

216654 - What is the ruling on option contracts on shares?

the question

What is the ruling on dealing in so-called option contracts? This refers to an exclusive right which is sold to people, according to which the purchaser has the right to buy or sell a particular share for a price that is agreed upon, within a certain period, or until a certain date.

Detailed answer

Praise be to Allah.

With regard to option contracts, this kind of contract is described as being a contract of exchange which gives the exclusive right to one of two parties, entitling the bearer to sell or buy something specific in return for a specific price, within a set period or until a certain date, either directly or through a separate body that guarantees the rights of both parties.

End quote from al-Ikhtiyaaraat: Diraasah Fiqhiyyah by Dr 'Abd al-Wahhaab Abu Sulaymaan, in Majallat Majma' al-Fiqh (no. 7, 1/279).

The most prominent types of option contracts are two:

1. Call option

This is an agreement that entitles the bearer (but does not force him) to buy a specific share or any other financial certificate, for a set price within a set period, which is usually ninety days. The price that is agreed upon between the two parties is called the strike price.

Based on that, this option gives the purchaser the right to go ahead with the purchase or cancel it within a specific period. As for the seller, he has no right to change his mind about the deal, so

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long as he has received the price for this option, which is known as the premium. The purchaser is protected against any rise in the price of the deal, and the seller gets the premium in addition to the value of the deal at the time of the contract, if the purchaser goes ahead with the purchase.

2. Put option

This is an agreement which gives the purchaser of this option – who is the owner of the financial certificates – the right to sell a specific number of shares or other financial certificates for a certain price within a specific period, but he is not obliged to sell, so it is optional. As for the one who receives the money for this option, he is compelled to buy if the purchaser of this right decides to sell for the price agreed upon, during the specified period.

For more information, please see the book: Ahkaam at-Ta'aamul fi'l-Aswaaq al-Maaliyyah al-Mu'aasirah (2/1005-10 79)

From the above it is clear that the object of the contract – in these kinds of contracts – is merely the right to buy or sell for a certain price. The object of the contract is not any specific shares. So what is being sold is the option itself, and this contract is binding upon one of the two parties, namely the seller of the option, whilst it is not binding upon the other party, namely the buyer of the option.

With regard to this type of contract, and the form in which it now appears in the financial markets, because of what it involves of ambiguity and gambling, resolutions and fatwas have been issued stating that it is prohibited to sell or deal in such contracts.

It says in a resolution of the Islamic Fiqh Council, no. 63 (1/7):

Option contracts – as they are known today in the global financial markets – are a new kind of contract that does not come under the heading of any kind of shar'i contracts.

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Because the object of the contract is not a specific item or benefit, or a financial right that could be compensated with something else, this type of contract is not permissible according to Islam.

As these contracts are not permissible in the first place, it is not permissible to deal in them. End quote.

This is supported by the resolution of the seventeenth Barakah Conference on Islamic Economics, in which it says the following:

Because options refers to the right to buy or sell a product on the basis of specific conditions in return for some compensation for that right, and the people involved in the contract have contradictory expectations regarding the fluctuation of prices, the conference, on the basis that what the two parties want and wish for is not something that can be subject to a contract, or be compensated for, reiterates the resolution of the Islamic Fiqh Council, no. 63 (1/7)... End quote.

<http://www.islamicfeqh.com/Kshaf/List/ViewDecisionDetails.aspx?DecisionID=1639>

Dr. Saami ibn Ibraaheem as-Suwaylim said:

Option contracts that are traded in the global markets, whether they are call options or put options, come under the heading of ambiguous contracts which are prohibited according to Islamic teaching. This was stated in a resolution issued by the Islamic Fiqh Council in Jeddah in 1992 CE, no. 63.

What makes these contracts come under the heading of ambiguity is the fact that the entire function of the contract is connected to fluctuation in prices, to the extent that it does not allow both parties to win. In the case of the option to buy, the purchaser pays a specific amount (the premium) so that he will have the right to buy the share or shares for a fixed price during the option period. If the market price of these shares rises within the stated timeframe, the purchaser will go ahead and he will gain the difference between the market price and the actual price (the

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strike price). Similarly, with regard to the option to sell, the owner of the shares pays a specific amount in return for having the right to sell the shares for a fixed price during the contract period. If the market price falls within the stated timeframe, the owner will proceed with the sale and gain the difference between the market price and the strike price. Naturally, this gain in itself represents a loss to the other party; if it were known beforehand in what direction the price would go, this contract would not have been agreed to, because it represents certain loss for one of the two parties.

Options are tools of speculation and risk-taking with regard to prices. Therefore this contract comes under the heading of contracts that made the French economist Maurice Allais describe the global stock exchanges as “huge casinos for gambling”, because the essence of gambling means that one of the two parties gains at the expense of the other, and this is exactly what happens in the case of option contracts in the international markets.

This is in contrast to regular buying and selling of shares (that does not involve anything that is disallowed according to Islamic teaching), because the sale contract is a contract that takes effect immediately and ends as soon as the deal is done. Thus each party has complete freedom to dispose of what he has gained through the contract immediately after the deal is concluded, without any commitment from one party to the other. As for the option contract, it is a deferred contract in which one party makes a commitment to the other to take the risk of price fluctuations during the period of the option contract. Thus the true nature of the contract is that the one who is offering the option gives a commitment or a guarantee to the other party to go ahead with the contract at the agreed-upon price. Hence it is a contract in which one party pays something in order to guarantee the price. Therefore the option contract is regarded as a kind of insurance contract in reality, and thus it is used as insurance for investment (portfolio insurance). It is well-known that commercial insurance contracts are contracts that involve ambiguity, according to the unanimous agreement of fiqh councils.

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Conclusion:

This kind of transaction comes under the heading of haraam transactions that it is not permissible to initiate or deal in.

And Allah knows best.