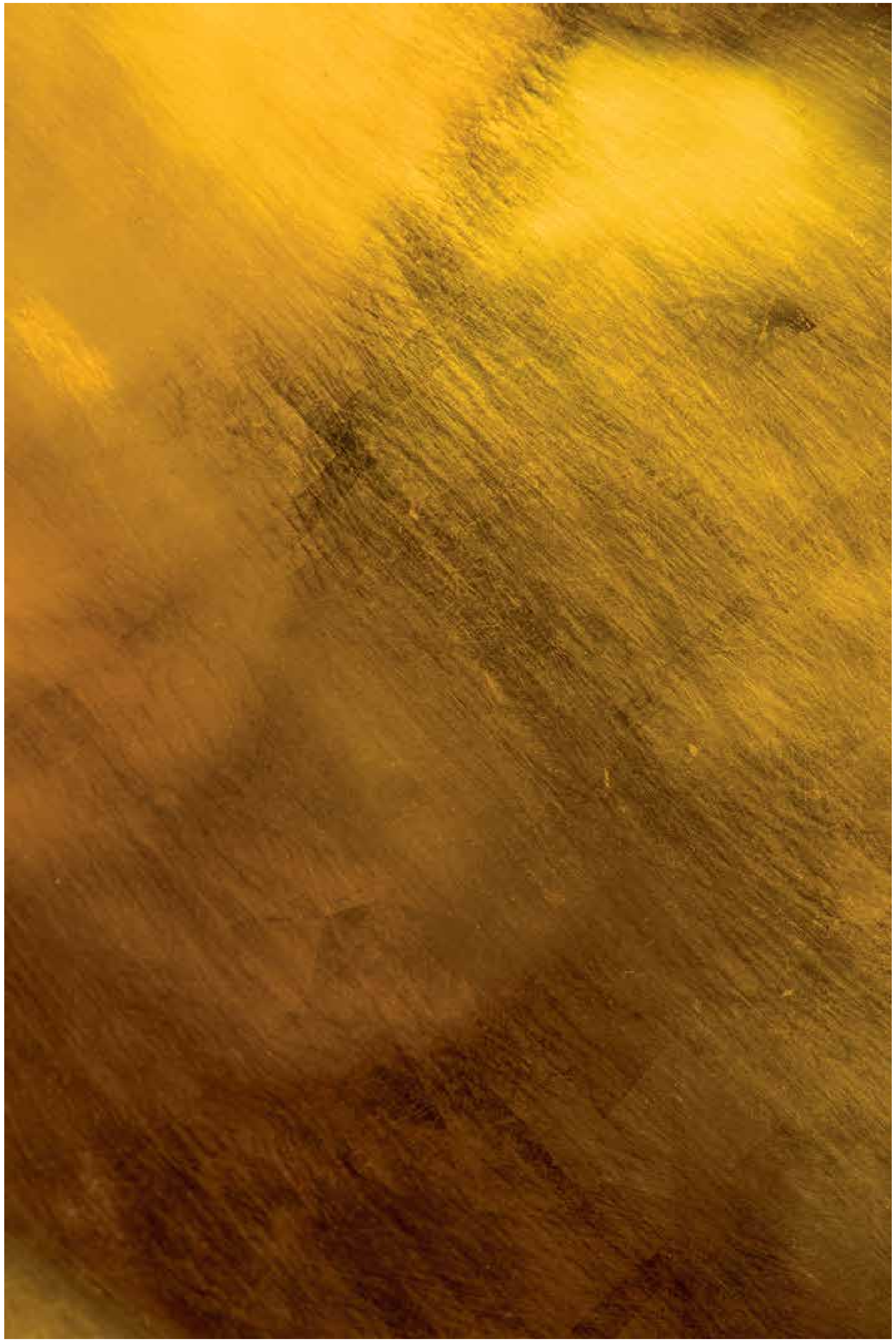
WORLD GOLD COUNCIL
مجلس الذهب العالمي

Physical gold ETFs
Product schematic

Shari'ah-compliant gold savings and investments



Physical gold exchange traded funds (ETFs) and similar products are regulated funds that invest in gold bullion. Shares in physical gold ETFs can be bought and sold similarly to shares of publicly traded corporations through exchanges. The price of a share of a physical gold ETF usually closely tracks the performance of the spot price of the underlying gold bullion. Physical gold ETFs are used by both individual and institutional investors.

Physical gold ETFs offer:

- Low costs
- High liquidity
- High convenience similar to other exchange-traded securities

Physical Gold ETFs

The table below summarises key aspects of physical gold ETFs and compares them to other forms of Shari'ah-compliant gold investments. In order for these products to be Shari'ah-compliant, they must be fully backed by allocated physical gold.

Since their introduction in 2003, physical gold ETFs have transformed the gold investment market.

They have reduced total cost of ownership, increased efficiencies, provided liquidity and access, and brought new interest – and demand – into gold as a strategic investment.

Physical gold ETFs are regulated funds backed by physical gold. These instruments offer investors indirect ownership of gold bullion without having to handle physical gold on their own. The main objective of most physical gold ETFs is to track the price of gold bullion, less the expenses of the fund's operations. Shares of physical gold ETFs are traded on exchanges, similarly to corporate shares.

The launch of the first physical gold ETF in the US in 2004 increased the accessibility of gold for investors dramatically. Today there are approximately 70 different physical gold ETFs, though not all of them are fully backed by physical gold. These physical gold ETFs hold more than US$78 billion in gold bullion (as of December 2016). While the US and Europe account for the majority of assets under management, ETFs in Asia have grown in recent years, too.

In addition to physical gold ETFs, there are other exchange-traded securities backed by physical gold, including exchange traded commodities. There are also some close-end funds that are exchange traded and fully backed by physical gold.

This document focuses only on physical gold ETFs. Different structures and terminology are applied in other markets.

A physical gold ETF invests in gold bullion. The mechanism is often an in-kind exchange of shares for physical gold. The ETF issuer creates and issues baskets of shares (e.g. 10,000 or 100,000 shares) to Authorised Participants (APs) in exchange for physical gold. Each share represents units of fractional interest in and ownership of the fund's assets – physical gold. In addition to the creation process the reverse process is also possible, which is called redemption. Authorised Participants may redeem baskets of shares and receive in exchange physical gold, which they can sell in the market.

Individual shares of physical gold ETFs are traded on the secondary market, typically regulated exchanges. This is where investors – individual or institutional – buy and sell shares of these ETFs.

The operating model of a physical gold ETF involves several parties and roles. Each party or role receives remuneration for its services, such as commission fees, account management fees, bid-ask spreads, ETF management fees, transaction fees for the creation or redemption of baskets of shares, and other fees. To the investor, a physical gold ETF is a cost effective solution to owning gold – as vaulting, delivery and security are all taken care of, the product is highly liquid, and the management fees are generally low.

	Shari'ah-compliant vaulted gold		Shari'ah-compliant gold savings plans		Shari'ah-compliant physical gold ETFs		Shari'ah-compliant gold undertakings (similar to futures)		Shari'ah-compliant gold certificates	
Value proposition	Own gold, which is stored in professional vaults		Accumulate gold in small amounts over a period of time and redeem for the physical metal or cash		Trade and track gold like an exchange-traded financial security		Hedge the price of gold		Own gold, evidenced and guaranteed by an individual certificate	
Target customers	individual	Institutional	Individual	Institutional	Individual	Institutional	Individual	Institutional	Individual	Institutional
	✓	(✓)	✓	✕	✓	✓	(✓)	✓	✓	✕
	$ – $$$	Corporate/ institutional investors	$ – $$		$ – $$$	Corporate/ institutional investors	$$$	Corporate/ institutional investors	$$$	
Minimum investment	$/$$		$		$		$$$		$$$	
Convenience	⊕⊕⊕		⊕⊕		⊕⊕⊕		⊕		⊕	
Cost efficiency	⊕⊕		⊕		⊕⊕⊕		⊕⊕⊕		⊕⊕	
Additional aspects	+ Customer can often choose between different vault locations		+ Continuous accumulation + Cost average effect + Redemption as bullion/cash jewellery + Gift option		+ High liquidity + Traded like an exchange-traded financial security + Physical withdrawal permitted but restrictions to individual investors may apply		+ Suitable for gold price hedging + Expert knowledge required		+ Added security through personalised certificate + High degree of confidentiality possible + Gift option	

Investor proposition of physical gold ETFs

Physical gold ETFs offer investors the opportunity to obtain exposure to movements in gold price with the convenience of a modern investment product.

Customers who buy shares in these ETFs do not have to trade physical gold directly or manage the safekeeping of their holdings. Instead, customers can buy shares of these ETFs just as easily and quickly as they can buy shares of listed companies through their bank or broker. The unique characteristics of these ETFs and similar products have drawn investors into the gold market for a variety of reasons:

- **Lower management fees** – ETF fees are generally lower than actively managed funds with precious metals strategies as they benefit from a difference in management and economies of scale.
- **Reduction of premiums** – ETFs offer investors of all sizes the ability to track gold at a wholesale price. This results in a much cheaper cost per unit than traditional investment gold purchases at a smaller scale.
- **Elimination of separate storage and vaulting costs** – physical gold ETF management fees typically include storage and vaulting costs.
- **Standardisation in quality and security** – physical gold ETFs generally hold a standard form of investment gold. Some hold exclusively London Good Delivery Bars which have standardised quality and characteristics in weight, minimum fineness, and dimensions. These bars are typically stored at custodian or bullion banks with appropriate secure storage facilities which are regularly audited.
- **Added liquidity** – investors who hold gold through an ETF are participating in a deep and liquid market, that typically trades more than US$1 billion a day collectively (as of 2016).
- **Increased operational efficiency and transparency** – gold ETFs provide transparency and security through an approved custodian, typically a bullion bank or dealer, with experience in custodying gold accounts. Additionally, gold ETFs must meet strict regulatory requirements similar to publically traded equities and publish intra-day prices and reports.

Commercial benefits for banks supporting physical gold ETFs

Physical gold ETFs are a modern instrument that provide customers indirect ownership in physical gold. Banks able to provide trading access to these ETFs benefit from addressing customer needs for cost efficiency, convenience and high liquidity. They also represent a commercial opportunity for the bank to:

- Increase trading revenues or fees charged on managed accounts;
- Acquire new customers through diversification of the banks product offering;
- Increase product cross-selling opportunities.

Key product features and design considerations

Physical gold ETFs vary in features. The table below provides an overview of some of the key features and design options.

Physical gold ETFs are aimed at both individual and institutional investors. Required minimum investments are very low.

Typical target customers for physical gold ETFs are:

- *Mass affluent customers*
- *High net worth individuals*
- *Institutional investors*

The minimum investment amount in a physical gold ETF equals the price of one share of the ETF. Shares of these ETFs typically are issued initially as representing, e.g.,

1 *troy ounce of gold*

1/10th *fine ounce of gold*

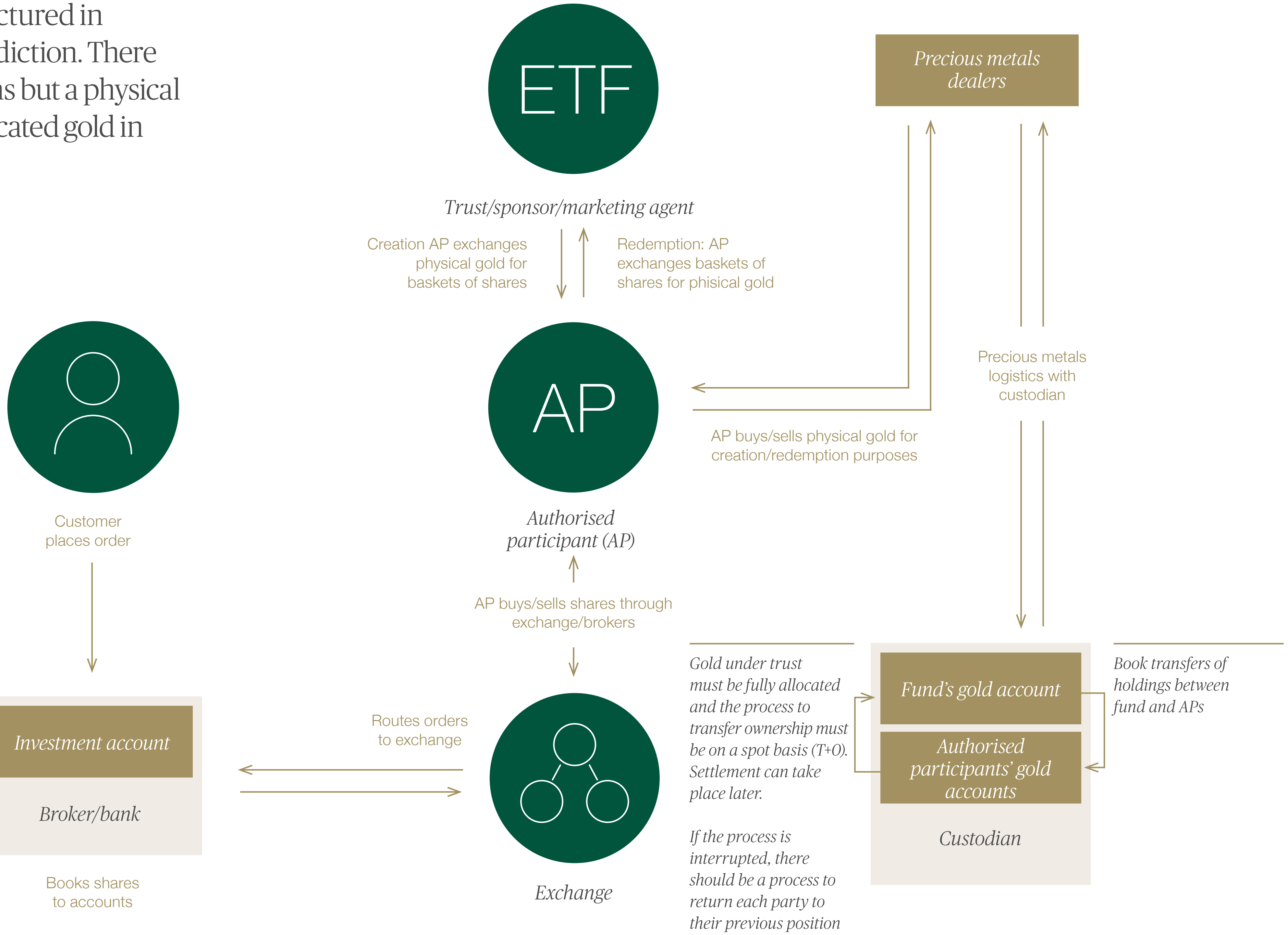
Operational expenses are usually deducted from the fund's assets base over time. The amount of gold held per share, that forms the basis for the fund's net asset value, reduces continually to cover expenses. Thus, the initial amount of hold per share diminishes marginally over time.

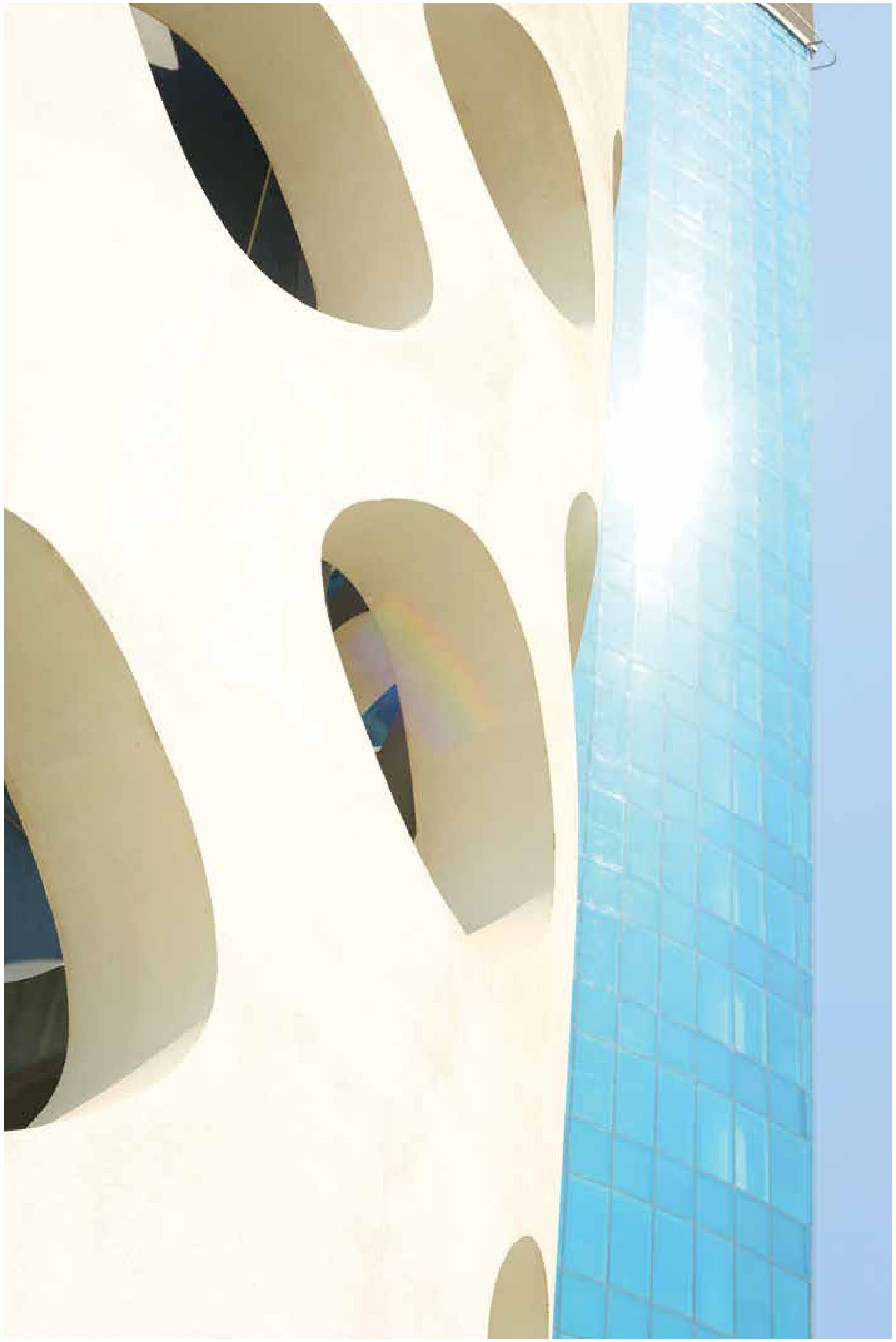
Some funds base their share on fractional ounces while others may use grams as their reference unit.

Form of gold	Physical gold ETFs hold allocated investment gold, which meets defined requirements. For example, some physical gold ETFs hold London Good Delivery bars that contain between 350 and 430 fine troy ounces of gold, with a minimum fineness (or purity) of 995 parts per 1,000 (99.5%). Other such ETFs may also hold COMEX good delivery bars or others.
Type of ownership	Investors own shares of physical gold ETFs. Shares of physical gold ETFs are backed by physical gold. The structure of such an ETF can vary – several ETFs offered in the US are set up as grantor trusts. Each share of a physical gold ETF represents a fractional, undivided interest in the trust's net assets. The assets comprise of physical gold bullion and, from time to time in exceptional cases, cash.
Listing	The shares of physical gold ETFs are listed and traded on regulated exchanges.
Net Asset Value (NAV)	The net asset value is calculated as the aggregate value of the fund's assets less its liabilities including accrued expenses. The NAV per share is calculated by dividing the NAV by the number of outstanding shares. Creation and redemption of shares by Authorised Participants is based on the NAV.
Price formation	Regular investors – other than Authorised Participants creating/redeeming large baskets of shares – buy and sell shares of physical gold ETFs in the secondary market through exchanges. The price of a share seeks to track the price of the underlying gold, although fund expenses as well as supply and demand for the product can result in tracking error. The process of creation and redemption of shares by the Authorised Participants helps to keep the share price aligned to the value of its underlying gold, i.e., the net asset value.
Buying/ selling	Shares of physical gold ETFs are traded according to the rules of the respective exchanges.
Custody	Custodians are typically established custodian banks. If the fund holds physical gold according to particular specifications, e.g., in the form of London Good Delivery bars, the custodian has to meet the respective vaulting requirements.
Withdrawal	Usually physical gold ETFs do not allow investors, other than APs, to directly take physical possession of the gold backing their shares. There are exceptions and some physical gold ETFs provide investors with a means to invest in gold and be able to take delivery of physical gold bullion in exchange for their shares, at a prescribed cost. Customers can request delivery of gold in the form of bullion bars or bullion coins. The required minimum amount of shares is low, but minimum fees apply.
Insurance	Custodians typically maintain insurance for their business, and a Shari'ah-compliant ETF would require full Takaful coverage (see below).
Regulation	Regulation varies across jurisdictions. US-based trusts forming physical gold ETFs are not registered as regulated investment companies. Although these ETFs therefore do not need to comply with mutual fund regulations, they are required to meet disclosure and listing rules, as required in the United States of America under the Securities Act of 1933. and applied to other public companies. Being listed on a regulated exchange means that the public offering and trading of shares of these ETFs is subject to review of the respective regulatory bodies, e.g., the Securities and Exchange Commission in the United States of America. Another consequence of being listed on a regulated exchange is often the required designation of a lead market maker, who needs to continuously quote the product.
Fees	The different parties involved in the provision of physical gold ETFs charge various costs/fees to customers or other market participants: ○ **Management expenses** per shares are deducted from the fund's assets, i.e., borne by the investor. Common values range typically from 0.25% to 0.50%. ○ **Buying/selling commissions** are paid by the investor to the broker/bank and the exchange and vary according to the provider ○ **Account fees** like account opening fees or account deposit fees are paid for by the investor to the broker/bank and vary according to the provider ○ **Spreads** – bid/ask spreads are implicitly paid by the customer when buying or selling shares through an exchange. Spreads for the SPDR® Gold Trust sometimes vary and could amount to about 1 US cent/less than 1 basis point (bp). ○ **Transaction fees** are paid by Authorised Participants for the creation or redemption of baskets of shares and cover the costs of the transfer agent ○ **Withdrawal/delivery fees** – often starting from US$ 1,000 per delivery

Operation of physical gold ETFs

ETFs and similar products can be structured in different ways, depending on the jurisdiction. There are a number of Shari'ah considerations but a physical gold ETF must be 100% backed by allocated gold in order to be Shari'ah-compliant.





Shari'ah considerations

An ETF is a more complicated product than simple vaulted gold and therefore there is greater room for varying permutations of the product structure and subsequent legal documentation.

The Shari'ah considerations very much depend on these permutations and there is no single structuring solution. However, Shari'ah-compliant physical gold ETFs that fully adhere to the provisions of the AAOIFI Shari'ah Standard on gold exist.

In general, gold ETFs involve the purchasing of shares that represent ownership of physical gold. Some gold ETFs offer an exposure to unallocated gold which would be impermissible under Shari'ah. The main condition for a gold ETF to be considered Shari'ah-compliant is that it must be 100% backed by allocated physical gold.

Where the fund structure is based on a trust, the trustee should be able to identify all of the gold owned under the trust. This is usually via documentation provided by the custodian to the trustee.

It is particularly important that the process to transfer ownership of shares in the fund is clear, meticulous and timely. The process often involves a number of parties and can therefore take a few days to be finalised. Most importantly it is necessary that the exchange of shares for cash happens on spot and at the same time (T+0). If, for whatever reason, the process is interrupted, delayed or frustrated, there should be a process to return each party to their previous position.

Given that a fund may represent a portfolio of investments into gold and (possibly) other assets (such as cash), it is not necessary for the fund to provide physical redemption of gold, although such may be agreed between the parties. However, the fund must allow the redemption of the shares in return for what was originally committed to purchase the shares, be it physical gold, cash or other, unless expressly agreed otherwise by the parties.

The shares must not represent a portfolio that is overleveraged or has excessive cash over and above proportions stipulated as permissible by the Shari'ah standards; otherwise such shares must be traded only at par.

Any cash that is held by the fund must be managed in a Shari'ah-compliant manner.

The above are some of the key considerations in designing a Shari'ah compliant physical gold ETF and should be supplemented by other ancillary factors to ensure end to end Shari'ah compliance.

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Operational considerations

The typical parties involved in operating a physical gold ETF and their roles are described below.

Broker

A broker executes investors' buy or sell orders and charges fees for its services.

The exchange

The exchange is a marketplace in which financial instruments are traded. An exchange ensures fair and orderly trading, as well as price discovery for any securities such as shares in physical gold ETFs trading on that exchange.

The trust and the trustee [this structure is specific to the US]

The trust is an investment trust, formed according to a trust indenture and respective laws. The trust holds gold bullion and issues baskets of shares in exchange for deposits of gold bullion and distributes gold bullion in connection with redemptions of baskets. The investment objective of the trust is for the shares to reflect the performance of the price of physical gold bullion, less the trust's expenses.

The trustee is responsible for the day-to-day operations of the trust. The trustee holds and administers the assets of the trust and makes decisions in its best interests. The trustee calculates the net asset value per share, sells the trust's gold as needed to cover the trust's expenses, and receives and processes orders for creation or redemption of baskets of shares from the Authorised Participants.

The sponsor

The Sponsor establishes the trust and oversees the performance of the trustee and the trust's service providers, but does not exercise day-to-day oversight over the trustee and service providers.

The custodian

The custodian is responsible for safekeeping the trust's gold bullion as well as facilitating the transfer of gold in and out of the trust through gold accounts, which are maintained by the custodian for the trust and the Authorised Participants.

The Authorised Participants

An Authorised Participant is a registered broker-dealer or other securities market participant such as a bank or other financial institution and has established an unallocated gold account with the custodian. Authorised Participants may create or redeem baskets of shares in physical gold ETFs. The Authorised Participants pay a transaction fee for each creation or redemption order and may sell the shares from the baskets they create to other investors.

The marketing agent

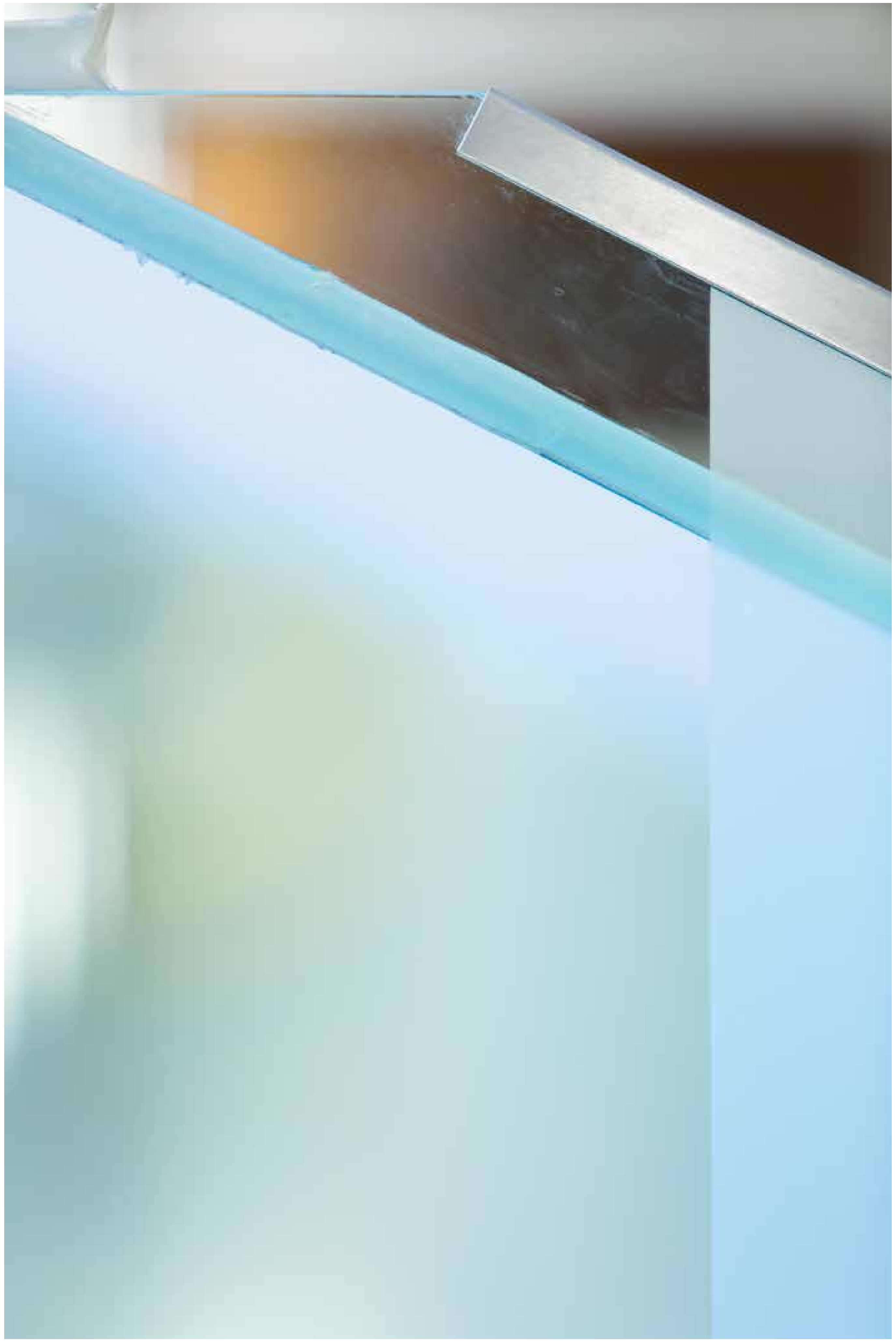
Physical gold ETFs are often structured and marketed by the same organisation. If an external marketing agent is commissioned, the agent assists the sponsor in marketing the shares. Responsibilities of the marketing agent could include developing, maintaining and executing marketing plans.

Market makers

A market maker for a physical gold ETF is a broker-dealer, which facilitates the trading in the ETF's shares in the secondary market. Under rules in the US, the designated lead market maker of a physical gold ETF has to continuously quote prices for the physical gold ETF.

Potential roles for a bank

Depending on relevant laws, a bank could act as a broker-dealer, offering the trading in Shari'ah-compliant physical gold ETFs to its customer base.



Frequently asked questions

Who invests in physical gold ETFs?

Shares in physical gold ETFs are purchased by both individual and institutional investors. Private investors can range from mass market customers to high net worth individuals, although banks or brokers often focus on offering exchange-traded funds to more wealthy customers. Institutional investors could be insurance companies, endowments or asset managers.

What are the main benefits of physical gold ETFs to customers?

Physical gold ETFs provide investors with a simple means to get exposure to the gold price at relatively low costs. Investors can trade in physical gold ETFs in the same way as they trade in other exchange-traded instruments as, for example, company shares. An important characteristic of physical gold ETFs is that their shares represent ownership backed by actual physical gold holdings. Physical gold ETFs are typically liquid, since they are traded on regulated exchanges and market makers provide liquidity.

What type of gold ownership do physical gold ETFs provide?

Investors holding shares of a physical gold ETF own physical gold indirectly, since they own shares of the fund, which directly owns physical gold. This gold is typically fully allocated.

Can the customer withdraw their physical gold holdings?

This depends on the specific physical gold ETF. For example, investors in some physical gold ETFs can only request the redemption of their shares into physical gold through an Authorised Participant in baskets of specified sizes, sometimes with a minimum of 100,000 shares.

What are the costs and fees for physical gold ETFs?

Costs of exchange-traded funds are in general low compared to alternatives like mutual funds. This also applies to physical gold ETFs, while the costs vary according to the respective fund and its characteristics.

In addition to the spread and expense ratio, investors may pay trading commissions and account fees. These fees can vary by provider, e.g., the respective broker/bank, customer type, and individual trading volumes.

How quickly can a bank start offering access to physical gold ETFs?

Depending on the availability of a Shari'ah-compliant physical gold ETF, trading in such an ETF could be offered very quickly, since the offering could be based on the bank's existing brokerage infrastructure.

What happens in case of damage, loss, theft or restriction on access to the trust's gold?

In general, the shareholder of a physical gold ETF has a fractional undivided beneficial interest in and ownership of the trust. However, the recourse of the trust in case of various events could be limited, for instance due to limited insurance cover of the custodians.

Who bears the risk of a gold price decrease?

The risk is borne by the customer. It should be noted that although the shares of a gold ETF should track the price of gold after expenses, in reality the price could deviate. Trading of shares on the exchange determines the price of a share for the customer. Historically though, at least some products have relatively closely replicated the performance of the spot gold price.