity Futures Trading Commission’s reported data on which they rely. Hence this report argues that these studies are inadequate to discern the actual condition on the ground.

It is widely recognise that the global food crisis is intimately connected with the impact of financial speculation on the world trade prices of food (Ghosh, 2011: 288). Greenberger (2011: 26) contends that the higher price of commodities has been affected by the copious inflow of purely financial speculative capital. Apart from the unprecedented increase in financial speculation, there have also been dramatic changes in real supply and demand

293 For example Bohl and Stephen (2012: 3) argue that since futures trading in commodity markets are not limited to speculators but are also (and often predominantly) done by hedgers, nobody should simply conclude that increased spot or futures price volatility is necessarily caused by growing speculative positions. Their study on six heavily traded agricultural and energy commodities-corn, crude oil, natural gas, soybeans, sugar and wheat - has found that the alleged destabilising impact of futures speculation on commodity spot price is unwarranted.
factors. These include the growing population and income in emerging and developing countries, weather-related crop losses, export restrictions, high oil prices, the depreciating US dollar, and the demand for food and feed crops for the production of biofuels. Nevertheless there is a growing consensus that increased financial speculation in agricultural commodities markets has contributed to their volatility and higher prices. In a joint study published in May, 2011, the FAO, the International Monetary Fund, the Organisation for Economic Co-Operation and Development, the World Bank and others concluded that:

“While analysts argue about whether financial speculation has been a major factor, most agree that increased participation by non-commercial actors such as index fund, swap dealers and money managers in financial markets probably acted to amplify short term price swings and could have contributed to the formation of price bubbles in some situations.” (as cited in Greenberger, 2011: 26)

In a speech at the University of Chicago on May 5, 2011, the Commissioner of the U.S. Commodity Futures Trading Commission, Bart Chilton, elucidated the impact of futures speculation on commodities prices:

“There are now more speculative positions in the commodity markets than ever before. The number of futures equivalent contracts held by these types of speculators increased 64 percent in energy contracts between June of 2008 and January 2011. In metal and agricultural contracts, those speculative positions increased roughly 20 per cent or more. I think there’s good evidence that excessive speculation is heating up the market and prices have gotten out of line as a result. Rather than help to fairly discover and “make the price,” these speculators “shake and bake the price”- up or down, depending on which side of the market they’re in…And, President Obama correctly spoke about speculators’ impact on consumers…Researchers at Oxford, Princeton and Rice Universities and many other private researchers say that speculators have had an impact on prices-oil prices and food prices most notably.” (Chilton, 2011).

In fact, this heated issue has been raised by a number of international institutions. For example, in 2006, the Societe Generale (as cited in Antoshin and Samiei, 2006: 153) postulated that speculative activity has been a major contributor to the surge of crude oil and metals prices and may have even caused a bubble. They argued that speculation has magnified the impact of changes in the fundamental determinants of supply and demand (which have been supportive of higher prices) to the extent that, in some cases, prices have risen far in excess of levels justified by fundamentals. At a similar time, the Organisation of Petroleum Exporting Countries (OPEC) (OPEC, 2006) issued a press release highlighting its concern about the sudden rise in the volatility of oil prices. The OPEC
argued that speculation played a significant role in driving up the price despite the market remaining well supplied with crude.\footnote{A number of studies have been carried out on this topic. Sornette, Woodard, and Zhou (2009) study the volatility and significant increase of the oil price traded in the US Dollar and other major currencies during the year 2006 to 2008. The study addressed the question of whether (1) oil prices exhibit bubble-like dynamics, which may be a symptomatic of speculative behaviour; and (2) whether the faster-than-exponential price rises resulted from a faster-than-exponential rise in demand which was actually not met by supply. The analysis was based on statistical physics and complexity theory; and data was taken from published reports of two leading agencies, the International Energy Agency (IEA) and the US Energy Information Administration (EIA). These reports show the world’s total liquid fuel demand and total world supply. The study found that oil price run-ups, expressed in any oil major currencies, have been amplified by speculative behaviour of the type found during bubble-like expansions. The underlying positive feedbacks, nucleated by rumours of rising scarcity, may result from one or several of the following factors acting together: (1) protective hedging against future oil price increases together with a weakening dollar; (2) the search for a new high-return investment with growing numbers of hedge funds, pensions and sovereign funds; (3) since the deregulation of oil futures trading in 2006, the spot price has actually been more and more determined by speculative futures markets and thus more and more decoupled from genuine supply-demand equilibrium. Went, et al. (2009) has also conducted a study to investigate the speculative bubbles in a host of commodities due to a sizable increase in commodities prices. The study found evidence of speculative bubbles in the wider agriculture sector, as well as the grains and oilseeds sector, such as, corn, soya bean and wheat.}

Pavaskar (2005: 15) contends that the impact of price volatility in the commodity market is different compared to the security market, where in the security market, the impact is on willing investors in the market. However, the impact of the sharp rise and fall in the price of commodities is borne by the entire economy; namely, the large innocent bystanders. It forebodes an impending crisis – fuelling inflation in the economy and bringing the much dreaded recession. Likewise, Toutouchian (2009: 186) adduces that the effect of speculative trading, in the secondary market, is that the price is manipulated far exceeding its real value. This exceeded value does not contribute to the assets or capital of the issuing firm. The difference in value is nothing but bubbles. Based on this condition, Imai, Gaiha and Thapa (2008: 3) aptly maintain that the combination of a mismatch between futures and cash prices, and high volatility, has undermined the role of commodity exchanges as a guide to future price and risk management.

It is worth noting that the high cost of food has severely affected the majority of the world’s population. The World Food Programme (2012) views that, although the food is available and is sufficient enough to feed the entire global population of 7 billion people, there are still 925 million people in the world going hungry. In view of this dire situation, it is estimated that around 146 million children in developing countries are underweight as a result of acute or chronic hunger. The World Bank (2012) reported that the impact of the hike in food prices exposed children to the risk of increased malnutrition, increased
susceptibility to infections, slow cognitive development, poorer school performance, and reduced work productivity.

Islamic economics safeguards the economy from this humanitarian crisis. This is why Islam disciplines the way to earn a living – fair but profitable without exploiting others. The emphasis is on the benefits and rights of the community over the individual. Hence when even a small portion of society earns its living by harmful and unwholesome means, the repercussion of this type of trading is felt by the rest of society (De Lorenzo, 2004: 12). This concept collides with the open-market approach to economic management - "unbridled capitalism" – which emphasises economic growth at all costs without regard to the quality of life and the widening gap between the rich and poor in the society (Vernados, 2008: 44).

5.11.2 The Contagious Effect of Destabilising Speculation

Kamali (1999: 488) maintains that futures speculation does not expose contractual parties to risk-taking, unlawful appropriation, and gain of one party at the expense of others. This is because speculators act as risk-takers who convert the risk-taking motive in the futures contract into an economically productive channel, hence making risk-taking a real commercial risk. To enable futures speculation in becoming an economically productive activity, Rilk and Dar (2009: 344) suggest a certain standard of investors and level of speculation. They argue that where speculative trading is conducted by qualified and sophisticated investors, who are well informed and are able and willing to bear the risk, speculation can be transformed into entrepreneurial risk-taking.

However, Chapra (2010: 36) views that speculative activity by supposedly sophisticated and able institutions, for example in the case of the large hedge fund, LCTM, has caused major disruptions in financial markets, due to its knock-on effect. In the words of Alan Greenspan:

295 Similarly Dema (2009: 8) argues that the increase in commodity prices has also occurred before in the past as a result of supply crises, such as during the 1973 Arab Oil Embargo. But today, unlike previous episodes, there is sufficient supply. There is no line at the gas pump and there is plenty of food on the shelves. But prices are still rising.

296 Destabilising speculation is the sale of stocks or commodities without the intention of taking or making actual delivery. The gain is generated from the price difference and it indulges only in a short-term transaction.

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"Had the failure of the LCTM triggered the seizing up of the markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the form and could potentially impaired the economies of many nation including our own." (as cited in Chapra (2010: 36).

The collapse of another hedge fund, Amaranth in 2006, is another testimony to the failure of sophisticated and able institutions to contain the adverse impact of destabilising speculation. Amaranth was forced to close after it incurred substantial losses of around $6 billion in a single week from a wrong bet in the natural gas spread. In a paper issued by the United Kingdom’s Financial Services Authority (2007: 42), it reported that the collapse can be used as an important test to the stability of the market. It also demonstrated the ability of the market to spread risk. The aftermath of the Amaranth collapse resulted in an $18 billion increase in consumers’ energy prices. In another paper on the Commission’s Review of the Financial Regulatory Framework for Commodity and Exotic Derivatives (2007: 19), the Financial Services Authority reports that the failure of Amaranth did cause a negative impact on market confidence.

In 1997, Malaysia experienced a currency crisis. The then Malaysian Prime Minister, Mahathir Mohamad, alleged that the crisis was the result of a speculative attack on the currency by short-term speculators. This monetary crisis had depreciated the Malaysian ringgit rapidly against the US Dollar. The aftermath of the crisis caused a total loss of RM2.3 billion to the nation due to the increase of the non-performing loan in the local banking system. The crisis also caused economic standstills which led to workers losing their jobs, a high rate of bankruptcies due to defaults, and the people’s standard of living being forced to a minimum level (Mohamad, 2000).

In another episode of destabilising speculation, a number of Islamic financial institutions, which put their financial resources into futures markets, were forced to face the brunt of massive losses due to futures speculation. These institutions engaged in precarious futures speculation in gold, foreign currencies, and commodities. Inevitably a number of institutions suffered heavy losses. Some were at the brink of insolvency. The International Islamic Bank for Investment and Development, for example, incurred heavy losses due to its involvement in speculative trading in the US commodity market and was taken over temporarily by the Central Bank of Egypt (Warde, 2000: 84).
These are amongst the many examples of the impact of destabilising speculation. Borna and Lowry (1987: 221) maintain that a business activity is a gambling activity by virtue of, not its inherent risk but the impact of such risk had on the society. It follows that destabilising speculation generates erratic and unhealthy movement in stock or commodity prices which entails quick gains at the expense of community. It disturbs the economy which emphasises cash flow or resources to be distributed to productive investments. The sheer wastage of economic resources created by the destabilising speculation affects all levels, micro and macro. Maurice Allais aptly describes the adventure of futures speculation when he says:

"...be it speculation on currencies or speculation on stocks and shares, the world has become one big casino with gaming tables distributed along every latitude and longitude. The game and the bids, in which millions of players take part, never cease." (1993: 11)

5.12 What Matters: Maslahah vis-à-vis the Crude Palm Oil Futures Contract or Gambling Legislation

History has shown that the commodity futures contract evolved from the on-spot grain market in Chicago, America. The objective of the market was then to principally trade forward contracts, which allowed buyers and sellers to agree for the delivery of a specified quantity and quality of grain at a predetermined price and date. This type of trading was to address the problem of glut and scarcity in the commodity market (Lurie, 1979: 24). However, this classic futures market evolved into a modern futures market when it introduced contract standardisation as well as offsetting into the structure of the futures contract. This structure attracted the attention of speculators, and thus led to a rapid increase in the volume of futures contracts in the grain market (Spence, 1999: 24).

297 The Metallgesellschaft lost $1.4 billion speculating in oil futures in 1993. The Sumitomo Corporation lost $2.6 billion mostly in copper futures. The future value of the underlying assets are extrinsic to the derivatives contract and to the counterparties in the sense that the counterparties have no or very limited ability to control the outcome of these contingencies. This is unlike a farmer with a forward contract on his wheat who would be able to influence the market price of the wheat if he produces so much wheat that the market price of wheat declines (Lynch, 2011b: 12). Stout (1995: 54) argues that derivatives trading poses not only public problems like systemic risk, it also reduces net social welfare by reducing the welfare of the derivatives traders, namely, the banks, corporation, and retirement funds to which depositors, investors and pensioners confide their savings.

298 For more discussion on this subject, please see (Ariff (a) and (b) (1982: 15), Al-Yousef (2005: 84), Chapra (1986: 95) and El-Saif and Hassan, 2007: 249).
The proponents of the commodity futures market contend that the market plays a more important role than a mere platform for buying and selling commodities. It is a price discovery and risk-shifting mechanism, enabling those exposed to price risk, like hedgers, to shift this risk to other interested players, like speculators. Speculators are now the main player in most of the commodity futures markets in the world. They are said to play a key role as risk-takers as they provide the depth and volume needed in the market (Securities Industry Development Corporation, 2007). On this basis, the proponents argue that the commodity futures contract is permissible under the principle of mașlahah (public interest) (Al-Amine, 2008, Kamali, 2002, Kunhibava, 2009, Ibrahim, 2000 and the SAC, 2006). Kamali (2002, 148) further contends that in dealing with the futures contract, its economic effect is what really matters relative to the motive of the players. Tamer (2005: 127) propounds similar views when he slated Shari’a scholars for missing the broader picture of why instruments like futures and options were needed in modern business environments.

Nonetheless, it is submitted that the mașlahah to use the commodity futures contract as protection against price risk cannot be overruled by the norms of ethics, ribā, gharar, and maysir (Obaidullah, 2005: 381 and : 6). Additionally, the commodity futures contract must be in harmony with the objectives (maqāsid) of Shari’a. The five objectives: namely, religion, human life, progeny, material wealth, and human faculty of reason, must be protected and not transgressed at any cost. Protection of material wealth, for example, is endowed with the right of ownership - to be catered with fair trade and lawful exchange of goods and services. Although individuals are allowed to acquire their own wealth, its acquisition and utilisation must not be in conflict with the interest and benefit of the community (Al-Omar and Haq, 1996: 5).

The analysis of maysir elements in the futures margin system, offsetting and futures speculation as well as the adverse social and economic impact brought about by the futures contract evidence the non-compliance of the above mașlahah prerequisites on the commodity futures contract. The distortion of the role of the futures contract as a mechanism of price discovery and risk management is clearly described by Greenberger where he said:299

299 Manipulation and cornering also distort the useful function of the futures market. Any type of manipulation will trigger prices which are unrelated for a short time to the estimated future supply and demand. As the price trend on the cash market is related to the price trend on the futures market, manipulation of the futures prices might cause the general public to pay prices for the processed commodity not warranted by the supply and demand (n.n.(g), 1955: 908).
One of the fundamental purposes of futures contract is to provide price discovery in the "cash" or "spot" markets. Those selling or buying commodities in the spot market rely on futures prices to judge amounts to charge or pay for the delivery of a commodity...it has been widely accepted that excessive speculation undermines the price discovery function of the futures market. This distortion of the economic fundamentals is otherwise manifested by the unnecessary and substantial price increases that consumers around the world pay for energy, especially crude oil and other everyday consumer staples.” (Greenberger, 2011: 6).

The recent bankruptcy of the American derivatives trading company, MF Global, augments the above submission. Its bankruptcy provoked wrath from the Midwest farmers. These farmers placed their money with MF Global for the purpose of hedging – to lock in a price for wheat, corn, soybeans or whatever they plan to sell in the future. Instead of their risks being hedged, these farmers had to face bigger risks when their capital “were stolen from them” (Bernfeld and Durban, 2011). The futures risk management tool also lost its appeal when Wallace Darnielle, the President of the Plains Cotton Cooperative Association stated:

“The market is broken...It no longer serves its purpose.” (as cited in Tilburg and Stichele, 2011: 35)

A similar view is given by Roger Johnson, the President of the US National Farmers’ Union:

“Excessive speculation led to commodity price bubble. Unfortunately, as speculators created this market bubble, many farmers ended up locking in higher input and feed costs. Now, following the market collapse, farmers and ranchers are struggling to pay these higher costs and rural communities, in turn, are feeling the pinch.” (as cited in Tilburg and Stichele, 2011: 35)

Additionally, the European Commission has found that there is considerable mistrust in the gas and electricity market. This is due to the opacity in the commodity derivatives market which has prevented market participants from having complete trust in the pricing mechanism of the commodities (as cited in Cinquegrana, 2008: 17).

Despite the speculative derivatives contract providing for better price discovery in the market, Lynch (2011a: 51) questions whether this benefit is great enough to warrant the existence of this contract. He even argued that the other plausible alleged societal benefits, such as enhancing liquidity for the hedging market and redistributing wealth from less
efficient investors to more efficient ones, are probably illusionary. On the basis that the social cost of the speculative derivatives contract (the contract entered into between a speculator and a speculator) outweighs their social benefits, Lynch (2011a: 51) maintains that it should be declared void on public policy grounds.300

5.13 Conclusion

This chapter has examined three fundamental parts of the crude palm oil futures contract—the futures margin system, the offsetting transaction and futures speculation. This examination has addressed the question of whether they are contaminated with elements of maysir; namely, betting, chance, gain of one party at the loss of the other party, unlawful acquisition of wealth as well as hatred and enmity. The analysis has revealed that these three sets of apparatus are contaminated. In addition to that, this chapter has shown that though proponents of the commodity futures market argue for it to be permissible under the concept of maṣlaḥah, the evidence has proven that the commodity futures market has failed to represent its purpose as a mechanism of risk management and price discovery. Based on the analysis and in line with the notion that all maysir activities including maysir-tainted activities are prohibited, the chapter has established that, contrary to the SAC resolution, the crude palm oil futures contract is not free from any of elements of maysir.

300 El-Diwany (2010: 121) argues that the harm done by speculation substantially outweighs any supposed benefit in the longer term. Similarly, El-Gamal (2009: 48) contends that though futures contracts can be used judiciously to reduce risk and enhance welfare, they can, on the other hand, entice otherwise cautious individuals to engage in ruinous gambling behaviour. Stout (1995: 57) argues that though the futures contract offers hedging and arbitrage, deemed as having an element of social values, the futures market is widely recognised to further speculation. Carter (n.d., 216) has found that, despite theoretical literatures stating that primary commodity producers (or even marketing boards or entire countries) stand to derive considerable price reduction benefits from hedging with futures, this appears to contradict the reality. The reality is that very few primary producers actually hedge. For example, a 1977 survey by the Commodity Futures Trading Commission found that only 7 per cent of US grain farmers use futures and many of these farmers were speculating rather than hedging. In a 1993 survey of California farmers, only 6 per cent of the surveyed farmers hedged with futures contract.
CHAPTER SIX

The Legitimacy of Gaming or Wagering in the Crude Palm Oil Futures Contract

6.1 Introduction

This chapter extends the analysis on maysir in the offsetting transaction and the variation margin mechanism in the crude palm oil futures contract. Chapter five has shown that these two mechanisms were designed to enable parties to wager under the pretext of the sale and purchase of crude palm oil. With this background, this chapter sets out to establish that wagering via crude palm oil futures contracts is legitimate by virtue of section 103 of the 2007 Act. Section 103 stipulates that:

“For the purpose of any written law, a futures contract made or traded-

(a) on the futures market of a futures exchange; or
(b) on an exempt futures market,

or anything done under such a futures contract, shall not to be taken to be a gaming, or wagering contract.”

The legitimacy of wagering via futures contracts was the result of the revolution in the law on gaming or wagering. This chapter investigates this revolution which was predicated upon the liberalisation movement of futures contracts from the claw of gambling law. This analysis will show that section 103 is premised upon the fact that the wager or bet is legal. It follows that betting or wagering on the rise and fall of the future price of crude palm oil is legitimate and enforceable.

This revolution on the law on gaming or wagering was primarily contributed to by the cooperation and facilitation rendered by the English judiciary. As early as the nineteenth century, the judiciary has demonstrated its willingness to gradually accept the normality of wagering or betting or speculation in the stock and futures exchange. The validation of wagering in the stock and futures exchange was attained through the formulation of three legal tests: namely, the mutual gain and loss; the subjective intention test; and the literal intention test. The literal intention test was obviously engineered towards legitimising wagering on the exchange market. This activity was finally officially sanctioned by the
promulgation of section 63 of the UK Financial Services Act 1986 (which has now been replaced by section 412 of the Financial Services and Markets Act 2000) and section 102 of the Malaysian Futures Industry Act 1993, which has since been substituted by the current section 103.

The analysis here is primarily founded on English common law and statute law. This heavy reliance on the English legal regime is due to the fact that the Malaysian legal system is inherited, via colonisation, from the English legal system. It must also be noted that the cases analysed here are not only cases of commodity futures contracts but also the sale and purchase of shares or stocks. The reason is that the sale and purchase of shares or stocks have been consistently referred to and considered by the English judiciary in adjudicating the legitimacy of commodity futures contracts. It is also due to the fact that these contracts entail a wagering mechanism in the form of settlement by difference in their trading.

6.2 The Relationship between the Commodity Futures Contract and the Gaming or Wagering Contract

Section 2 of the 2007 Act defines a futures contract as an agreement that is, or has at any time been, an eligible delivery agreement or adjustment agreement. The nature of an eligible delivery agreement or an adjustment agreement is elucidated by Slate L.J., in the case of S C F Finance v Masri as:

"...a legally binding commitment to deliver at a future date, or take delivery of, a given quantity of a commodity, or a financial instrument, at an equal price. The contract is standardised in all aspects, except with regards to the price and terms of delivery. Standardisation of contracts allows interchangeability with all other contracts of the same delivery period. This allows buyers and sellers to offset or liquidate any of their open position with an equal and opposite transaction of a futures contract."

In practice, the commodity futures contract is essentially a trading of contracts (James, 1999: 21). This trading entails that its contractual parties only acquire the ordinary rights and obligations in the nature of an ordinary sale and purchase transaction. The right to receive physical delivery and its payment are enforced in the future (Dalhuisen, 2010: 279). Similarly, Chaikin and Moher explicate that the contractual parties in the futures contract do not receive:

"an interest in the underlying commodity or financial instrument, whether it be shares, soya beans or dollars. There is no tangible participation in an asset; there is merely a contractual right either to make delivery or to take delivery of a given commodity or financial instrument at a future time and a given price.” (1986: 390).

So where is the relationship between the commodity futures contract, and the gaming or wagering contract? The relationship lies in the inherent nature of these two contracts. According to Taylor (1993: 65), the structure of the commodity futures contract, which facilitates the so-called buyer or the so-called seller to wager on the rise and fall of the price of the underlying commodity, characterises it as a gaming or wagering contract.302 Thus, Wood (2008: 429) argues that the futures contract is not a contract for the sale of a commodity. This is based on the fact that most of these contracts are settled by offset or by cash instead of physical delivery. Street (1937: 116) elucidates that the contract for future delivery of goods is sometimes even referred to as a “disguised wager”, as it operates on the basis of not having “any interest in the event which may reasonably be represented by such stake.” This is so as the party must pay to the other the future price of the underlying goods (and not for the underlying goods) which was originally unfixed. The parties have no other interest in the contract beyond that amount and they do not even know what the actual amount at stake is.303

The issue on whether the commodity futures contract is a contract by way of gaming or wagering or a legitimate sale and purchase contract has long enveloped the English judiciary. As far back as the seventeenth century, English courts have regarded some contracts for future delivery as wagers and would not attempt to enforce them. This legal position was further bolstered by the statutory proscription - the Gaming Act 1845 (the 1845 Act) - which declared contracts by way of gaming or wagering as void and unenforceable (Gray and Fennell, 1997: 161). This position has vexed commodity futures market players.304 Nevertheless, this position has changed over the centuries as trading by

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302 He also raised an intriguing legal argument in deciding the legality of this contract. The question is whether trading in contractual rights to goods is regarded as an equivalent to trading in the goods themselves; or is trading a mere contractual interest in which parties have the option to perfect into a property interest (namely, acquiring legal proprietary interest over the property).

303 Hence it is impossible to say that either party has any interest in the event as represented by such stake.

304 There will not be a problem if parties intend to settle the contract by physical settlement. In a case where parties have an election to either settle physically or by cash settlement, it would then be necessary for the parties to prove that they have a genuine intention in taking delivery as part of some commercial purposes and not as merely a sham (Hudson, 2006: 258).
difference or futures speculation in the commodity futures market has become part of the custom and norm of the market.\(^{305}\)

The reason for this shift is because speculation has become “domesticated” as people have come to believe that, like investment and unlike gambling, it was a legitimate way to risk money. By the beginning of the nineteenth century, Britain experienced, on the one hand, a legal growth in the restrictions on gambling and on the other hand, a rise in the removal of restrictions on speculation (Itzkowitz, 2002: 126). At this juncture, it is worth noting the remark of J. Phillip Jones:

“As in all advanced societies the British gamble on the stock exchange and in currency speculation, but there is an element in British society, perhaps unique in the word, which, while, vociferously anti-gambling in the betting sense, does not hesitate to take speculative risks on the Stock Exchange. These people regard the investment in stocks and shares solely in the expectation of a rise in value as a legitimate enterprise and, in the absence of the customary appurtenances of gambling, this can never in their view be a gamble in the ethical sense.” (1973: 28)

Hence, it is not surprising that the proponents of the commodity futures contract maintain that the commodity futures contract is just like any other contract.\(^{306}\) The complex structure of its trading just warrants it to be treated distinctively (Kwai, 1996: 4). This distinctive treatment is meted out in the following areas: (i) that the commodity sold in the futures contract is not owned by the seller or even exists at the time of contract, yet is not only common but legal; (ii) that the transaction which is entered into on “margin” will not be branded as a wager but as a legal contemplation in the event of a default;\(^{307}\) and (iii) that

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\(^{305}\) The setting up of the private exchange with membership requirements, margin requirements and a host of other rules was to ensure that fellow speculators make good on their contract promises. This establishment together with its governing framework ameliorated the problem of unenforceability of contract of difference (Stout, 2009: 6).

\(^{306}\) On the other hand, Taylor contends that it is a contract of sale but in the form of, “the purchase and sale of contract rights in unidentified grain. A speculator makes no promise of a performance for which there is no agreed exchange; if he undertakes to deliver, he receives a promise to pay for what is delivered and by delivering he requires full payment. If he promises to pay for a given amount of goods, he receives a promise to deliver that identical amount, and, by paying in full, he can enforce such delivery. He clearly has an “interest” outside of the contingency which determines whether he gains or loses, for he always has a contract right to trade money for goods, or goods for money.” (1993: 89)

\(^{307}\) Simon and Novack argue that, "...where both parties to a market transaction are market traders who are dealing with commodities of fluctuating value, the contract should be treated as equivalent to a bet which the parties are making against the future market price. Payment of market damages amounts to specific performance of the bet. Since a functioning futures market is predicated on a system of enforceable bets against the future, “specific performance” of those bets - through payment of market damages - can be viewed as fundamental to the continued existence of the market itself." (1979: 1437)
trade settled by difference rather than physical delivery\textsuperscript{308} is an instance of damages paid for an anticipatory breach represented by differential sum (Kreitner, 2000: 1103).

In order to comprehend this development, the pursuing sections analyse the revolution of gaming or wagering contract law from the aspect of intervention rendered by the English judiciary and statute. The discussion will illuminate the progressive liberalisation of commodity futures contracts from the claw of gaming or wagering law. As the discussion is essentially predicated on the development of English common law, it is important to explain the connection and influence of English common law and statutes to the legal system in Malaysia.

6.3 The Application of the English Legal System in Malaysia

The English legal system plays a significant role in the existing features and structure of the Malaysian legal system. Malaysia's current legal system is the result of one hundred and seventy years\textsuperscript{309} of British colonisation (Andaya and Andaya, 2001). Section 3 of Malaysia's Civil Law Act 1956 (1956 Act) enshrines the wholesale application of English law into Malaysia (application is qualified by the existence of local laws and customs) while section 5 provides for the mandatory areas of application.\textsuperscript{310}

\textsuperscript{308} On the ground that commodity futures contracts would commonly provide for substitution of physical delivery with cash settlement, Patterson (1931: 855) questions the legality of such a provision. Notwithstanding the fact that this contractual provision specifies the measures for damages due to a breach in the agreement (which is equivalent to the measures taken by the court in the absence of any agreement), the law does not recognise such provisions which ostensibly stipulate that payment of money shall be substituted for other performances. It is submitted that at present, the futures legal framework accommodates and validates such practices of incorporating substitution provision in the commodity futures contract. Even the mechanic of setting off (settlement by way of difference) is by virtue of the decision of the Supreme Court in Board of Trade v/Chicago v Christie, is now legally regarded as delivery (n.n.(b), 1932: 914).

\textsuperscript{309} Malaysia was a British colony from 1791 till 1957.

\textsuperscript{310} Section 3(1) states that "Save so far as other provision has been made or may hereafter be made by any written law in force in Malaysia, the Court shall –

i. in West Malaysia or any part thereof, apply the common law of England and the rules of equity as administered in England on the 7th day of April, 1956;

ii. in Sabah, apply the common law of England and the rules of equity, together with statutes of general application, as administered or in force in England on the 1st day of December 1951;

iii. in Sarawak, apply the common law of England and the rules of equity, together with statutes of general application, as administered or in force in England on the 12th day of December, 1949, subject however to subsection (3)(ii):

Provided always that the said common law, rules of equity and statutes of general application shall be applied so far only as the circumstances of the States of Malaysia and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary.
Section 26 of the 1956 Act and section 31 of Malaysia’s Contracts Act 1950 (1950 Act) envisage the laws on the gaming or wagering contract. These statutory provisions are modelled after section 18 of the 1845 Act. Section 26 of the 1956 Act provides that:

“(1) All contracts or agreements whether by parol or in writing by way of gaming or wagering shall be null and void.”

(2) No action shall be brought or maintained in any Court for recovering any sum of money or valuable thing alleged to be won upon any wager or which has been deposited in the hands of any person to abide the event on which any wager has been made.

(3) Subsections (1) and (2) shall not be deemed to apply to any subscription or contribution, or agreement to subscribe or contribute, for or toward any plate, prize, or sum of money to be awarded to the winner or winners of any lawful game, sport, pastime or exercise.”

Section 31 of the 1950 Act stipulates that:

“(1) Agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to any person to abide the result of any game or other uncertain event on which any wager is made.

(2) This section shall not be deemed to render unlawful a subscription or contribution, or agreement to subscribe or contribute, made or entered into for or toward any plate, prize, or sum of money, of the value or amount of

(2) Subject to the express provisions of this Act or any other written law in force in Malaysia or any part thereof, in the event of conflict or variance between the common law and the rules of equity with reference to the same matter, the rules of equity shall prevail.”

Section 5(1) states that “In all questions or issues which arise or which have to be decided in the States of West Malaysia other than Malacca and Penang with respect to the law of partnerships, corporations, banks and banking, principals and agents, carriers by air, land and sea, marine insurance, average, life and fire insurance, and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in the like case at the date of the coming into force of this Act, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law.

2. In all questions or issues which arise or which have to be decided in the States of Malacca, Penang, Sabah and Sarawak with respect to the law concerning any of the matters referred to in subsection (1), the law to be administered shall be the same as would be administered in England in the like case at the corresponding period, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law.”

For a more comprehensive discussion on the reception of English common law and statute law, please see Ahmad (2007), Batholomew (1985), Harding (1985), Hooker (1983) and Rutter (1989). Gengatharen (2001: 103) suggests that though both provisions, namely; section 26 of the 1956 Act and section 31 of the 1950 Act achieve a similar flavour of legal effect, however, in the event of any inconsistency, section 26 supersedes section 31.
five hundred dollars or upwards, to be awarded to the winner or winners of any horse-race.”

Their predecessor, section 18 of the 1845 Act\(^{312}\) prescribes that:

“All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law or equity for recovering any sum of money or valuable thing alleged to be won upon any wager, or which shall have been deposited in the hands of any person to abide the event on which any wager shall have been made: provided always, that this enactment shall not be deemed to apply to any subscription or contribution, or agreement to subscribe or contribute, for or toward any plate, prize, or sum of money to be awarded to the winner or winners of any lawful game, sport, pastime or exercise.”

The application of the doctrine of binding precedent or *stare decisis*\(^{313}\) as well as section 3 of the 1957 Act binds the Malaysian judiciary to take the precedent of their English counterparts in deciding cases related to the contract of gaming or wagering.\(^{314}\) For instance, in the case of *S E Mizrahie v Stanton Nelson & Co Ltd*,\(^{315}\) the question of legality of the rubber futures contract was raised by one of the parties. The court held that the rubber futures contracts which were entered into between the client via his broker and third parties (in this case, the client, via his broker, entered into two sets of futures contracts. One was with the members of the public and the other set was with the Singapore Chamber of Commerce Rubber Association) were not real transactions of commerce for the purchase and sale of rubber but were entered into for the purpose of enabling the client to gamble in difference.\(^{316}\) The contracts, therefore, were contracts of gaming or wagering. In

\(^{312}\) This section is also referred to as section 18 of 8 & 9 Vict. c. 109 (Street, 1937: 129).

\(^{313}\) *Stare decisis* is a maxim which denotes the binding nature of an earlier judgement or decision onto a later case which litigates on the same or similar points (Law and Martin, 2009: 524).

\(^{314}\) Other Malaysian cases which bear reliance on English law are *Ganda Oil Industries Sdn Bhd & Ors v The Kuala Lumpur Commodity Exchange & Ors* [1988] 1 CLJ (Rep) 56, where the issue was whether the KLCE was acting judiciously in their administrative decision-making; *Pet Far Eastern (M) Sdn Bhd v Tay Young Huat & Ors* [1999] 2 CLJ 886 which deals with the issue of legality in conducting gambling activities over an international waters and the case of *Southern Acids (M) Berhad v Standard Chartered Bank Malaysia Berhad* [2011] 1 LNS 132 which deals with the issues of conflict of laws and that the ISDA (International Swaps and Derivatives Association) Master Agreement is alleged as a wagering contract and hence unenforceable in law.

\(^{315}\) [1958] 1 LNS 73.

\(^{316}\) In the case of the contracts entered into between the clients via his broker with the members of the Singapore Chamber of Commerce Rubber Association, the court held that they still amounted to contracts for difference. This was due to the method the broker adopted in performing the contract entered into with these members. Under the Rubber Association’s rules, bye-laws and FOB conditions of sale, the clients (because they were members of the public and not being a member of the Association) could not accept or deliver the contract notes (made pursuant to the sale and purchase of rubber futures); namely, the registered tender, from and to the actual members of the Association. On this condition, and to avoid breaching the conditions of sale, when the broker received the registered tender from a member of the Rubber Association, the broker would not deliver it to his clients, who were members of the public, but instead diverted it to another member of the Association who wished to receive a registered tender for that particular month. Due to this
coming to this decision, the court relied on the judgement of English cases; namely, \textit{Weddle, Beck \& Co v Hackett}, \textit{Thacker v Hardy}, \textit{Universal Stock Exchange v Strachan} and \textit{Woodward v Wolfe}.\footnote{\cite{Ibid., at 79.}}

In another case, \textit{John Lo Thau Fah v Face Resorts Berhad},\footnote{\cite{[2007] 8 CLJ 484.}} the court had to determine whether some terms of the contract, which are contingent in nature, would amount to a contract of wager. In deciding this issue, the court relied on the decision of \textit{Carlill v Carbolic Smoke Ball \& Co} and \textit{Earl of Ellesmere v Wallace}.\footnote{\cite{Ibid., at 491.}} Similarly, the Court of Appeal in the case of \textit{YK Fung Securities Sdn Bhd v James Capel (Far East) Ltd}\footnote{\cite{[1997] 4 CLJ 300.}} adopted the decision of \textit{Universal Stock Exchange v Strachan}, \textit{Re Gieve} and \textit{Philp v Bennet}. By taking precedent from these English cases, the court held that the forward contract for the sale and purchase of shares was not illegal nor was it a contract for gaming or wagering. In passing, their Lordships even referred to section 18 of the UK Financial Services Act 1986. This section stipulates that no contract which is entered into by any or either of the parties for the purpose of business shall be void or unenforceable for reasons of section 18 of the 1845 Act.\footnote{\cite{Ibid., at 333.}}

Finally, in the case of \textit{Macphail \& Company (Ipoh) Ltd v Oam Parkash},\footnote{\cite{[1964] 1 LNS 108.}} a share broker company sued his customer for a sum of money incurred in the course of performing their contractual duty. The question to be decided was whether the contractual relationship between the customer and the broker company was so tainted with wagering or gaming that it could render the company’s claim unenforceable. Applying the case of \textit{Cooper v Stubbs}, \textit{Universal Stock Exchange v Strachan} and \textit{Thacker v Hardy}, the court held that the broker company was entitled to recover as the transaction was not held to be a gambling contract.\footnote{\cite{Ibid., at 109.}}

Based on the above legal position, English common law on gaming and wagering contracts is very significant in the legal framework of the Malaysian crude palm oil futures contract.
The revolution of this law has not only revolutionised the UK futures market but also Malaysia’s. The following discussion on this revolution will commence with the definition and concept of a contract by way of gaming or wagering.

6.4 Gaming or Wagering Contract: Its Definition and Concept

The term “gaming or wagering contract” is not defined anywhere in the UK or the Malaysian gambling statutes. As a result, the British judiciary came up with its own judicial interpretation. This section initiates the definition of the gaming or wagering contract by first defining its basic words. For a start, the word “wager” is defined by Sir William Anson (as cited in the case of Ellesmere v Wallace\textsuperscript{325}) as:

"a promise to give money, or money’s worth, upon the determination or ascertainment of an uncertain event; the consideration for such a promise is either something given by the other party to abide the event, or a promise to give upon the event determining in a particular way...there must be mutual chances of gain and loss...and the parties must contemplate the determination of the uncertain event as the sole condition of their contract."

Wager is also defined by Lord Hunter in his judgement in the case of Strang v Brown\textsuperscript{327} where he says:

"...a man hands over a certain amount of money to another on the understanding that he will receive a larger sum of money if some uncertain future event occurs in the way in which he predicts it will occur."

Lord Alverstone C.J. in Lockwood v Cooper\textsuperscript{329} describes gaming, which is essentially wagering:

“To amount to gaming the game played must involve the element of wagering – that is to say, each of the players must have a chance of losing as well as winning.”\textsuperscript{330}

\textsuperscript{324}The terms gambling, gaming, betting and wagering are often used interchangeably. Technically however, these terms are derivatives of gambling. The discussion on the legal position of gambling covers a vast area of gambling which includes not only gambling activities as understood in the ordinary sense of the word, for example horse racing, lotteries, jackpots, but also relates to contract for difference practiced in futures and stock exchange (Chenery, 1963: 1).

\textsuperscript{325}[1929] All ER Rep Ext 751.
\textsuperscript{326}Ibid., at 761.
\textsuperscript{327}(1923) J.C. 74.
\textsuperscript{328}Ibid., at 78.
\textsuperscript{329}[1903] 2 K.B. 428.
\textsuperscript{330}Ibid., at 431.
Similarly, Huddleston, B., in deciding the case of *Dyson v Mason*,\(^{331}\) described gaming as a game, whether it is one of skill or chance, and that it is played for money. It is a game which involves both players initially staking an agreed sum of money and that the winner will eventually take all the money staked. The amount of stake that is involved in such a game is not a material issue.

Hence, the expression of a gaming contract or wagering contract indicates the parties’ agreement, either orally or in writing, made to materialise their arrangement of a wager. In this respect, Lawrence LJ in the case of *Ellesmere v Wallace*\(^ {332}\) defined a contract by way of gaming, as expressed in section 18 of the 1845 Act as:

"...the contract resulting from the mutual promises which the players necessarily make (expressly or by implication) in playing for stakes, as to the transfer of such stake upon the result of the game."\(^ {333}\)

Whereas a wagering contract is defined by Hawkins J. in the case of *Carlill v Carbolic Smoke Ball C.*\(^ {334}\) as:

"A wagering contract is one by which two persons professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum or money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract."\(^ {335}\)

Finally, the contract by way of gaming or wagering is described by Cotton LJ in the case of *Thacker v Hardy*\(^ {336}\) as:

"(t)he essence of games and wagering is that one party is to win and the other to lose upon a future event, which at the time of the contract is of uncertain nature –

\(^{331}\) (1889) 22 Q.B.D. 351, 354.

\(^{332}\) [1929] All ER Rep Ext 751, 765.

\(^{333}\) Ibid., at 765.

\(^{334}\) [1892] 2 Q.B. 484.

\(^{335}\) Ibid., at 490.

\(^{336}\) (1878) 4 Q.B.D. 685.
that is to say, if the event turns out one way A will lose, but if it turns out the other way he will win."337

The above definitions of the gaming or wagering contract echo the difference settlement achieved through offsetting and the variation margin. These futures mechanics enable contractual parties to wager on the rise and fall of the underlying commodity prices, which eventually results in one party gaining at the expense of the other. In economic reality, futures contracts performed through set-off were difference contracts by another name338 (Stout, 2011: 15). The offsetting enables parties to settle their contract by way of difference instead of delivery. Lord Donaldson MR in City Index v Leslie339 described contract for difference as:

“pairs of contract, one for the notional sale and one for the notional purchase of a particular quantity of the commodity, the intention of both parties being that no property in the commodity shall pass, but that the contracts will be fulfilled by paying sums of money based upon price differences at different times.”340

In the same case, Leggatt LJ refers to a contract for difference as:

“a contract intended by both parties to end in the payment of differences.”341

Hence, as will be shown in the later section, contract for difference clearly contradicts the law on gaming or wagering held prior to the twentieth century. In principle, the application of this law would inevitably outlaw the whole mechanism of commodity exchanges. However, due to the legal revolution, this is no longer the case (n.n.(b), 1932: 914).

The next section analyses the evolution of the law on the gaming or wagering contract which went through a few stages of legal tests. As a result of these legal tests, the commodity futures contract was no longer adjudicated as a contract by way of gaming or

337 Ibid., at 695
338 This is done by a procedure where either party to the contract extinguishes his or her contractual obligation by selling or purchasing (as the case may be) a second offsetting contract. For example, a trader is obligated to sell 100 bushels of wheat on May 1 but, prior to May 1, decides to offset her obligation by purchasing a contract to buy 100 bushels of wheat on May 1. By doing this, she will absorb the price difference as either a profit or loss (Stout, 1999: 720).
340 Ibid., at 106
341 Ibid., at 111.
wagering but rather a valid and enforceable contract on the basis that it is traded on a legal and official institution. 342

6.5 The Revolution of the Law on Gaming or Wagering

The laws on contract by way of gaming or wagering have been laid down in numerous English gambling statutes as early as the fourteenth century. 343 By the passing of the 1845 Act, all contracts by way of gaming or wagering became void and unenforceable in courts of law. 344 Though the 1845 Act has been repealed and replaced by the Gambling Act 2005, 345 for the purpose of this discussion, section 18 of the 1845 Act will be referred to in the analysis of the liberalisation movement. The reason is that section 18 was the catalyst for the illegitimacy of most of the on-exchange commodity futures contracts.

To be precise, the effect of section 18 was not that it caused gaming or wagering contracts to become illegal, but it only made such contracts unenforceable (Chenery, 1963: 11). In other words, it became legal to gamble, bet or wager but any disputes arising from such betting or wagering arrangement would not be meted out by the courts due to their invalid nature. However with the increase in the trading volume of commodity futures, in the nineteenth century, this trend has changed. English courts were inundated with cases

342 Purely on technical reasons, the transactions on the stock exchange (as well as the futures exchange) were seen as legal even if they might have the appearance of gambling. Coldridge and Hawkford wrote, “The result of the speculator may be the same as if he had entered into a mere differential transaction. But he has employed a different machinery and has utilised a separate legal obligation which could have been specifically enforced or for a breach of which damage of an ascertainable amount could have been recovered” (as cited in Itzkowitz, 2002: 127).

343 The effect of these statutes includes declaring certain games to be illegal, making certain lawful games unlawful due to the involvement of wagering, restricting the use of certain places for gaming and betting, and, by virtue of Gaming Act 1845, preventing the enforcement of gaming or wagering contracts (Chenery, 1963: 7).

344 Beside the UK, the wild speculation of the tulip bulbs futures market in Holland in the year 1634-1637 (better known as the “Tulip Mania”) had sanctioned the pure speculative futures contract as unenforceable. The authorities lambasted it as immoral gambling. Nonetheless, futures for hedging were permitted. See also Day (2004) and Weber (2008).

345 On 1st September 2007, all statutory provisions which previously prevented the enforcement of commodity futures contracts were repealed. As a result, the commodity futures contract which embodies a differential settlement mechanism is now valid and enforceable so long as it falls under the category of regulated activities under the Gambling Act 2005 (the 2005 Act) and the Financial Services Market Act 2000 (the 2000 Act) (Halsbury(b), 2008: 362). The 2005 Act provides for the licensing of gambling businesses and exempted from these businesses activities which are regulated by the 2000 Act. Section 335 of the 2005 Act provides for the enforcement of gambling contracts where it states, “335(1) The fact that a contract relates to gambling shall not prevent its enforcement”. However, this legal position is not applicable if there is any rule of law which prevents the enforcement of such contract on the ground of unlawfulness. Section 412 of the 2000 Act generally exempts contracts from being contracts of gaming or wagering if the contracts are entered by way of business by one of the contractual parties.
involving contracts for difference, in the form of commodity futures. In most of these cases, the judiciary were assigned to construe whether they were contracts by way of gaming or wagering or real commercial contracts.

The absence of the definition of the phrase "gaming or wagering contract" in the 1845 Act is capitalised on by the judiciary to reengineer the working of the 1845 Act. Bearing the task of defining the context of such a phrase, the judiciary has innovatively formulated a series of legal tests to ascertain whether the difference contract underneath a commodity futures contract is to be adjudicated as a contract by way of gaming or wagering or a commercial contract of sale and purchase. The judiciary has devised the following legal tests:

(a) the mutuality of gain and loss;

(b) the mutuality of intention to execute the delivery of stocks or commodities (Chaikin and Moher, 1986: 393). This test can be further divided into two:

(i) the subjective intention of non-delivery derived from an underlying secret arrangement, irrespective of the express provision of delivery; or

(ii) the literal intention of delivery derived literally from an explicit contractual provision of delivery.

For the purpose of this discussion, the mutuality of gain and loss will be discussed prior to the mutual intention tests though, historically, the mutual intention tests were the first test introduced. The reason for doing so is that mutual intention tests were applied more extensively by the courts.

6.5.1 The Mutuality of Gain and Loss

This test came from an 1878 Court of Appeal case, Thacker v Hardy. The claim involves a contract made between a stock broker who, at the same time, was a member of the London Stock Exchange, and his principal cum client. This contract was for the appointment of the broker to enter into speculative buying and selling of stocks on behalf

346 (1878) 4 Q.B.D. 685.
of his client at the London Stock Exchange. Though the instructions were to enter into buying and selling of contracts, the broker was aware that his client intended to neither accept the stocks bought nor deliver the ones that were sold. The broker was also aware that the client was not in the capacity to carry out these obligations of making and taking delivery. There was in fact an arrangement between the client and the stock broker for these transactions to be settled by way of difference. Despite the stock broker performing his contractual duties, his client refused to pay his commission. The broker brought this case to the court to claim his due and an indemnity for the liabilities incurred by the broker on behalf of his client.347

The crux of the dispute involved two sets of contracts. One was the contract between the broker and his client and the other type of contract was the contract between the broker and a third party, and in this case, a jobber. One of the judges, Lindley J., found that the contract between the broker and his client was not a buying and selling contract but a contract to cause the broker to enter into buying and selling contracts with the jobber on behalf of his client. It was in respect of the contract between the broker and the jobber that the broker had incurred a liability on behalf of his client and, against this contract, the broker had sued his client. As the buying and selling of stocks in the stock exchange were deemed legal transactions, the judge held that the transaction entered into between the broker, on behalf of his client, and the jobber was a real and valid transaction. On this line of reasoning, the judge held that the broker was entitled to indemnity under the contract between the broker and jobbers, notwithstanding the demoralising and reprehensible nature of gambling in the transaction between him and his client.348

As the decision was not in his favour, the client appealed to the Court of Appeal. In delivering their judgment, one of the judges in the Court of Appeal, Cotton L.J., propounded the test of mutuality of gain and loss. He states:

"The essence of games and wagering is that one party is to win and the other to lose upon a future event, which at the time of the contract is of uncertain nature – that is to say, if the event turns out one way A will lose, but if it turns out the other way he will win."349

347 An agent, in this particular case, the broker, is entitled in law to an indemnity from his principal for all liabilities incurred by the agent in executing the orders of the principal, so long as the orders are not illegal orders or the liabilities incurred are not due to the fault or negligence of the agent.
348 Ibid., at 688.
349 Ibid., at 695
Relying on this test, he argued that the broker had derived no gain from the transactions in which he entered with the jobbers, on behalf of his client. The broker was only gaining from his commission, the gain of which he was entitled to for performing his contractual obligations. The commission was due and payable to him by his client irrespective of the trading result. In view of this, the judge held that the contract between the broker and his client was absent from any element of gaming or wagering.

The judges have also distinguished the test of mutuality of intention, formulated in an earlier case, *Grizewood v Blane*, in order to justify the non-applicability of the Grizewood's test to the fact of *Thacker v Hardy*. In *Grizewood v Blane*, the contract for the sale and purchase of stocks was entered into between a broker and another broker. Both of these brokers never intended to execute the contract as actual buyer and seller. It was simply a bargain which resulted in the parties gaining or losing based on the rise or fall of stock price on an agreed future date. On this fact, the court in *Grizewood v Blane* decided that such contract was a wagering or gaming contract as there was an essential element of wager. The court in that case applied the mutual intention test to the facts of the case and found that the contract, though it appeared as a contract for sale of stock, was, in reality, made purely to carry out a gambling transaction.350

Before going to the next case, namely the case of *Forget v Ostigny*, it is important to note two pointers made in *Thacker v Hardy*. First is the contract factor in which Lindley J. states that though:

“This Act (the 1845 Act) does not expressly mention or allude to Stock Exchange transactions; but it has been decided that agreements between buyers and sellers of stocks and shares, to pay or receive the differences between their prices on one day and their prices on another day, are gaming and wagering transactions within the meaning of the statute.”351

Accordingly, a “sale and purchase” agreement is adjudicated a gaming and wagering transaction if there is an additional agreement which letters the agreement of the parties to pay and receive the differential payment instead of delivery. If no such agreement is found, the “sale and purchase” agreement is not a gaming or wagering agreement. Based on this premise, the contract to appoint the broker to enter into such sale and purchase transactions on behalf of his client was held to be not a gaming or wagering contract. This was held

350 Ibid., at 698.
351 Ibid., at 686.
notwithstanding as Lindley J. found facts pertaining to gambling in the transaction between the broker and his client.\textsuperscript{352}

At this juncture, it is worth noting the gambling elements found by Lindley J.: namely, (i) the client was a speculator and the broker was aware of this fact; (ii) the client appointed the broker to speculate for him in the Stock Exchange; (iii) the client knew, or must be taken to have known, that in order to carry out this instruction, the broker would have to enter into a series of contracts to sale and in return, contracts to purchase; (iv) there was no other way for the broker to speculate for his client; (v) the broker did buy and sell accordingly; (vi) the client never expected or intended to accept or make actual delivery of the stocks and the broker was aware of this fact; (vii) the client knew that he incurred the risk of having to accept or deliver but was content to assume such risk in the expectation and hope that his broker would be able to arrange matters so as to render nothing but difference payable by or to him; and (viii) unless the broker could arrange matters as expected, the client would not be able to pay what had been bought for him nor deliver what was sold for him and the broker was fully aware of this fact.

Second is the party factor. As the sale and purchase bargain transpires between the broker and a third party, and not between the broker and his client, the court would only scrutinise this broker and third party relationship to find out whether the parties have in fact mutually entered into a bargain of wager or a real bargain of sale and purchase. The examination of this relationship is feasible in the case of the sale and purchase of stocks as parties would have the knowledge and information pertaining to one another and the contract itself matures between the original parties. However, the examination of contractual parties in commodity futures contracts may not be feasible as Taylor (1993: 75) contends that: (i) contracts are assigned freely between a multitude of parties in the exchange; (ii) consensual elements between the initial parties or principal parties disappear; hence (iii) discovering the intent of principal parties are accordingly difficult. This gets complicated with the procedure of the clearing house interposing itself as the counter-party to each individual contract.

Thus, this raises the question on how to examine the intent of the clearing house – whether it would have had any intention to wager with its counter-party or not. James (1999: 23)

\textsuperscript{352} Co \textsuperscript{oper} and Cridlan (1971: 25) have also observed that despite such dealings are speculative, it is only in very rare cases that a contract between a broker and his client is considered under the law as a wager contract.
argues that the clearing house does not have any intention of wagering as it does not incur any profit or loss from the movement of the price of the underlying commodity. By taking the margin from its counter-party, the clearing house is insulated from any credit risk or loss. Nevertheless, it is submitted that though in theory the clearing house is not exposed to the gain and loss, in reality the clearing house may still be held in a detrimental position. For example, due to the substantial concentration of risk on the central counter-party on October 19, 1987 ("the Black Monday"), Hong Kong's futures exchange was suspended. The temporary suspension was due to the failure of the clearing house via its Guarantee Corporation to cope with the crash caused by the collapse of the global stocks market. As a result, the market faced a wave of dishonoured contracts due to the continued sharp descent of the futures price. This failure brought Hong Kong's futures market to the brink of collapse, disabling numerous members of the exchange from getting their winnings, worth billions of dollars (Gunningham, 1990: 2).353

In the case of Forget v Ostigny,354 the court had referred to and applied the decision of Thacker v Hardy. This case involved an appeal to the Privy Council by a stock broker who sued his client to recover a sum of $1926 arising out of a series of sales and purchases of shares. These contracts were entered into by the broker on behalf of the client in the Montreal Stock Exchange. The trail of transactions was initiated with the purchase of shares of the Montreal Railway Street Company, which was then followed by a later purchase of shares of other companies. The shares so purchased were sold from time to time. In every case, the delivery of shares was obtained by the stock broker from a member of the Stock Exchange from whom he purchased the shares and these shares were duly paid for. In between the time of the purchase and that of the sale of particular shares, dividends were paid upon them and credited into the account of the client. The Court of Queen's Bench for Lower Canada had decided that these transactions were gaming contracts and hence under article 1927 of the Civil Code of Lower Canada,355 the stock broker was not entitled to recover such sums of money from his client. Hence, the stock broker appealed to the Privy Council.

353 The failure was exacerbated by the fact that the total paid-up capital of the Guarantee Corporation of $15 million (US 2 Million) was disproportionate with the total trading of the futures market, namely, multi billions of US dollars. The Hong Kong's futures market was reported to be trading HK4.3 billion in August, 1987. This was due to the amount of 14,000 financial futures contracts being traded in a day. As the result of having such a massive amount tied up in the futures market, the Hong Kong's stock exchange and futures exchange were suspended to avoid catastrophic consequences to the entire financial system of Hong Kong.


355 Article 1927 of the Civil Code of Lower Canada stipulates that, "There is no right of action for the recovery of money or any other thing claimed under a gaming contract or bet."

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The judgement of the Privy Council was delivered by the Lord Chancellor, Lord Herschell. Applying the test as laid down in *Thacker v Hardy*, the judge held that the contract was not a gaming contract nor involved any betting as the broker who acted as the client’s agent did not suffer any losses for any gain acquired by the client in the series of speculative purchases and sales of shares. Nor did the broker acquire any gain for any losses suffered by the client. This is because whatever the result of the market value of the shares, the broker was entitled to benefit exclusively from his remuneration fixed at \(\frac{1}{4}\) per cent commission for each and every transaction entered.\(^{356}\)

In adjudicating this case, the court referred to and evaluated the contract entered into between the broker and his client and the contracts entered into between the broker on behalf of his client and the jobber. After ascertaining the exact nature of these contracts, the court outlined the following findings:

1. the stock broker was employed by his client to act as his agent to make certain contracts of purchase and sale;
2. the contracts entered by the stock broker were made within his given authority;
3. the shares purchased and sold via these contracts were in every case delivered and the price on them paid and received;

On this finding, the court held that they constituted real transactions. The court refers to the decision of the Court of Appeal in the case of *Thacker v Hardy* where in that case, Bramwell L.J. remarked that:

"The bargains made by the Plaintiff on behalf of the defendant were what they purported to be; they gave the jobber a right to call upon the broker or the principal to take the stock, and they gave the broker the right to call upon the jobber to deliver it... I would assume that was the nature of the bargain between the parties, and that by its terms the principal would be entitled to call on the broker to resell the stock, so that, instead of taking and paying for it, the principal would have to pay only the differences."\(^{357}\)

It is important to note that the facts of this case clearly exhibit a real sale and purchase transaction. There was delivery of shares and payment for delivery, including a receipt of dividend by the client, being the owner of the company shares, throughout the business

\(^{356}\) Ibid., at 2122.
\(^{357}\) Ibid., at 2124.
period. Based on these facts, the proposition of Lord Herschell of the intention test in the form of express stipulation in the contract is well premised. In this respect, he states that:

“(m)uch stress was laid on the fact that the respondent never asked for delivery of any of the shares purchased, and the appellant never tendered any such delivery. The question whether a contract is intended to be executed by delivery according to the obligation expressed upon the face of it is no doubt an important test for determining whether it is a real one or only a gambling arrangement under the guise of a commercial contract.”

In a later case, Richards v Starks, the judge, Channell L.J, adopted the decision of Thacker v Hardy but held a different ruling. This case involved a contract between a London stock broker and his client. The contract, in the form of a circular, showed that the stock broker would, upon payment of the subscription money, speculate the money of his subscribers in three named stocks held under the broker’s three-month’s trust. The broker had promised that the subscriber would be entitled to the profit which was made from the difference between the price of stocks on the opening day in the London Stock Exchange and the prices at the end of ninety days from that date in the same exchange. In the event that there was no such profit, the subscriber would be entitled to the return of their subscription. The client made two subscription payments for the two trusts in which one of them resulted in a loss. The client sued the broker to recover the amount of profit, less than ten per cent, accrued under the first trust and a reimbursement of the subscription payment from the second trust.

In deciding whether this contract was a contract by way of gaming or wagering, the judge referred to the test of mutuality of gain and loss. Based on this test, Channel L.J. opined that the contract made between the client and the broker could not be a gaming or wagering contract as the client did not incur any loss due to the refund of his subscription. However in view of the fact that the subscription money was returned to him without its accrued interest, the judge found that this was a loss to the client. Due to this loss in interest, the judge held that this contract was a contract by way of gaming or wagering under section 18 of the 1845 Act. It is intriguing that despite the glaring indication in the contract that the broker would wager on behalf of the client on the rise and fall of the stock price in the London Stock Exchange this did not form part of the judgement.

358 Ibid., at 2123.
A similar attitude is exhibited in the case of Weddle, Beck and Company v Hackett.\(^{360}\) In this case, the judge, Swift J., had to decide on the legality of a claim to recover payments for the shares paid by the stock brokers on behalf of their clients. The arrangement was that one of the agents of the stock brokers would enter into a series of contracts to buy and sell shares which the client was not expected to take up or make delivery of these shares. The arrangement also included the sale of shares by the agent before they became due and the client would then settle these contracts either by receiving the gains or paying the loss – namely the difference between the buying and selling price of the shares. To implement the instruction of his client, the agent would enter into contracts to buy and sell shares with stock jobbers who did not know that the transactions were not genuine and that, in due course, the shares would not be taken up. The client objected to the claim and argued that these transactions were void and unenforceable under the Gaming Act 1892 and, under this Act, the stock brokers were not entitled to recover any money which they may have paid away on his behalf or in commissions.

In ascertaining the legality of the contracts for the sale and purchase of shares made between the agent of the stock brokers and the stock jobbers, the judge referred to the decisions of Thacker v Hardy, Carlill v Carbolic Smoke Ball C. and Grizewood v Blane. Based on these decisions, the judge held that the contracts between the agent and the stock jobbers were not wagers. The judge found that the wager was carried by only one of the contractual parties. The evidence shows that the agent had entered into these contracts on behalf of his client solely to enable the client to gamble in differences. The client’s intention to wager was supported by the fact that the client never intended to take up the shares but to speculate in the difference of their values between different dates. Despite the conspicuous wager intention by the client, the contract was not a wager contract as the judge could not find any evidence from the stock jobbers of their intention to wager. Instead the judge found that the stock jobbers entered the contracts for the sale and purchase of shares as genuine transactions which bound them to deliver or take up the delivery. As these intentions were at variance, the want of mutuality had destroyed the wagering element and left it enforceable by law as an ordinary contract.\(^{361}\)

\(^{360}\) [1929] 1 K.B. 321.

\(^{361}\) Ibid., at 329.
The subjective intention test was propounded by the Lord Chief Justice, Jervis C.J. in *Grizewood v Blane*. The case involved a series of contracts of sale and purchase of railways shares entered into between a stock jobber in London and a client of another broker. Essentially, this series of contracts was initiated by the sale of the railways shares from the broker (on behalf of his client) to the stock jobber at a certain purchase price and delivery time. Later, another contract of sale was then entered into by the same parties, though this time the contract was for the sale of an equivalent number of railways shares from the stock jobber to the broker (on behalf of his client) at the prevailing market price which was higher than the price agreed to in the first contract.

The judge found that these two sale contracts were in fact setting-off not only the delivery of shares against each other but also the payment of the purchase price for the said shares. These two contracts had, in fact, facilitated parties to settle by way of a differential payment. It was found that the parties had, on a few occasions, gone through dealings of a similar character with no shares passing and merely settlement on differences according to the usual course of speculators in the Stock Exchange. The judge ruled that these facts could only establish a wager if they were corroborated with the mutual intention to wager.

As the determination of this intention is held to be a question of fact, the question on the intention to wager was assigned to the jury. The jury were left to say what the intentions of the stock jobber and the stock broker (acting for his client) were at the time of making the contract – whether either party really meant to purchase or to sell the shares in question. If the parties had no such intention, the contract was a gambling transaction and was accordingly void. The jury found that there was no intention of the parties to enter into a real agreement for the sale and purchase of shares. Unsatisfied, the stock jobber applied for a new trial on the basis that the jury was misdirected.

The judges, who heard the motion for a new trial, all agreed with the direction of Jervis C.J. to the jury. One of the judges, Creswell J., pointed out that:

"The contest at the trial was, whether Colonel Blane (client to the stock broker) had entered into contract with Mr. Grizewood (the stock jobber) for the purchase and
sales of shares, - a *bona fide* contract which each at the time meant to perform. The jury were told, that, if neither party intended to buy or to sell, it was no bargain, but a mere gambling transaction. I think that was the true question to leave to them. As to the evidence, I think it abundantly warranted the jury in coming to the conclusion that there was no real contract of sale, but that the whole thing was to be settled by the payment of differences. It clearly was a gaming transaction within the meaning of the statute (8 & 9 Vict. c. 109, s. 18).”

It is important to note that the approach in this case is distinguishable from the approach taken in the case of *Forget v Ostigny*. In the latter case, the actual dealings and actual delivery and payment for the shares were consistent with what was provided for in the contract. In this respect, the court found it sufficient to ascertain the intention of the parties based on what was expressly written in the contract. However the facts in *Grizewood v Blane* demonstrate otherwise. Hence it is submitted the test laid in this case affects most of the eligible delivery agreements. This is because most of the parties settled by way of difference despite contracts provided for physical delivery. In this circumstance, this test allows a court to unveil the express contractual terms for delivery for the purpose of examining the underlying intention of the parties (n.n.(c), 1905: 677).

This subjective intention test was later adopted in *Barry v Croskey*. In this case, a stock jobber (“stock jobber A”) sued another stock jobber (“stock jobber B”), who acted on behalf of his client, for a relief under certain contracts for the sale and purchase of shares entered into between them. Stock jobber B, on behalf of his client, entered into a contract to purchase shares of Buenos Ayres and San Fernando Railway Company from stock jobber A. According to the terms of the contract, the shares were deliverable on the first settling day to be appointed by the committee of the London Stock Exchange. Stock broker A then entered into another contract with stock broker B to sell the shares of the company to be delivered on the first settling day (to be appointed by the same exchange).

Just before the time appointed for the delivery, stock jobber A was not able to find the company shares to be delivered (as the whole shares of the company had been fraudulently acquired by stock jobber B and his colleagues). Stock jobber A was given respite by stock jobber B by cancelling the sale contract and entering into a new contract for the next

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364 Ibid. at 540.
365 The position is different in the case of sale and purchase of stock, in the stock exchange as rules of this exchange necessitates delivery of stocks (n.n.(b), 1932: 913).
366 (1861) 2 Johnson and Hemming 1, 70 E.R. 945.
367 It was claimed by the stock jobber A that this was part of the stock jobber B’s scheme to acquire the whole shares of the company, either by way of allotments and contracts to purchase, at which only a minimal price of the shares was deposited initially.
settling day's delivery with a higher selling price on the condition that stock jobber A pay a moderate sum of money to stock jobber B as the cancellation fees. Similar arrangements were entered into for a period of two months until stock jobber A requested to be released from the contract. Upon paying a sum of money to stock jobber B, he was then released. Later, the stock exchange discovered the fraudulent scheme of stock jobber B and eventually the name of the company was struck out from the list of the exchange.

Stock jobber A then sued stock jobber B for repayment of all the monies paid including interest. Stock broker A claimed that stock broker B had manipulated the rules and customs of the stock exchange in a way to fraudulently acquire a large sum of money from him. Hence, the sale and purchase contract entered into by stock broker B, on behalf of his client, was not for any bona fide purpose. On the other hand, stock jobber B argued that these contracts were contracts by way of gaming or wagering within section 18 of the 8 & 9 Vict. c.109 which rendered the contract to be null and void.

In determining this issue, the judge adopted the subjective intention test as laid down in *Grizewood v Blane*. This test required that for a contract of sale and purchase to become a contract by way of gaming or wagering, both parties must mutually intend to end the bargain with a difference and not physical delivery. Therefore, in the current case, stock jobber A was able to prove that he had the intention to end the bargain with delivery and to receive from stock jobber B payment for such delivery. On this basis, the judge held that the stock jobber A had sufficiently proven that, at the time of entering into these contracts, he had a bona fide intention to deliver the shares in question.368

The subjective intention test laid down in *Grizewood v Blane* is further articulated in the case of *Universal Stock Exchange, Ltd v Strachan*.369 This action was about a claim by a customer to recover his shares which were deposited with stock jobbers, who were not members of the stock exchange. The customer alleged that a number of contracts for the sale and purchase of shares, stocks, and securities between them were made by way of gaming or wagering and not by way of a valid sale and purchase contract. These shares were deposited by him as a cover or security for the payment of differences upon the rise and fall of the tape prices of the shares, stocks, and securities. The defendant denied that

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368 Ibid., at 958.
the transactions were gambling transactions, as if they were gambling, he would not be able to retain and realise the deposited securities.

Cave J., who adjudicated this case at the Queen’s Bench Division, left the question on the parties’ intention to the special jury to decide. He gave the jury the following direction:

"The question that you have to try is, whether these transactions were real bargains for purchase of stock or whether they were simply gambling transactions intended to and in flee payment of differences... I have no doubt that most, if not all, of you are perfectly familiar with transactions on the Stock Exchange, but I may make use that as an illustration of my meaning. A man goes to a broker and directs him to buy or sell so much stock, as the east, may be. That may be in the eyes of the purchaser a gambling transaction, or it may not. If he means to invest his money in the purchase of the steel which he orders to be bought, that undoubtedly is a perfectly legitimate and real business transaction. If he does not mean to take up his stock, if he means to sell again before the settling day arrives, that may be a gambling transaction so far as he is concerned; but it is not necessarily a gambling transaction so far as the broker is concerned; and in order to be a gambling transaction, such as the law points at, it must be a gambling transaction in the intention of both parties to it... Notwithstanding the ostensible terms of business\textsuperscript{370}, was there a secret understanding that the stock should never be called for or delivered, and that differences only should be dealt with? If there was that secret understanding, then the plaintiff (customer) is entitled to recover his securities. If there was not that secret understanding, he is not entitled to recover them, and that is the only question with which I need trouble you."\textsuperscript{371}

Based on this direction, the jury found that the real contract between the parties was that there should be no delivery of shares and that those parties should pay for the difference. On this premise, these contracts were held to be contracts by way of gaming or wagering and the judge ordered the shares to be returned back to the customer. Dissatisfied, the stock jobbers appealed to the Court of Appeal on the basis that the judge had misdirected the jury.

\textsuperscript{370} Based on the fact of this case, the terms of business as provided for in the contract were as follows:

i- all bargains were to be completed on the next settling day unless the stock brokers agreed to a postponement at the request of the stock exchange;

ii- the stock brokers were to receive interest at 5 per cent per annum on the purchase money on all stocks from the date of purchase until completion;

iii- the stock brokers were to have lien upon certain of the stock exchange’s property for the due performance of the contract; and

iv- the contract was not of a gaming or wagering (at 752).

\textsuperscript{371} Ibid., at 752.
The judges in the Court of Appeal collectively approved the direction given by Cave J. to the jury in ascertaining the legality of these contracts. In supporting the decision of the jury, one of the Court of Appeal judges, Rigby L.J. remarked that:

"...there was evidence upon which a jury might well find that the written transactions, which are of course in form - it is an elementary part of such a transaction that they should be in form - were a cloak for the real transactions, and that the real transactions were transactions for differences - gaming and wagering transactions of a simple character."\(^{372}\)

The stock brokers lost their appeal and now appealed to the House of Lords. The House of Lords overwhelmingly approved the direction of Cave J. to the jury. One of the judges in the House of Lords, Lord Halsbury LC., upheld the findings of the jury. He referred to the terms of business contained in the contract and found that it was an ingenious device made to cover the scheme of an unreal transaction. This was so as no real sale and purchase had been proven to exist throughout the said transaction. Based on these conditions, the jury rightly inferred that the real meaning of the parties was to be only the payment of difference.\(^{373}\)

It is submitted that the decision in Strachan establishes two important points. Firstly, anyone who uses the means of a sale and purchase contract to wager on the rise or fall of the price of a stock or commodity is, in fact, carrying out a gambling activity. This is regardless of whether his counterparty also has similar intentions to him. It is only when a person needs to defend or excuse himself from bearing the responsibility arising out of such ostentatious sale contracts, must he then prove that he and his counterparty mutually intend to enter into a contract of difference and not a contract of sale and purchase. To prove this intention, J.S.R.C. (1928: 261) suggests it must be determined by the existence of an actual agreement between the parties to non-delivery. The production of such a binding agreement is conclusive of the mutual wagering intention. Without this, a mere assumption of intention is immaterial and not conclusive.

This approach is applied in the case of Ironmonger & Co. v Dyne.\(^{374}\) The plaintiff in this case sued the defendant for a sum of £39,000 with respect to the foreign currency sold by the defendant to the plaintiff and later re-sold by the plaintiff to the defendant. The

\(^{372}[1895] 2\) Q.B. 329, 335.

\(^{373}\) Ibid., at 753.

\(^{374}\) Times, Jan. 27 - 2 Feb, 1928.
The defendant pleaded that the contracts were not a real sale and purchase of foreign currencies. The parties neither intended to deliver nor accept deliveries. Applying the decision of *Strachan*, Horridge J states:

"The defence is that this is a gaming transaction; but one must be careful as to use the word "gaming". Every day people speculate on the Stock Exchange without the least intention of taking up the stocks they buy. The question to be decided is, Was there an agreement between the defendants and the plaintiff that in case should the defendant have to deliver and in no case should she have to receive, and that the only thing agreed by their contract was that they should respectively receive and pay according to the market prices? If there was such an agreement, judgement must be given for the defendant; if there was not, it must be given to the plaintiffs." (J.S.R.C., 1928: 261)

The jury found no evidence as to such an agreement and the judgement was delivered in favour of the plaintiffs.

Secondly, the fact that the contract incorporates expressions to negate it as a gaming or wagering contract does not bar the court from disputing it as such. It is submitted that if this test is to be applied to the commodity futures contract, the impact would be devastating. To address this problem, section 103 of the 2007 Act insulates the legitimacy of the commodity futures contract by providing that all futures contracts traded on the Exchange are deemed not to be contracts by way of gaming or wagering. The question is whether the subjective intention test can prevail over section 103. Theoretically it could if it is based on the following case, *Re Gieve* and the view of H.G. Robertson (as cited by Swift J. in *Weddle, Beck and Company v Hackett*) where he states:

"It may, then, be stated as a general rule that, apart from the very unusual circumstances, a contract made on the Stock Exchange, or upon any provincial Stock Exchange with similar rules and usages, and whether between principals direct or through agent, is not made by way of gaming and wagering. The mere fact that a contract purports to be subject to such rules is not conclusive, and will not exclude evidence that there was in fact a tacit understanding that, in spite of the form of the contract, there should be no obligation on either party to take or deliver,

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375 Section 103 of the 2007 Act states, "For the purposes of any written law, a futures contract made or traded-

(a) on the futures market of a futures exchange; or
(b) on an exempt futures market,

or anything done under such a futures contract, shall not to be taken to be a gaming or wagering contract."
but that in any event differences only should be payable. If such an understanding
were established by evidence, the contract would be null and void.” 376

The decision of *Strachan* is applied later in *Re Gieve*. 377 The judge in the Queen’s Bench
Division, Wright J., construed a series of contracts of sale and purchase of shares between
two stock dealers and found that the claim by one of the stock dealers to recover an amount
of money was not based on a gambling transaction. The judge also ruled that this case was
not within the decision of the *Universal Stock Exchange, Ltd v Strachan*. This was because
the judge found that, though the contract *prima facie* resulted in a differential settlement,
there was not enough evidence to support that the parties had mutually agreed to conceal a
bargain solely for difference. The trustees for the bankrupt stock dealer, Gieve, then
appealed against this decision to the Court of Appeal.

One of the judges in the Court of Appeal, Vaughan Williams L.J., disputes the inference
made on these contracts by Wright J. He said that though the contract provides the right for
the parties to call for the delivery or acceptance of the stocks, this does not bar the court
from drawing any inference that there was a secret bargain or understanding or practice
between the parties which was inconsistent with what was written in the contracts. Applying the decision of *Universal Stock Exchange, Ltd v Strachan* into the facts of this
case, he said:

“...to use the words of Cave J....‘notwithstanding those ostensible terms of
business, was there a secret understanding that the stock should never be called for
or delivered, and that difference only should be dealt with? If there was that secret
understanding, then the plaintiff is entitled to recover his securities. If there was not
that secret understanding, then he is not entitled to recover them’. In my judgement,
if you look at the whole of the transaction in the present case, the proper inference
to draw is that neither of the parties ever contemplated delivery or acceptance of
stock, but that both of them intended that the matter should be dealt with as a
matter for difference only, and not of delivery or acceptance...the condition as to,
in the one case, the payment of an additional of one-eighth if the stock is taken up,
and as to, in the other case, the deduction of one-eighth if the stock is delivered,
shows that these parties were minded to prepare a contract between them which
should facilitate that which was their sole object, namely gambling in
difference...The whole form of the transaction is just what one would have
expected if the parties were minded to gamble in differences but were anxious to
put the contract into such a form as to cloak or conceal the fact that they were
gambling. Then, when one adds to that the history of the transactions from

376 Ibid, at 331.
beginning to end, the conduct of the parties leads almost necessarily to the inference that they only intended gambling transactions."

Lindley M.R. who adjudicated the appeal together with Vaughan Williams in the Court of Appeal also opined that Wright J. was wrong as he did not attend to the form of the agreement sufficiently. Lindley claims that the judge had failed to give effect to the real intention of the parties as expressed by the terms of the contracts. The following are the terms and conditions contained in the contract for sale:

"...I beg to advise having sold to you 20 Canadas, Cover 1%, Price 50 1/8, Plus 1/8th if stock is taken up... (1) All stocks or shares become closed without notice whenever the cover is exhausted, so as to limit the liability of the operator, unless arrangements are made to the contrary. (2) All stocks or shares, unless closed prior to the first day of the account, must either be taken up or carried over to the next account. (3) If contangoes or backwardations are not settled separately, the cover will be increased or reduced by the same amount. (4) If it is desired to increase cover, cash must accompany order before the margin is reached, unless arrangements are made to the contrary. And any orders for increasing cover, if not altered before the close of business on one day, must hold good till the opening price of the next day. (5) It is distinctively understood that I am prepared to deliver the stock or shares to which this contract refers, if demanded, but require cash on the first day of the account for securities, I have to deliver to customers.""}

The contract for purchase contained similar terms and conditions as the contract for sale except in the following variations:

"...I beg to advise having bought of you 20 Canadas, to close at 521/4 Less 1/8th if stock is delivered... (2) If to be delivered, the certificate or scrip must reach me before twelve o’clock on the first day of the account... (5) It is distinctively understood that I am prepared to accept delivery of the stock or shares to which this contract refers, if required, and will pay cash if desired at any time, subject to discount for cash.""

Lindley M.R. suggested that if the provision of "I beg to advise having sold to you 20 Canadas" is taken by itself, it would show an ordinary sold note which represents the intention of the parties. However, the additional expression "plus 1/8 if stock were taken up" clearly shows the intention of the parties to not take up the shares. It shows that the buyer had an option to either not take delivery or, if he chose, to take delivery. In the later option, the buyer has to bear an additional payment of one eighth. Hence, on the surface, this was not a bargain for sale and purchase. This was in effect the parties’ real intention as

378 Ibid, at 803.
379 Ibid., at 795.
380 Ibid., at 795.
explicitly shown in the contract. The judge also considered the conditions, namely condition (1) to (5), and said that they accentuated the contract to look like more of a bargain for difference rather than an ordinary sale of stocks. He went further to suggest that the true intention of the parties, based on the language used in these contracts was that "(t)his is a bargain for differences, but if you, the buyer like to pay 1/8th more, then, I, the seller, will deliver at the increased price." Both judges especially Lindley, also seemed to apply the approach propounded by Lord Herschell in *Forget v Ostigny*. By applying this approach, the intention of the parties is as literally expressed in the contract. This means that the explicit contractual terms mirrored the actual transaction as was carried out by the parties. Hence, in the current case, the parties have incorporated a term which connotes to negation of delivery. By having such a term in the contract and substantiated with the proof of difference settlement, a mutual intention to wager was deemed established. This approach is submitted to bear a detrimental effect on the majority of the eligible delivery agreement as they are offset or settled by difference. The offset mechanism is further supported by its governing legal framework which entails express provisions that negates delivery and settlement by difference. For example, rule 1303A.1 of the Rules of Bursa Malaysia Derivatives Berhad incorporates that:

"Settlement of Crude Palm Oil Futures Contracts may either be by cash or physical delivery, as determined by the Exchange from time to time."

Similarly, rule 608(b) of the Bursa Malaysia Derivatives Clearing Berhad Business Rules stipulates the manner of offsetting:

"608 Liquidation by offset

b) Upon two Open Contracts being off-set pursuant to Rule 608(a), any settlement difference, as calculated by the Clearing House, becomes immediately due by the Clearing Participant or the Clearing House, as the case may be."

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381 Ibid., at 799.
382 Ibid., at 799.
6.5.3 The Literal Intention Test

In 1892, the *Universal Stock Exchange v Stevens*[^383] developed a new test which founded the legitimacy of futures trading.[^384] In this case, a stock jobber company claimed that their customer had failed to pay them a sum of money from which payment was derived from a series of contracts of sale and purchase of shares entered into with their customer. The relationship between the stock jobber company and their customer was governed by the terms of business, written at the back of all their contract notes. The material terms of business were as follows:

"1- The company acts as principal or jobber in all transactions and buys from and sells to customers on its own responsibility. The company never acts as a broker or agent, and it is of paramount importance that before opening an account customers should fully understand the difference between brokers and agents and principals or jobbers and be cognisant of all the rudiments of stock and share dealing...

2- Every purchase or sale contracted by the company is a bona fide transaction for delivery on a specified settling day, and the company is always prepared, and by means of its capital able, to deliver or take up any stock it may at any time have bought or sold, and the contracts entered into by the company are not contracts of gaming or wagering. All bargains are to be completed on the settling day named in the contract, but any customer wishing to postpone completion of a purchase or sale may arrange with the company (upon terms) for postponement of completion until a future date (carry over), but the company being always prepared to complete on the settling day originally fixed, may decline to postpone completion, at its option.

3- ...The buyer to receive from the seller all dividends falling due while the account is ensuing, the buyer paying all expenses of transfer of stocks.

[^383]: (1892) 66 L.T. 612.
[^384]: At the same time, in America, a congregational hearing was debating the subject of Fictitious Dealings in Agricultural Products. The opposition of futures trading argued that settling by difference is not legitimate trading. It was argued so as "no one can claim a right to sell that which he does not own, never intend to acquire and consequently never intends to deliver, for he is selling that which nobody owns and which in the nature of things, has no real existence... (hence) Trader's sale were sale of Minnesota wind instead of Minnesota wheat, and yet help to determine the price the Ohio farmer shall receive for his wheat. The futures market abrogated the independent producer's dominion over his product, his right to negotiate the sale of his own property." (as cited in Levy, 2006: 323). In 1892, a paper was issued after the Farmers' Anti-Option Bill was thrown out by the U.S. House of Senate's Committe on Agriculture, which rebuked the decision of the Committee. It stated that, "This move leaves the Chicago Board of Trade to continue its gambling in grain without interference. It is not too much to say, that our Boards of Trade are the worst nest of gamblers that they are in this country. They are the most subtle, the most infamously designing crowd the most audacious robbers of the farmers that this country has ever produced!" (Smith, 1896: 18). On the other hand, Emery (1895: 79) suggests that the reason for despoiling the farmers from the voice of fixing the price of their own produce was, contrary to experienced, knowledgeable and courageous speculators, that the farmers lacked the competency to forecast the course of the future prices and forestall probable events by their own purchases and sales.
4- The completion of all purchases and sales shall take place at the company’s office at noon on the day specified in the contract, or otherwise as may be mutually agreed upon. All customers shall, not less than seven days before the settling day, give to the company notice in writing of the manner in which they desire to deal with the stocks they have bought or sold, and stating what they wish to deliver, take up, or carry over..."

The customer argued that these contracts were, in effect, gaming or wagering transactions and hence were null and void under section 18 of 8 & 9 Vict. c. 109. The customer alleged that not one of the pretended purchases or sales were ever intended by either party to be actually completed and neither party intended to pay to the other more than the difference of the price of the shares.

In deciding that these contracts were not gaming or wagering, Romer J. remarked that:

"The written term between the parties was that the contracts between them should take the form of purchases or sales of stock, involving the liability for, or contemplating the actual delivery, the stock dealt with. The evidence itself shows no agreement or understanding that these written terms should not be acted upon, or should not be binding upon both parties, or the written terms were in fact illusory, or made between the parties merely to cloak, by agreement between them, a gaming or wagering transactions. No doubt the parties contemplated that actual delivery of stock would not take place except under special circumstances, but the contracts were, in fact, sales and purchases of stocks, and were not wagering or gaming, and not the less so because both parties may have thought that as a whole, the contracts would result in the long run in the mere payment of differences."

This decision echoed the opinion of Bramwell L.J. in the case of Thacker v Hardy where he said:

"The bargains made by the Plaintiff on behalf of the Defendant were what they purported to be; they gave the jobber a right to call upon the broker or the principal to take the stock, and they gave the broker the right to call upon the jobber to deliver it...I would assume that was the nature of the bargain between the parties, and that by its terms the principal would be entitled to call on the broker to resell the stock, so that, instead of taking and paying for it, the principal would have to pay only the differences."  

This decision signifies the literal approach in construing a contract of sale and purchase of stock or commodity futures contracts. Using this approach, the court construed a contract based on what was explicitly written in the contract. Chaikin and Moher (1986: 395)
rightly argue that this approach symbolises the willingness of the court to turn a blind eye to the actual subjective intentions of the parties and instead to only consider the explicit form of the contract. Raines and Leathers (1994: 198) suggest that, by this approach, the incorporation of the purchaser's right to demand actual delivery, in a contract or under the rule of the exchange, is adequate to establish the intention of delivery irrespective of whether the action would eventually be carried out.

In principal, this legal notion runs contrary to the earlier subjective mutual intention propounded by Grizewood v Blane and Forget v Ostigny. These two cases cast importance on the intention of parties in a case which involves an ostentatious sale and purchase contract. Kreitner (2000: 1105) suggests that the implication of this literal approach is that a legitimate and an illegitimate contract can be identical. The only distinction is the ability of the court to discover whether the legitimate form is only a ruse to cover the illegitimate form. However it is submitted that the discovery of such ruse depends not only on the ability but also on the willingness of the court to do so.388

Around the same period, and in response to the tolerability of commodity futures contracts by the British judiciary, one Charles William Smith (1894a: 9) delivered a lecture on agricultural and commercial depression caused by exchange-traded futures contracts.389 This lecture was conducted before the National Agricultural Union Rural Councils of Bristol, Bath and Chepstow. In his lecture he described futures exchange as a system of artificial trade or "speculative gambling" as it is based on vouchers of property and not on the property. He further explained that, in real practice, the bargain was not about commodity but price. This is so as there is no need to exchange a ton of corn in order to close the transaction. As a result, the transaction resembles a bet upon the course of the corn market; namely, the agreement by party A to pay if the price of corn falls and party B to pay if it rises. The effect of this system is that it destabilises the price of commodities.

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388 Some courts are, doubtless, moved by the desire to protect such transactions between the customer and the broker, despite the striking pertinent facts as evidence of intention to gamble. Others have less difficulty in finding illegality in the usual transaction between a customer and a broker. The effort to find the intention of non-delivery when it is perfectly obvious that such an intention exists seems a useless expenditure of energy. On the other hand, if the court wishes to protect the customer and the broker, they must, in order to satisfy the common law rule, close their eyes to the facts and draw a fine distinction between intention and expectation (n.n.(a), 1927: 639).

389 See also Smith (1894b).
The prices were no longer regulated by supply and demand but instead by the quotation of values of gambling papers.\textsuperscript{390}

Oblivious of the angst it created, the literal approach began to proliferate in the British judiciary at the start of the twentieth century. The courts have shown much interest in applying this test more than other legal tests: namely, the mutual gain and loss; and the subjective intention test. The literal approach was applied in the year 1902 in the case of \textit{Philp v Bennet & Co.}\textsuperscript{391} This case involved a claim by a customer to recover from his stock jobber a sum of money being the difference on certain stocks and shares transactions entered into between them. The customer signed an application form which was addressed to the stock jobber. The form contained terms, amongst others, that the customer agreed to accept the amount of stock that the stock jobber may sell to him. Besides this form, the customer also received from the stock jobber an advice note regarding the sale of shares which stipulated that, "Plus 1/8 if stock is taken up." The customer then sold some stock back to the stock jobber at a profit before the end of the account and claimed for this profit, being the difference, from the stock jobber. However, the stock jobber refused to pay on the ground that the contract was a gambling transaction.

The judge, Bingham J., distinguished this case with \textit{Re Gieve}. He argued that the question of whether the transactions were gaming or wagering contracts or not was entirely a question of fact. The application form shows that that the customer had agreed to accept the amount of stock that the stock jobber may have sold to him and hence was bound to accept the stocks which had been bought. He contended further that the phrase "Plus 1/8 if stock is taken up", as contained in the advice note, must be read together with the term stipulating delivery in the application form, of which the form preceded the advice note. Hence, based on these facts, the judge declared that they were not betting or gaming transactions.

It is submitted that from this case, the whole concept of the literal approach is, to take the words of Kreitner (2000: 1109), a "fig leaf" to legitimise contracts of gaming or wagering

\textsuperscript{390} In the issue of destabilised commodity prices, Easterbrook (1986: 118) maintains that an exchange member who trades by betting on his ability to conceal his position from other traders for the sole purpose of gaining profit from such concealment has committed an offence of manipulation. The effect of his action is likely to cause commodity prices to diverge from those that reflect the underlying conditions. According to Hutcheon (1992: 299) manipulation is the most serious crime of speculation as it produces artificial price fluctuations. As a result, the whole economy is left in a dire confused situation and the community is forced to pay more for a commodity than they would necessarily have. See also Davis (1892).

\textsuperscript{391} (1901) 18 TLR 129.
under the pretext of sale and purchase contracts, of shares or commodity. This is so observed as the court would not hesitate to blatantly ignore a potential non-delivery contractual term; namely, “Plus 1/8 if stock is taken up”, but instead have construed the said term as contemplating delivery. The decisions of the later cases securitised the futures and stock market liberalisation movement from the incarceration of gaming and wagering law.

The case of Cooper (Inspector of Taxes) v Stubbs\(^{392}\) involved the issue of whether revenues derived from speculative cotton futures trading were deemed as “profit” or “gains”. If this is so held, the revenues would accordingly be assessable to tax under Schedule D Para 1 of the Income Tax Act 1918. In this case, a cotton futures trader challenged the income tax assessment made by the Additional Commissioner of the Liverpool Division in respect of profits made from his speculative cotton futures trading. He contended that these dealings were gambling transactions and as such were not assessable to income tax. In deciding that such a speculative cotton futures contract was not a wager contract, the judges in the Court of Appeal unanimously upheld the decision of Thacker v Hardy. One of the judges in the Court of Appeal, Pollock M.R. went on to say that:

“...these futures delivery contracts which are made upon the Cotton Exchange or the contracts which are made upon the Stock Exchange in London are real contracts in the sense that the party with whom they are made is a real party, and if the dealer and broker making them should desire at any moment to have the contract implemented he can do so. There is no distinction between contracts which are made for the real purpose of securing the sale or purchase of stock or cotton...It may be that they were speculative in the sense that they were for his own purposes a speculation...and that it may be said that he was gambling in making these contracts, but the purpose for which he made them did not alter the character or nature of the contracts that he did make: they were real transactions, although the purpose of them may have been in his mind, in respect of all or some of them, to fulfil his desire to gamble in speculative transactions.”\(^{393}\)

Atkin L.J. reinforced the view of Pollock M.R. and said that:

“...all contracts that were entered into by the appellant, whether they were entered into by him through his firm or through other brokers, were in fact real transactions. They gave rise to real contractual rights: they were contracts either for the purchase

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\(^{392}\) [1925] 2 K.B. 753. The issue involved in this case was not so much of ascertaining the enforceability of the exchange-traded cotton futures contract but it was more to ascertain the taxability of the gain resulting from such trading. Hence, there is a slight difference in the way the court directed their minds. However, this case is relevant as it shows the trend of decision-making held by the courts from the beginning of the twentieth century till the statutory intervention, namely, the 1986 Act (Financial Services Act 1986).

\(^{393}\) Ibid., at 763.
or for the sale of cotton in future which could be enforced, and so far as the other party to the contract, who might be a dealer in this country, or a dealer in America was concerned, he would not know whether the contract into which he had entered would be eventually closed by a contra contract or whether it would not. For these reasons, it seems to me to be plain law that transactions such as the appellant entered into were real transaction and not mere bets. I think that the principle in respect of wagering is this, that it takes two parties to make a bet, and, that if you consider one party alone, you do not sufficiently consider all the elements of the case; you have to consider the other party, and unless that other party is also betting there cannot be a bet. Therefore these transactions were, as I have said, real and enforceable contracts, in which the differences could have been sued for on one side or the other. It is true that they were speculations, and I think myself that that may be one of the material facts to be considered in respect of the question whether or not the appellant was engaged in a trade, because for my part I see some difficulty in forming a conception of a trade which consists solely of entering into transactions which would merely result in differences, and when the supposed trader never intends to get possession or control of any commodity, so that he may have the disposal of it. Although I do not say it is impossible to have a trade or adventure of that nature, I think it is a fact to be taken into account.\textsuperscript{394}

The exchange-traded commodity futures contract, whether it be settled by way of difference or delivery is no longer discriminated. Gambling or wagering in the form of a commodity futures contract is now legitimate and enforceable. The shift in the mind of the judiciary is said to stem from the fact that speculation, and its attendant risks and the possibility of rapid gain, had become more respectable during the period of the eighteenth to the nineteenth century in the United Kingdom (Itzkowitz, 2002: 129). Itzkowitz (2002: 144) believes that the "domestication" and moralisation of speculation in that era was due to the members of the London Stock Exchange being constituted of respectable people from society.

In this manner, the judiciary, including the society, had legitimised the conduct of these members in the exchange, yet, on the other hand, illegitimised the activities of the outside brokers (who were not members of the exchange but carried out their speculative stock trading in shops called the bucket shops). Raines and Leathers (1994: 200) maintain that by stigmatising bucket shops, the exchange has successfully diverted the charges that commodity futures contract and various types of stock market practices constituted gambling. The speculation on organised exchanges was defended on the basis of their economic efficiency. Instead, the bucket shops were physically demolished from society despite the fact that similar settlement by difference was carried out in these two places. As

\textsuperscript{394} Ibid., at 771.

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a result the question is no longer about distinguishing speculation with gambling but between legitimate speculation and illegitimate speculation.395

The following cases rooted the domestication and moralisation of the commodity futures contract. The court in *Barnett v Sanker*396 dealt with a claim by a general merchant for the monies he had paid to a member of the London Metal Exchange. The merchant alleged that the money was paid for the losses on speculations caused by a clerk who worked for that exchange member. Because of the close relationship between the merchant and the clerk, the merchant agreed for the clerk to use the name of his firm to enter into speculative dealings at the London Metal Exchange. The judge, McCardie, J., referred to the decisions in *Universal Stock Exchange, Ltd v Strachan*, *John Shaw v Caledonian Railway Company* and *Thacker v Hardy*. In giving legal recognition to futures speculative dealings, he said:

> "If the parties meant that no legal bargain should be effected between them, and that there should be no right to demand a payment of differences except a moral right, the contract was a gaming contract. But if the parties intended to enter into a legal contract, which gave legal rights and imposed legal obligations, then the contract, though it dealt with speculative transactions, was enforceable." 397

Similar treatment is found in *Woodward and Another v Wolfe*.398 This case involved a claim to recover an amount of money, being the differences, interest, and brokerage due and owed to the broker by his client. The broker, who was a cotton futures broker and a member of the Liverpool Cotton Exchange was appointed by his client to speculate for difference in cotton futures. The futures broker entered into the futures contract to buy and sell cotton in form, and in accordance with the rules, regulations, and usages of the Liverpool Cotton Association. His clients challenged the claim and contended that these contracts were contracts by way of gaming or wagering, and hence were unenforceable. He supported his contention by stating that the contract between the futures broker and him was made between them as principals and not as a broker and principal. He further contended that there was an express understanding that there should be no delivery on either side but only an eventual payment of difference.

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395 Throughout the legislative debate on futures trading during the late nineteenth century and the early twentieth century, futures transactions were often equated with speculation, and speculation and gambling were thought to be no different than identical twins (Pashigian, 1986: S56).

396 (1925) 41 TLR 660.

397 Ibid, at 662.

398 [1936] 3 All ER 529.

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The judge, Hilbery J., dismissed the applicability of the decision of *Universal Stock Exchange, Ltd v Strachan* and held that, in the current case, the futures broker entered into these contracts as an agent for his client and not as a principal. As an agent, the futures broker was merely trading for the purpose of implementing the client's instruction to buy and sell. Hence, the futures contracts were held to be genuine contracts. Applying the decision of *Weddle, Beck and Company v Hackett*, he remarked that:

"True...the defendant (the client) would not be expected to take delivery of the cotton or to deliver it and that it was to be a matter only of differences between the purchases and the sales, but the plaintiffs (the broker) in fact merely allow the defendant in form to buy from or sell to them. They acted for the defendant to enable him to gamble and they acted in the capacity of brokers in the market in which the defendant wished to gamble in the only way in which the defendant could gamble in that market. If all that the Plaintiffs had done was to pass a form of contract made directly between themselves and the defendants with an existing arrangement that only differences should be paid, the matter might well be concluded on the principle of the decision in *Universal Stock Exchange, Ltd v Strachan*. It is not, however what took place here. The plaintiffs made contracts on the market for the defendant to give effects to his orders. Those contracts I am satisfied in the evidence bound him and they have, I am satisfied, had to meet their obligations under them."\(^{399}\)

It is submitted that this case reinforced the following facts about the eligible delivery agreement: (i) the legality of wagering on the fall and rise of commodity prices in the futures exchange; (ii) the acceptability of provision for delivery in pseudo-sale contracts when such contracts are formed on Exchange\(^{400}\) and (iii) actual delivery, or the parties' intention of delivery, is immaterial. To preserve this status quo, statutory intervention is mandatory.

### 6.6 Statutory Intervention

In July 1981, Professor LCB Gower of Southampton University was commissioned by the UK Secretary of State for Trade to: (i) consider the statutory protection required by private and business investors in securities and other properties; (ii) consider the need for statutory control of dealers in securities, investment consultants and investment managers; and (iii) advise on the need for a new legislation (Elliott and Henshaw, 1995: 9). Later in 1986, Professor Gower issued the result of his findings and named the report the "Review of

\(^{399}\) Ibid., at 533.

\(^{400}\) Patterson (1931: 864) contends that since the exchange has prescribed rules for every contract to contain the provision relating to delivery and the fact the parties are customarily referred to as "buyer" and "seller", it is practically impossible to rebut contrary intention against delivery.
Investor Protection – A Discussion Document”. In this report, he commented on the issue of the unenforceable gaming and wagering contract where he said:

"Another problem that has caused difficulty in recent months is that of distinguishing between legitimate investments and unenforceable gaming contracts. The public has been offered arrangements ranging from betting on whether the quoted price of a listed stock or an index (such as FT Index) will rise or fall to entrusting a capital sum to a company to invest and to use the income to bet on race-horses. On the face of it, all these seem more akin to gaming and wagering contracts and therefore unenforceable. On the other hand, in the former type the objectives of the participants may be indistinguishable from those when purchasing options or futures. To treat them as gaming contracts would be the worst possible way of protecting investors. The Act must find a way of clearly distinguishing legitimate investments from illegitimate wagers.” (as cited in Chaikin and Moher, 1986: 390)

As the result of his report, the Financial Services Act 1986 (the 1986 Act) came into force. Section 63 of the 1986 Act stipulates that:

“(1) No contract to which this section applies shall be void or unenforceable by reason of-
   (a) Section 18 of the Gaming Act 1845, Section 1 of the Gaming Act 1892.

(2) This section applies to any contract entered into by either or each party by way of business and the making or performance of which by either party constitutes an activity which falls within paragraph 12 of Schedule 1 to this Act or would do so apart from Parts III and IV of that Schedule.”

By the promulgation of this section, the question of whether or not the commodity futures contract was a contract by way of gaming or wagering and such, not being enforceable under section 18 of the 1845 Act is immaterial. This section is intended to replace the blunt all-embracing prohibitions in the Gaming Act 1845. Section 63 is enshrined with elaborately qualified permissions for wagering contracts to be held as investment contracts and are hence enforceable (Fisher, 1990: 104). McCowan LJ in City Index Ltd v Leslie remarks that:

401 Paragraph 1 to 11 of Part 1 of Schedule 1 sets out what constitutes an “investment” and paragraph 12 of Schedule 1 defines various types of dealing in investments as activities which constitute investment business. Included in the definition of investments, at paragraph 7 to 9, are contracts for options and futures and contracts for differences (Hogarth, 1993: 333).

402 Yet the Gower’s Report gives no inkling as to how the gambling contracts are distinguishable from the investments (White, 1984: 561).

403 One of the important elements in generating traders’ confidence in the futures exchange is to have a legal system which recognises and enforces the rights and duties embodied in the contract (Powers and Tosini, 1977: 982).
"...that section (section 68) and paragraph (33 of Schedule 1of 1986 Act) make it plain that the intention of the 1986 Act is to reduce the circumstances in which a contract falls foul of s 18 of the Gaming Act 1845."

Similarly, Hobhouse J in the case of Morgan Grenfell & Co. Ltd v Welwyn Hatfield District Council and Islington London Borough Council maintains that the intention behind section 63 of the 1986 Act was to reduce the uncertainty brought about by gaming or wagering legislations and to increase the statutory level of investor protection. This was achieved by the wide coverage of its regulated investments, enlisted under Schedule 1 of the 1986 Act, to include the speculative nature of commercial or financial transactions.

The contract for difference is now part of a legitimate investment under the 1986 Act.

Paragraph 9 of Schedule 1 states that:

"Rights under a contract for differences or under any other contract the purpose or pretended purpose of which is to secure profit or avoid a loss by reference to fluctuations in the value of or price of property of any description or in an index or other factor designed for that purpose in the contract.

Note: This paragraph does not apply where the parties intend that the profit is to be obtained or the loss avoided by taking delivery of any property to which the contract relates."

Lord Donaldson elucidates this provision in the case of City Index Ltd v Leslie where he said:

"...it is clearly intended to legitimise contracts, which, whilst pretending to be agreements for the actual sale and purchase of shares, commodities or other property, are intended by the parties to be fulfilled by the payment of differences."

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404 "In determining for the purpose of this Schedule, whether anything constitutes an investment or the carrying on of investment business, section 18 of the Gaming Act 1845...whereby a contract by way of gaming and wagering is not legally enforceable shall be disregarded."


407 Meanwhile Leggat L.J. in the same case, City Index Ltd v Leslie, explains the Note in Para 9 above as indicating the means of distinguishing a commercial contract with a differential contract. The difference could be ascertained by the (1) real delivery of property; (2) the mutual intention of the parties; and (3) obtaining of profits being equated to securing it. Hence, based on the 1986 Act, the contract for difference which is entered to under the disguise of a commodity futures contract falls under the category of "any other contract" under Paragraph 9 of Schedule 1.

In 2001, the 1986 Act was repealed and replaced by the Financial Services and Markets Act 2000 (2000 Act) (Halsbury(a), 2008: 226). Embodying substantially similar wording from section 63 of the 1986 Act, section 412 of the 2000 Act also exempts contracts from falling within the ambit of any applicable gaming legislation. Treitel (1994: 856) rightly adduces that, although the contract for difference had become a binding legal contract under the 1986 Act, the legality of this contract did not alter the fact that this contract may amount to wager.

The revolution of the legitimacy of the contract of gaming or wagering is followed closely by the Malaysian futures legal system. Taking the same approach of displacing gaming and wagering law from the realm of the futures contract, Section 100(2) of the Malaysian Futures Industry Act 1993 (the 1993 Act) was incorporated. In 2007, the 1993 Act was replaced by the 2007 Act. Section 103 of the 2007 Act also incorporated similar provisions to its predecessor, namely, section 100(2), where it states:

"103 Futures contract not gaming or wagering contract"

409 The half part of subsection (a) of section 412(1) has been left blank. Its original wordings, as contained in the repealed section 63 of the 1986 Act were, "(a) section 18 of the Gaming Act 1845". Section 412 of the 2000 Act states that:

"(1) No contract to which this section applies is void or unenforceable because of –
(a) ...Article 170 of the Betting, Gaming, Lotteries and Amusements (Northern Ireland) Order 1985;
(b) ...

(2) This section applies to a contract if-
(a) It is entered into by either or each party by way of business;
(b) The entering into or performance of it by either party constitutes an activity of a specified kind or one which falls within a specified class of activity; and
(c) it relates to an investment of a specified kind or one which falls within a specified class of investment.

Part II of the 2000 Act contained activities which are categorised as investments and this includes futures contracts (in Para 18) and contracts for differences (in Para 19). It says:

18 Rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date.

19 Rights under-
(a) a contract for differences, or
(b) any other contract for the purposes or pretended purpose of which is to secure or avoid a loss by reference to fluctuations in-
(i) the value or price of property of any description; or
(ii) an index or other factor designated for that purpose in the contract.”

410 This Act was formed in 2007 through the consolidation of the Securities Industry Act 1983 and the Futures Industry Act 1993. The purpose of the consolidation of these two Acts under an umbrella governing statute is to streamline the regulation of the securities and the futures market. Prior to the coming into force of the 2007 Act, the regulatory framework for the commodity futures market was contained in the Commodities Trading Act 1985, which was later abrogated and placed under the Futures Industry Act 1993. (Geoffrey, 2010: 4 and 95).
For the purposes of any written law, a futures contract made or traded-
(a) on the futures market of a futures exchange; or
(b) on an exempt futures market,
or anything done under such a futures contract, shall not to be taken to be a gaming
or wagering contract."

Though the wording of section 103 of the 2007 Acts does not explicitly insulate commodity futures contracts from falling foul to section 26 of the 1956 Act and section 31 of the 1950 Act, the wording "For the purpose of any written law" in section 103 encapsulates it as a safe harbour for commodity futures contracts. The incorporation of section 412 of the later 2000 Act also reverberates in section 103 of the 2007 Act. The effect of this is that the crude palm oil futures contract is legitimate and enforceable regardless of whether it is entered to wager on the rise and fall of the crude palm oil futures price.411

6.7 Conclusion

This chapter has examined the revolution of the law on gaming or wagering, in particular, the issue of enforceability of the commodity futures contract. The product of the revolution was that betting or wagering on the rise and fall of the future price of crude palm oil was deemed legitimate. The liberalisation of commodity futures contracts from the claw of the gambling laws was mainly due to the role played by the British judiciary as well as the shift in the norm and perception of the society towards futures speculation. The legitimacy of the difference settlement is further materialised by the statutory intervention in the UK and Malaysia.

Essentially, this finding draws a more important picture in this study. This finding implicates the legitimacy of the crude palm oil futures legal framework within the context of Shari'a. Betting or wagering is religiously condemned. It follows that section 103 of the 2007 Act, rule 614.1 (c) of the Bursa Malaysia Derivatives Berhad Business Rules and rule 614(a) and (b) of the Bursa Malaysia Derivatives Clearing Berhad Business Rules, which provide for legitimacy of the act of wagering and accordingly facilitate the difference settlement, is deemed to be against Shari'a. In addition to that, the case laws shown in this

411 Gengatharan (2001: 103) views that since the definition of futures contract in the 1993 Act covers most of the derivatives contract, which take the form of eligible delivery agreement or adjustment agreement, the likelihood of derivatives contracts to be rendered void is less likelihood.
chapter aptly illustrate the element of hatred and enmity amongst gamblers. Hatred and enmity is one of the many reasons as to why Islam prohibits gambling. Based on this analysis, this chapter reaffirms the finding of Chapter five that, inconsistent with the stance of the SAC, the crude palm oil futures contract, including its legal framework, is not free from any element of *maysir*. 
CHAPTER SEVEN

Conclusion

This study has analysed one of the many controversial resolutions issued by the SAC on capital market products and services. It examined the SAC resolution on the crude palm oil futures contract. This resolution, as many others, is contentious as it collides with the resolutions of other internationally represented bodies of Shari'a scholars like the IFAM, the IFAJ and the AAOIFI. The aim of this study was to analyse the adequacy of the SAC resolution. This study has resolved the two critical research questions; namely, whether or not the SAC resolution is coherent with the real trading of crude palm oil futures contracts and whether or not the legal framework of crude palm oil futures contracts has eliminated the Shari'a prohibitions inherent in the contract.

The study has found that the SAC resolution is not coherent with the real trading of crude palm oil futures contracts based on the following grounds. Firstly, the SAC has not accurately defined the meaning of crude palm oil futures contracts. It defines the contract as an exchange-traded agreement to buy and sell a commodity in an actual market (cash market). However, in reality, physical delivery of crude palm oil transpired not on a cash market, but instead on the Clearing House via the transfer of a warehouse receipt or Negotiable Storage Receipt (NSR). Additionally, and in reality, most of the crude palm oil futures contracts do not end with physical delivery but cash-settled on the Clearing House.

Secondly, the SAC has not adequately examined the contract specification of the crude palm oil futures contract. The SAC contends that there is no element of gharar in crude palm oil futures contract as, when the contract is offered, the contract specifications such as quantity, type, price, and delivery date are made known to the contractual parties. However, this study has found that the delivery date and type or quality of the oil is not adequately described in the legal framework. For example, Rule 1317 and Schedule 13 of Bursa Malaysia Derivatives Berhad Business Rules describe that the delivered crude palm oil must be of “crude unbleached palm oil of good merchantable quality, in bulk”. To attain this description, the desirable level of specifications - namely, FFA, I&M, IV, SMP page 208 | P a g e
and DOBI - must be incorporated. Currently, Rule 1317 and Schedule 13 only contain FFA, I&M and DOBI. The inadequacy in the description is supported by the judgement of a Malaysian case, *Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another*, which declared such an inadequacy in the contract specification of crude palm oil futures contracts.

In relation to the issue of the existence and quality of the oil, Rule 1305 and 1306 of Bursa Malaysia Derivatives Berhad Business Rules provides that after crude palm oil has been appraised, a Negotiable Storage Receipt (NSR) together with a certificate of quality will be issued. The certificate of quality is a declaration of guarantee with respect to the quality of the crude palm oil. However, this appraisal will only take place when a seller wishes to deliver his crude palm oil to the buyer via the Clearing House at any business day between the first till the twentieth day of the delivery month. On this condition, any eligible delivery agreement, which is traded without a valid NSR, will not escape the taint of *gharar*. Even with an NSR, this study has found that parties were still disputing the quality of the oil delivered, for example, *Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another Appeal*.

Besides the inadequacy of the description of the quality of the oil, the contract specification does not specify the delivery date. Schedule 13 of Bursa Malaysia Derivatives Berhad Business Rules provides that, in the delivery month, the seller may dispose of the crude palm oil in any of these business days, the first till the twentieth day of that calendar month. The uncertainty of the actual delivery date reverberates in the actual date for the buyer to remit the purchase price of the oil.

Thirdly, the SAC argued that, as commodity futures contract can be settled in cash before the due date or that the settlement can be made by physical delivery on the due date, the element of *gharar* has been eliminated. The SAC relied on the existence of a guarantee system in which the Clearing House guarantees the delivery and settlement of crude palm oil futures contract. Even if there was *gharar*, it has been eliminated by the provision of the Futures Industry Act 1993 and Business Rules (Exchange and Clearing House) which provide for surveillance and insulation against any form of cheating. Nonetheless this study has found that *gharar* has not been eliminated in the contract settlement of crude palm oil futures contract. In reality, when the seller defaults in making a physical delivery of the crude palm oil, Rule 1102 of Bursa Malaysia Derivatives Clearing Business Rules...
empowers the Exchange to instruct parties to settle their contract with cash, which amount will be determined solely by the Exchange. This amount is known as the “emergency settlement price”. However, the crude palm oil futures legal framework is silent on the method of its calculation. The uncertainty in the manner of its calculation has brought about legal suits challenging the validity of emergency settlement price. Amongst those cases are Ganda Oil Industries Sdn Bhd & Ors v The Kuala Lumpur Commodity Exchange & Anor and Palmco Holdings Bhd v Sakapp Commodities (M) Sdn Bhd & Ors.

Apart from showing that gharar exists in the method of calculating the emergency settlement price, this study has found that the operational method of futures trading, or guarantee system, has not been able to effectively eliminate the prospects of non-delivery or the failure of parties to fulfil their contractual obligations. Irrespective of the guarantee mechanism, defaults still transpired, on two occasions. First, when the seller failed to deliver the required quality of the crude palm oil, as evidenced in Federal Flour Mills Bhd v Fima Palmbulk Services Sdn Bhd & Another. Second, when the supply of the commodity was not available at the time of delivery, as demonstrated in the massive physical default of the Maine potatoes futures contract in America. The physical default was exacerbated by the artificially inflated commodity price, which made it uneconomical for the seller to procure and sell the underlying commodities to the buyer. This precarious condition is evidenced by the case of Peto v Howell (involving corn futures contracts) and Cargill, Incorporated, et. al., v Clifford M. Hardin, Secretary of Agriculture, Thomas J. Flavin, Judicial Officer by Appointment of the Secretary of Agriculture, and the United States Department of Agriculture (involving wheat futures contracts).

Fourthly, the SAC contended that, even if there was gharar, it has been eliminated by the regulatory provisions which are designed to protect the futures market from offences like cheating. Nonetheless, this study has shown that, despite trading regulation endeavouring to circumvent such a situation, the futures market authority has constantly been undermined by their members’ manipulation and cornering. Chapter four demonstrates the adverse impact of manipulation and cornering on the economy and society at large.

Fifthly, the SAC has not adequately described the whole system of the futures margin. The SAC has described only the initial deposit. In reality, the futures margin is comprised of not only the initial margin but also the maintenance margin, variation margin, margin call, as well as marking to market. This study has shown that the maysir (gambling) element is
found to be inherent in the futures margin system. The analysis of the whole futures margin system revealed that at the time of making the initial margin payment, both contractual parties do not know the future daily settlement price or the direction of the crude palm oil futures price. Based on this uncertainty, the parties actually bet or wager on the direction of the crude palm oil futures price. The outcome of the bet is determined by the next day’s daily settlement price. This price will determine who is to pay the variation margin, namely the differential amount, to the other contractual party via the Clearing House. As a result, this payment obligation known only on the following day, arises purely out of chance and or luck. The variation margin payment which the loser has to pay is exactly the same amount of money which the winner gets.

Sixthly, although the SAC has not found any issue with the crude palm oil futures contract being cash-settled before its due date, this method of settlement, namely offsetting, is found to contain a maysir element. The offsetting transaction, as stipulated in rule 608 of Bursa Malaysia Derivatives Clearing Business Rules, is essentially a mechanism to cause one party to pay the other contractual party the difference between the current and the previous settlement price of crude palm oil futures. The obligation to pay the differential payment depends on the futures position of the parties and not on the basis of an exchange of counter-values. Under the offsetting transaction, whatever amount of money that one party receives is the exact amount of money that one party loses. Hence when this gain and loss is absolutely dependant on the movement of the prices, in which movement is determined by factors wholly independent of one’s control, this connotes gambling (Thomas, 1995: 21).

In relation to the issue of maysir, this study has learned that section 103 of the 2007 Act, which states that the exchange traded futures contract shall not to be taken to be a gaming or wagering contract, is premised on the fact that wagering or betting is legal. This section validates and enforces a futures contract even though, by nature, this contract is formed and entered into for the purpose of betting or wagering. Hence, in reality, betting or wagering on the rise and fall of the future price of crude palm oil is legitimate and enforceable. The cases discussed in Chapter six demonstrate the revolution of the law on gaming and wagering. It also evidences the shift in the public perception as to the morality and legality of wagering in the prices of commodities. Apart from this finding, the case laws aptly exhibit the reason why Islam prohibits gambling – engenderisation of hatred and enmity amongst the gamblers.
Seventhly, the SAC has not adequately distinguished futures speculation from typical commercial speculation. The SAC argues that futures speculation is no different to commercial speculation as both transactions involve parties profiting from price difference. However, one distinguishing characteristic of futures speculation, which was not analysed by the SAC, is that it does not involve the intention or act of taking or making a delivery nor any connection with the production or use of the commodity; and that it involve gain made at the lose of the loser. Hence, futures speculation is to make profit solely from the change in the future price of the underlying commodity. The detachment of futures speculation from economic realities breached a fundamental precept in Islam, namely, all trade must represent real economic transactions.

Eightly, the SAC contends that the commodity futures market plays the role of price discovery and risk-shifting mechanism, enabling those exposed to price risk, like hedgers, to shift this risk to other interested players, like speculators. The benefit of the futures market as a price discovery and risk management mechanism qualifies its trading to be permissible under the principle of *maṣlaḥah* (permissibility). However so, for the principle of *maṣlaḥah* to be applied in this case, it must be in harmony with the objectives (*maqāṣid*) of *Shari'ah* - religion, human life, progeny, material wealth, and the human faculty of reason. Nevertheless, this study has found that its role as a mechanism of price discovery and risk management has been distorted (Greenberger, 2011 and Tilburg and Stichele, 2011). The distortion of this market mechanism affects the social well-being of society. Excessive speculation distorts the useful function of the futures contract and the real supply and demand of commodities. It attributes to the unnecessary and substantial increase in the price of food commodities. This leads to an increase in the number of poor, undernourished, people and hence the food insecurity in the world.

There is, therefore, a definite need for the SAC to revisit and review its inadequate resolution on crude palm oil futures contract. Although the power to review its resolution is not expressly stipulated in the 2007 Act, the SAC may still be able to review its resolution under section 316A(2)(b) of the same Act. This section empowers the SAC to determine its own procedure. Hence, taking into consideration that the review involves the SAC resolution and matters pertaining to the Islamic capital market, the SAC will not be breaching or transgressing any of its statutory rights and duties in performing such a review.
Juristic review of existing resolutions is not something new. In 2007, the AAOIFI reviewed its Shari‘a standard as they found that almost 85% of Gulf Islamic bonds (sukuk) were not in compliance with Shari‘a. The flaw of this sukuk was that the risk and reward in the sukuk was not shared in accordance with actual venture proceeds. Though the repercussion of this decision would cost the industry as much as $50 billion, the AAOIFI reviewed and republished its fresh rulings on sukuk (Reuters, 2007). Undertaking such action, the President of the AAOIFI Shari‘a Council, Mufti Taqi Usmani, reminds the Shari‘a advisory institution of their duties. He said:

"It is now incumbent upon these Islamic banks and financial institutions to cooperate among themselves for the purpose of developing authentic products that are far removed from empty stratagems,... and that aim to serve the higher purposes of Islamic law in the spheres of economics, development, and social justice. None of this will come about without the guidance and encouragement of the Shariah supervisory boards. If these boards continue with their present policies, however, Islamic banks will stumble on the road, and there is a danger, God forbid, that this virtuous movement will fail. It is time for Shariah supervisory boards to review their policies...Instead, the Shariah supervisory boards need to apply themselves to upholding the Shariah standards issued by the Shariah Council, which are not insensitive to the real need of these institutions. Personally, I am certain that if Shariah supervisory boards uphold these Standards, the exceptional professional qualifications found in today’s Islamic financial institutions will have no difficulty in developing viable alternatives to these dubious products...Allah willing.” (n.d.: 14)

It follows that Muslims believe that they are accountable to their Creator and answerable to Him in the Day of Judgement. Due to this belief, Muslims are duty bound to ensure that all their undertakings, being in privy or public, are not inimical to the spirit and letter of the Shari‘a. This position is underscored by Nik Ramlah Mahmood, the Deputy Chief Executive of the Malaysian Securities Commission, who said that:

"ICM (Islamic Capital Market) products and services have unique characteristics especially those related to Shariah compliance. Also it must be borne in mind that in subscribing to ICM products and services, Muslim issuers and investors place their trust in the regulatory system and expect the products and services to be true to label.” (2004: 2)
The review of the SAC resolution will draw more confidence and trust from Islamic capital market players into the SAC and the governing system. On the other hand, the inaction of the SAC to revisit and review its SAC resolution would not only be detrimental to the validity of its resolution and its credibility as a “Shariah Advisory Council” but more importantly to Malaysia’s reputation as the international Islamic capital market hub.
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## APPENDIX I

The Specimen of Contract Specification of a Crude Palm Oil Futures Contract

<table>
<thead>
<tr>
<th>Contract Code</th>
<th>FCPO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underlying Instrument</td>
<td>Crude Palm Oil</td>
</tr>
<tr>
<td>Contract Size</td>
<td>25 metric tons</td>
</tr>
<tr>
<td>Minimum Price Fluctuation</td>
<td>RM1 per metric ton</td>
</tr>
</tbody>
</table>

### Daily Price Limits

RM100 per metric ton above or below the Settlement Prices of the preceding day for all months, except spot month. Limits are expanded when the Settlement Prices of all three quoted months immediately following the current month, in any day, are at limits as follows:

<table>
<thead>
<tr>
<th>Day</th>
<th>Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Day</td>
<td>RM100</td>
</tr>
<tr>
<td>Second Day</td>
<td>RM150</td>
</tr>
<tr>
<td>Third Day</td>
<td>RM200</td>
</tr>
</tbody>
</table>

Daily price limits will remain at RM200, when the preceding day's settlement prices of all the three quoted months immediately following the spot month settle at limits of RM200.

Otherwise, it shall revert to the basic limit amount of RM100.

### Contract Months

Spot and the next 5 succeeding months and thereafter, alternate months up to 12 months ahead.

### Trading Hours

First trading session: Malaysian 10:30 a.m. to 12.30 p.m.
Second trading session: Malaysian 3.00 p.m. to 6.00 p.m.

### Final Trading Day and Maturity Date

Contract expires at noon on the 15th day of the delivery month. If the 15th is a non-market day, the preceding Business Day.

### Tender Period

First business day to the 20th Business Day of the delivery month, or if the 20th is a non-market day, the preceding Business Day.

### Contract Grade and Delivery Points

Crude Palm Oil of good merchantable quality, in bulk, unbleached, in Port Tank Installations located at the option of the seller at Port Kelang, Penang/Butterworth and Pasir Gudang (Johor).

Free Fatty Acids (FFA) of palm oil delivered into Port Tank Installations shall not exceed 4% and from Port Tank Installations shall not exceed 5%.

Moisture and impurities shall not exceed 0.25%.

Deterioration of Bleachability Index (DOB) value of palm oil delivered into Port Tank Installations shall
be at a minimum of 2.5 and of palm oil delivered from Port Tank Installations shall be at a minimum of 2.31.

| Deliverable Unit | 25 metric tons, plus or minus not more than 2%. Settlement of weight differences shall be based on the simple average of the daily Settlement Prices of the delivery month from: (a) the 1st Business Day of the delivery month to the day of tender, if the tender is made before the last trading day of the delivery month; or (b) the 1st Business Day of the delivery month to the Business Day immediately preceding the last day of trading, if the tender is made on the last trading day or thereafter. |
| Reportable Position | Open Position of 100 or more open contracts, long or short, in any one delivery month. |
| Position Limit | 500 contracts net long or net short on the spot month. 1,500 contracts on any single month except for the spot month. 2,500 contracts on all contract months combined. |

APPENDIX II

Palm Oil Products and Malaysian Standard Specifications

**TABLE A**

<table>
<thead>
<tr>
<th>Product</th>
<th>FFA(max %)</th>
<th>M&amp;I(max %)</th>
<th>IV</th>
<th>Colour</th>
<th>Melting Point(C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crude palm oil</td>
<td>5</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Neutralised palm oil</td>
<td>0.25</td>
<td>0.1</td>
<td>50-55</td>
<td>-</td>
<td>33-39</td>
</tr>
<tr>
<td>Neutralised and bleached palm oil</td>
<td>0.25</td>
<td>0.1</td>
<td>50-55</td>
<td>max 20 red</td>
<td>33-39</td>
</tr>
</tbody>
</table>


**Fatty Acid Composition and Other Properties of Malaysian Palm Oil**

**TABLE B**

<table>
<thead>
<tr>
<th>Fatty acid</th>
<th>Palm oil mean</th>
<th>Range of palm oil</th>
</tr>
</thead>
<tbody>
<tr>
<td>C14:0 Myristic</td>
<td>1.1</td>
<td>0.9-1.5</td>
</tr>
<tr>
<td>C16:0 Palmitic</td>
<td>43.5</td>
<td>39.2-45.8</td>
</tr>
<tr>
<td>C18:0 Stearic</td>
<td>4.3</td>
<td>3.7-5.1</td>
</tr>
<tr>
<td>C18:1 Oleic</td>
<td>39.8</td>
<td>37.4-44.1</td>
</tr>
<tr>
<td>C18:2 Linoleic</td>
<td>10.2</td>
<td>8.7-12.5</td>
</tr>
<tr>
<td>C18:3 Linolenic</td>
<td>0.3</td>
<td>0.0-0.6</td>
</tr>
<tr>
<td>Iodine value</td>
<td>53.0</td>
<td>51.0-55.3</td>
</tr>
<tr>
<td>Slip melting point (C)</td>
<td>36.0</td>
<td>32.3-39.0</td>
</tr>
<tr>
<td>Cloud point (C)</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>