

## ISLAMIC EXCHANGE-TRADED FUNDS AS A MODERN MECHANISM TO REVITALIZE THE FINANCIAL MARKETS: CASE STUDY OF THE SAUDI FINANCIAL MARKET

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**Purpose.** The present paper aims to clarify the importance of exchange-traded funds (ETFs) as one of the creative Islamic financial products that have attracted the attention of investors in recent years. **Results.** This research concluded that: (i) Islamic ETFs are a useful and convenient option for Sharia-compliant investors who prefer this type of Sharia-compliant investment, whether they are beginners or want to diversify their stock investments without the hassle of research, analysis, and selecting the right companies. The fund itself consists of several stocks selected based on the nature of the indicator that the box simulates. (ii) Islamic ETFs are distinguished by their transparency as they are affiliated with a specific market index and their investments match the components of this index, such as if the fund is linked and affected by the movement of the general index of the market or a sector index, and the fund manager may set an index for his fund in coordination with a specialized body in this field. For example, he places an index of legitimate shares, it makes it simpler for the fund's unit owners to understand how well the fund is performing by comparing it to the performance of the indicators they monitor or model. (iii) From the same perspective, the method of creating an Islamic ETF is not different from its traditional counterpart, and the main difference between them lies in the benchmark index that Islamic ETFs track. (iv) Islamic ETFs invest only in companies that comply with Sharia regulations, and in the event that any stock in the index portfolio is not compatible, it is disposed of even if the expectations of its returns are high, and thus the investment opportunities for the Islamic ETF are in a narrow space compared to the investment opportunities available for traditional ETFs, which may reduce the opportunities for the fund's investment and affect the potential return of the fund. (v) The Islamic ETF industry is weak compared to its traditional counterpart, it has been witnessing a remarkable and important growth in the recent period, especially in the Gulf region, specifically Saudi Arabia, which is one of the regions most qualified to achieve significant growth rates in the Islamic ETF sector. (vi) In general, exchange-traded funds have an important place in the financial markets, especially the Saudi stock market, as investing in these funds would expand the base of the financial markets and give investors greater flexibility in choosing how to allocate their investments across market channels and sectors.

**Scientific novelty.** This study focuses on the general framework of ETFs, which aims to focus on Islamic ETFs by providing advantages and its most important dealers in addition to the mechanism of how Islamic ETFs work. Finally, the importance of Islamic ETFs in the financial markets was considered, specifically through a study of the case of the Saudi financial market, from which the

study concluded that it is necessary to pay more attention to this important investment tool, although the industry of Islamic ETFs is weak compared to its counterpart; but, it has recently witnessed a remarkable and important growth, and it plays a major role in stimulating trading in the financial markets.

**Practical value.** The results of this study can be used in several financial markets, taking into account everything related to compliance with Islamic law.

**Key words:** Islamic exchange-traded funds, Islamic Investment Funds, Islamic finance, financial markets, Saudi financial market.

**Introduction.** The Islamic financial industry has witnessed an enormous expansion and wide dissemination in international financial system in the recent times, especially since the 2008 global financial crisis and the resulting increase in Western the desire for Islamic finance. It is a brand-new Islamic investment tool that have emerged as a result of increased need for Sharia-compliant solutions and financial tools, as well as to meet the needs of willing investors and those looking for new investment tools and tools that add value and help them reduce the risks associated with their investments. Islamic ETFs, on the other hand, combine the main characteristics of Islamic investment funds, in terms of portfolio diversity and Sharia compliance, in terms of the ability to issue and redeem documents within permissible limits, with the main characteristics of Sharia-compliant stocks, in terms of secondary market trading. Unlike conventional ETFs, which can track any benchmark index regardless of whether the underlying securities are sharia-compliant, Islamic ETFs can only track benchmark indexes with sharia-compliant component equities.

Given the unique nature of Islamic ETFs, the mechanism for constructing them should be private, taking into account their legitimacy while also achieving the best design and performance of the fund, that is, it combines economic efficiency with legitimate credibility, satisfying the needs of investors who prefer Sharia-compliant investments. At the same time, it performs the typical functions that are expected of it. Islamic ETFs have emerged as an important tool in the financial markets, as investing in these funds expands the base of financial markets and gives investors flexibility, at a time when financial markets, particularly in Islamic countries, require new Sharia-compliant mechanisms to activate their work. As a result of the aforementioned, the following research questions emerge: What function do Islamic ETFs perform in the financial markets, in general, and in the Saudi financial market, specifically?

**Review of literature.** The results of comparative study between Islamic and conventional exchange-traded funds indicate that the returns of conventional ETFs are relatively higher as compared to Islamic ETFs (Yap et al., 2021). An intuitive explanation for this is that the flexibility of conventional ETFs to invest in any stocks, including those with higher risk compared to the limited investment choices in Islamic ETFs. The results of the study of performance of Islamic and conventional exchange-traded funds in Malaysia indicate that Notwithstanding their success to outperform their respective benchmarks, both ETFs had comparable negative performance, with decline in prices and NAV (Diaw et al., 2010). The negative returns have caused abnormality in their measurements.

The published articles analyzed only certain aspects of the development of Islamic exchange-traded funds (Almudhaf & Alhashel, 2020; Al-Rifai, 2013; Farouk & Masih, 2016; Gad & Andrikopoulos, 2019; Rompotis, 2017).

**Materials and methods.** In terms of the research method used, it follows a descriptive approach by gathering various data and statistics related to the growth and development of ETFs in general, and Islamic funds in particular, in order to present them and determine their development within the context of the research objectives and the problem's limitations.

The following are the key hypotheses that the study is based on:

- the procedure for establishing Islamic ETFs is the same as for standard ETFs;
- the demand for Islamic exchange-traded funds contributed to the financial market's revival in Saudi Arabia.

This article's objective is:

- clarify the Traded-based fund (ETF) and Islamic fund conceptual frameworks in general;
- defining the process for creating and launching Islamic ETFs;
- bringing attention to the relevance of Islamic ETFs in the financial markets, particularly in Saudi Arabia.

**Results and discussion.** This study revolves around the general framework of ETFs as it included the following points.

### **1. Exchange-traded funds**

#### *1.1. The definition*

They are defined as “funds of investments specifically intended to follow an indicator or a specific sector, so that each document is a basket containing a group of securities traded in a stock exchange, provided that these certificates are tradable in the stock exchange in the same way as ordinary shares” (Premier Securities, 2008). Furthermore, they are “a group of securities that exist in an investment fund, and the ownerships or holdings of these securities are called units of the fund, as these units are listed and traded in the stock market” (Qatar Stock Exchange, 2022)

They are also defined as an “open-ended investment funds that constantly create and extinguish investment units, and the assets of these funds are represented by an investment portfolio that is formed from a group of securities comprising a specific existing index such as: Dow Jones or Standard & Poor's, or an index created by the investment fund itself, which makes it an attractive investment tool for investors who tend to avoid risks, as it tracks an index that consists of a variety of securities with good and excellent performance that the rational investor is looking for” (Palestine Stock Exchange, 2009).

Moreover, the ETF is defined as “A listed indicator fund format conforming to a unit trust plan or any other authorized designs that primary purpose is to attain the profits to the performance of a specific indicator” (Shariah-compliant ..., 2022).

Following that, the ETF is a joint investment fund between a group of investors, which is restricted and exchanged on financial markets, and the funds that is divided

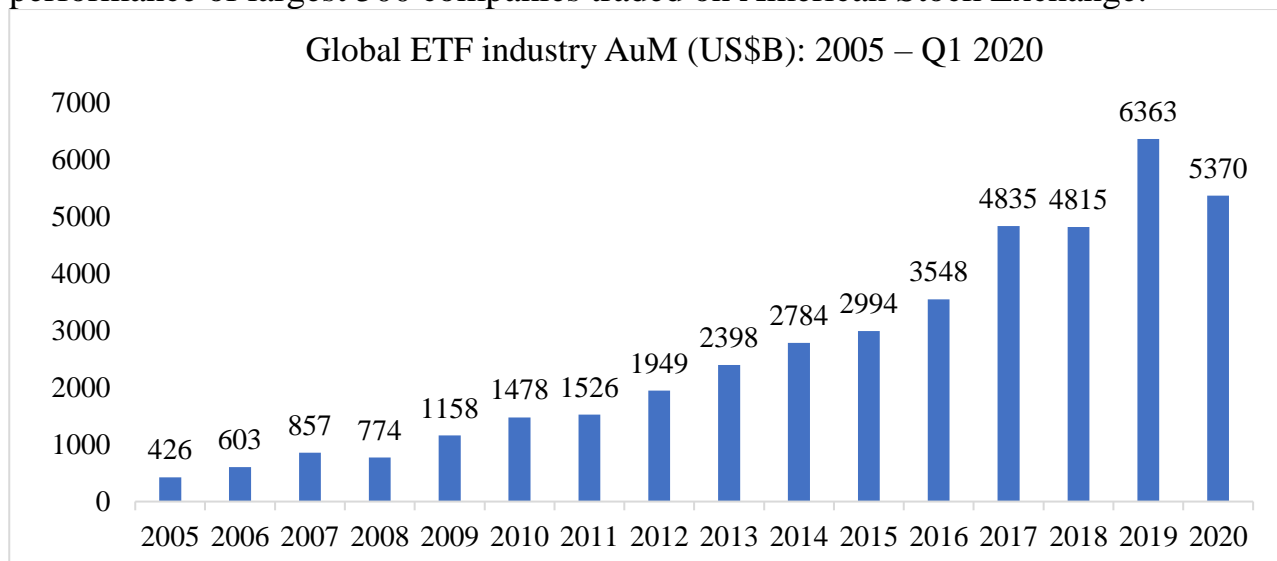
into a number of units of equal value (the fund documents); or the relative weights of the shares of a particular index so that the document represents the performance of that index, and this document in itself is tradable in the stock exchange in the same way as the ordinary shares are traded during the hours designated for trading in the stock exchange.

Therefore, since these funds are restricted on the stock exchange and their units are exchanged, investors can buy and sell units of these funds through market brokers or market makers directly, and do not need to deal with the fund manager as is the case in traditional investment funds.

### 1.2. Origin and development of ETFs

It is well established that the emergence of exchange-traded funds was linked to the emergence of financial innovations, as a group of investment companies launched the first index fund in 1973 in the United States of America, and it was directed to investment institutions, followed by the American Vanguard Group, which launched the first index fund in 1976 directed to individual investors, After that, index funds were developed in the form of tradable funds, and thus the first tradable index fund appeared in 1989 in the United States of America under the name (Index Participation Shares), which simulates the (S&P 500) index, but did not continue due to legal problems (Al-Ghufaili at al., 2013). The evolution of ETFs globally is shown in Figure 1.

On the same line of thought, in the same year, the first traded fund was launched through the Toronto stock market in Canada under Toronto Index Fund name (Tips35), which included the 35 largest shares traded on the Toronto Stock Exchange, after which the first market for index funds was created by State Street Global Advisors in collaboration with the American Stock Exchange in 1993, which was called Standard & Poor's Depository Receipts (SPDR), or as it is called (Spiders), and it was launched on the American Amex Stock Exchange that works for tracking (S&P 500) indicator performance of largest 500 companies traded on American Stock Exchange.



**Figure 1. Evolution of ETFs globally**

Source: Israelstam, 2020.

Following that, ETFs began to grow rapidly in the global financial markets, until their number reached 7,602 by the end of 2020 with assets valued at USD 7.74 trillion. They also met with a wide spread in the American financial markets, where their number increased from 79 funds in 2001. To 2,793 funds in 2021, with assets that increased from only USD 66 million in 2001 to USD 7.233 billion in 2021, the largest of which is the S&P 500 index traded fund, of which about 100 million shares are traded daily, equivalent to USD 34 billion per day, and the value of the units is close to its components consisted of USD 300 billion, and then spread of ETFs in Europe, whose number increased from only 168 funds traded in Europe in 2005 to 1,820 by the end of 2020 with assets that increased from USD 57 billion in 2005 to nearly from USD 1.2 trillion in 2020 (Statista website, 2022).

Furthermore, these funds have also spread in Asian countries such as Japan, Hong Kong and Thailand, as well as in South Africa, and some Arab countries that have seen this investment tool dealt with, such as: The Abu Dhabi Stock Exchange, the Muscat Securities Market, Egyptian, Saudi and Qatari Stock Exchange.

### *1.3. Benefits of investing in an exchange-traded fund*

Investing in ETF units has several advantages, the most important of which are (Egyptian Stock Exchange, 2011):

- immediate variation: it is regarded as an assortment of stock portfolios; Investors may be exposed to a variety of equity names through an ETF's trades. Investors may so lessen or even do away with unsystematic risk, often known as company-specific risk;

- tradability: ETFs are distinguished by the fact that the units issued by them are tradable in the regulated market throughout the trading session, like any other stock, and their prices are determined instantaneously according to the forces of supply and demand, unlike traditional investment funds whose unit price is only decided at the close of trade day;

- passive administration: the majority of ETFs follow an index's performance through passive management. The following are some implications of passive management:

- (a) low asset turnover increases the effectiveness of its tax and cost systems;

- (b) reduced management fee due to technological assistance;

- (c) ensuring market beta accomplishment by tracking market performance.

- liquidity: ETFs provide the investor with the advantage of obtaining cash quickly in the event that he wants to sell and there is no need to wait until he sells, as happens in traditional investment funds, which allows the investor to trade and sell them in the market and get the value of the units quickly, and every index fund must have a market maker Which commits to selling or buying to all investors who wish to do so, which guarantees the presence of permanent liquidity for the exchange-traded funds, which gives investors permanent confidence in the ability to sell or buy the units of the index funds they own whenever they wish.

Implementing an asset allocation plan will be simpler. By building a portfolio of

an ETF based on its tracked asset classes or sectors or any other combinations, a more complicated asset allocation strategy can be achieved with minimum effort because of its market imitating nature.

- transparency: ETFs are distinguished by the ability to easily identify the investments of these funds in terms of content and investment ratios, as well as follow their prices and trade them in real time at any moment during the Stock Exchange's daily trading session, without needing to wait for the calculation of the net value of the unit at the end of each day or every week, where it is calculated On the basis of its correlation coefficient with the index and is published every hour or half an hour during the trading session, and is published on the trading screens;

- cost: ETFs are characterized by their low administrative costs, which range from 0.1 % to 0.99 %, compared to the administrative costs of traditional investment funds, which range between 1 % to 3 %, due to the fact that these funds are linked to an index, and are treated as a security that is dealing with it, and trading commissions in buying and selling are applied to it, as is done on shares by setting their price according to the forces of supply and demand;

- flexibility in purchase and sale: ETFs may be purchased and sold by the trader at pricing levels prevailing today during each moment of the trading day as per their requirements such as unit investment trusts and mutual funds, which are exclusively exchanged by the investor at the close of trading;

- exceptional advantages: investors can sell index funds short, buy them on margin or place orders with a specific price, and invest the amount of capital they want without a minimum, and these advantages are not available in traditional investment funds, which are not allowed to borrow money or stocks in the first place, they are allowed, in special cases, to borrow to meet the recovery operations, within the limits of only 10 % of the value of the net assets;

- efficiency of taxes: ETFs basically provide comparatively meager capital gains, because of the reduced rotation of the securities in their portfolio. However, it may be viewed as a positive which they distribute to other indicator funds. The benefit is that the ETFs efficiency of Taxes is improved because they don't have to sell securities to redeeming investments;

- trading without conditions: ETFs are characterized by the absence of a minimum purchase amount for the fund units, as it is possible to buy one unit of the fund directly from the market, and one unit can be sold at any time of trading.

The main advantages and disadvantages of investing in an exchange-traded fund are presented in Table 1.

## ***2. Islamic exchange-traded funds***

### ***2.1. The concept of Islamic exchange-traded funds***

The ETFs that are considered as Sharia-compliant investing rules and principles are known as Sharia-compliant ETFs or Islamic ETFs (I-ETFs), ETFs that are Sharia compliant fall under the umbrella of "ESG" or "socially responsible investing" (Environmental, Social, and Governance).

*Table 1*

**Advantages and disadvantages of investing in an exchange-traded fund**

<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>– Provide investors with a more diversified exposure than individual stock, FX, or commodity investments.</li> <li>– Entrance costs are lower than those of direct investments, such as gold.</li> <li>– Decreased yearly management fees in comparison to unit trust funds.</li> <li>– Investors are informed as to exactly which assets are held in the ETF through disclosure.</li> <li>– ETFs are exchanged like stocks, giving investors simple access to liquidity.</li> <li>– The funds are expertly administered.</li> </ul>
<p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>– In comparison to unit trust funds, there are fewer ETFs available on the market.</li> <li>– Daily price fluctuations could terrify short-term investors.</li> <li>– Expenses could be greater than stock trading, which carries no management costs.</li> </ul>

*Source:* Comcec coordination office, 2018.

I-ETF is a type of investment product traded on a stock exchange, it is an indicator-tracking fund, in other terms. Typically, a stockbroker is used to price and trade the I-ETF during the business day (Hanudin, 2022).

Islamic ETFs combine the key traits of sharia-compliant stocks, such as their ability to trade in the secondary market, with the key traits of Islamic investment funds, such as the diversity and legitimacy of the portfolio that makes up each fund and the possibility of issuing and redeeming documents within the allowed limits.

The benchmark index that the Islamic ETF follows is the primary distinction between a conventional ETF and an Islamic ETF. Whereas a conventional ETF may track any benchmark index regardless of the status of its component securities with regard to sharia law, an Islamic ETF monitors a benchmark index made up entirely of securities that are compliant with the law. Also, a sharia committee was created to operate an Islamic ETF in accordance with sharia principles and regulations. To guarantee strict adherence to the sharia principles and practices, the sharia committee regularly evaluates and audits the Islamic ETF.

*2.2. The emergence and development of Islamic exchange-traded funds*

The Islamic Equity Builder which was introduced in 2001 by the Saudi NCB and Deutsche Bank may be the first Islamic ETF. In 2007, the first sharia-compliant index fund was launched based on an international index from Dow Jones of large companies. Islamic based on well-known international indices, and then a decent collection of sharia-compliant indicators were provided by FTSE, MSCI, S&P, etc., to be tracked by I-ETF. Many such Islamic ETFs have been developed over time. In 2007, iShares introduced the iShares MSCI World Islamic UCITS ETF (ISWD), iShares MSCI USA Islamic UCITS (ISUS), and iShares MSCI EM Islamic UCITS (ISDE). In 2008, the Singapore Stock Exchange listed the Daiwa FTSE sharia Japan 100 tracking the FTSE sharia USA Index. In 2015, the MyETF MSCI SEA Islamic Dividend tracking the MSCI South East Asia I (Yap et al., 2021).

The value of Islamic funds traded on the stock exchange in 2019 amounted to about USD 12 billion, down from USD 9 billion in 2018, an increase of 37 %. In the

US market for Islamic financing, three ETFs have been introduced: the S&P 500 sharia Industry Exclusions ETF (SPUS) and SP Funds, as well as the Wahed FTSE USA sharia ETF (HLAL) by Wahed Invest SP Funds' Dow Jones Global Sukuk ETF (SPSK). Each of the HLAL and SPUS invests in stocks that adhere to sharia law.

A sharia-compliant ETF by asset management company Chimera Capital was listed on the Abu Dhabi Securities Exchange and the Dubai Financial Market in August 2020. The GCC has the second-highest regional value of ETFs in 2019, after Europe. When the Al Rayan Qatar ETF was introduced in 2018, there will likely be more of these products available in Qatar. Al Meezan Investment Management introduced Pakistan's first sharia-compliant ETF in September 2020. This came after the first ETFs were introduced in the nation six months earlier (ICD-Refinitiv, 2020).

### *2.3. Benefits of investing in Islamic exchange-traded funds*

Investing in I-ETF units has several advantages, the most important of which are (Hanudin, 2022; Investing in Islam exchange-traded funds, 2020):

- diversified exposure: without directly purchasing each stock that each company owns, the funds allow investors to benefit from privileges generated from the companies included in the index. The funds enable investors to buy a choice of equities issued by companies with correspondingly diverse weightings. Investors gain direct exposure to the businesses that make up the monitored index by purchasing one unit of the I-ETF;

- compliance with Sharia regulations: to follow sharia norms and principles, the funds are kept in a sharia-compliant investing account. It also acknowledges non-Muslim investors who favor investing in these funds in order to receive profitable returns, safely invest their money, and use a secure research platform;

- expenditure: the fund's management charge is comparatively low because it is passively managed. This makes investing in I-ETF a profitable long-term strategy. In comparison to other unit trust products, the funds charge reduced yearly management fees. This is due to the fact that I-ETFs are purchased and sold at the same transaction costs as shares traded on a stock exchange;

- clarity and disclosure: throughout the trading day, the I-ETF price is easily accessible in real time. The website of the fund manager has further detailed and up-to-date information about the I-ETF, such as the daily fund value and quarterly manager report. The funds can be traded, allowing for the buying and selling of I-ETFs to take place at any time within stock market trading hours;

- simplicity: I-ETF is listed on the stock exchange like a stock; I-ETF units are traded at the most recent market price in one transaction. Investors may accomplish this via Internet or via stock exchange brokers. The shares that make up the indicators are published on funds or providers' websites. Thus, it is easy for the investor to access information to make sound investment decisions.

## **3. Creating Islamic exchange-traded funds**

### *3.1. Traders in exchange-traded funds*

There are many parties dealing in exchange-traded funds, and each of them has a



specific responsibility and a specific role, the most important of which are (Center for Studies and Research, 2023):

- fund administrator: the fund administrator is in charge of carrying out the investment plan of the fund and overseeing the portfolio trading operations. The fund may be managed by a team of three or more people, or by one or two co-administrators. It should be noted that the investment policy and the criteria for the investment selection process should be approved by the sharia Board of the Fund;

- market maker: the market maker is an entity licensed by the Capital Market Authority, whose function is to provide liquidity in the ETF market so that continuous offers are provided for purchase, and thus the investor can at any time sell or buy units, meaning that the market maker is committed to continuously By providing buy and sell offers on the funds within a specific price range around the indicative value of the net assets of the unit, and the value of the buy and sell orders must not be less than a specified amount or its equivalent in units, and the market maker is subject to the conditions imposed by authority of Capital Market in order to control and ensure market maker performance;

- custodian: provides services related to preserving the investor's assets and managing the operations that take place on them. He undertakes all matters arising from the custody operations of the Fund in accordance with the terms and conditions approved by the Capital Market Authority and the Fund's Board of Directors;

- provider of index information that the fund simulates: which is obtained from the financial market or one of the companies specialized in building indexes and disseminating their information;

- clearing company: the clearing company verifies the validity of the issuance and redemption operations;

- additional liquidity providers (if any): assist in supplying the ETF with liquidity;

- investors: use their brokers to purchase ETF units.

### *3.2. Mechanism of establishing an Islamic ETF*

The method of establishing an Islamic ETF does not differ from its traditional counterpart, as the party wishing to establish an Islamic ETF must submit an application to the Capital Market Authority, to be accompanied by the data and documents requested by the authority, in addition to what follows (Falcom Financial Services 2010, 14):

- the name of the index to be followed by the fund;

- the approval of the entity in whose name the indicator is registered;

- the expected issue size and currency;

- the number of documents expected to be issued and their face value.

After obtaining the approval of the Capital Market Authority, the fund's originating entity covers the fund's capital either alone or jointly with others, or through public subscription, and the prospectus should include the following data:

- identification data: the name of the fund's founder, the name, address and currency of the fund, the fund's capital limits, the fund's objectives;

- key investing plans and policies: the prospectus should clearly state the investment strategy and exact policies followed;

- description of the index: It includes information about the target index, the structure of the index in terms of how to choose the components of the stocks in the index after ensuring their compliance with Sharia, reviewing the index;

- the main fund's investing risks: clarify most important risks of investing in fund;

- characteristics and specifications of the fund units: the fund manager can create an unlimited quantity of the fund's traded units, and they are all of the same type and have equal categories of value, advantages and rights and do not have the right to vote. All traded units represent an equal joint share in the fund, and the process of creating and redeeming fund units is on an in-kind basis, whereby the fund manager and the market maker exchange the units of the traded fund in return for a box of shares, through custodian, for the purpose of creating and redeeming the units of the traded fund;

- primary and secondary market operations: the processes of issuing and redeeming units at the primary market level, and unit trading operations in the secondary market, are clarified;

- related parties: determining the functions and responsibilities of: the fund manager, the custodian, the market maker, the Fatwa and Sharia Supervisory Board, the auditor;

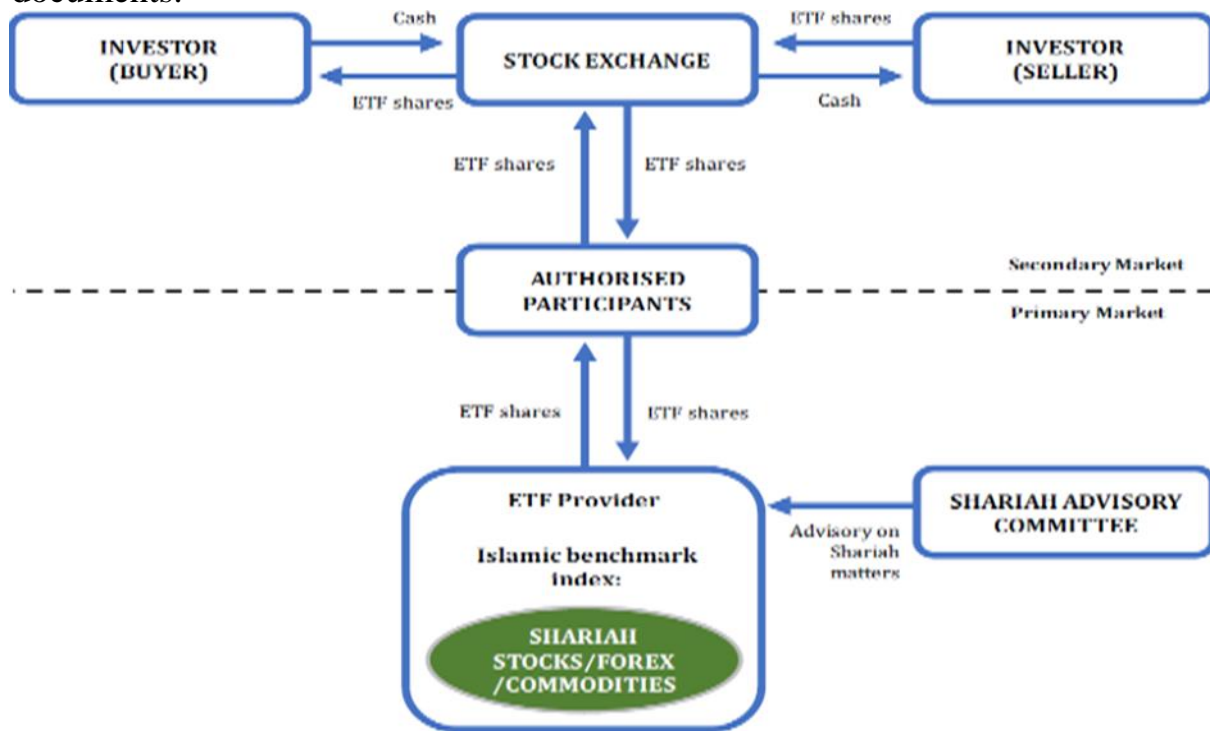
- fund sharia supervision committee: clarify the members, roles and responsibilities of the committee, in addition to defining the criteria applied to determine the legitimacy of assets intended for investment and periodic review, and the procedures followed in case of non-compliance with Sharia standards.

### *3.3. The general mechanism of the ETFs work*

This is done through both the primary and secondary markets (Figure 2):

- at primary market level: company that created the fund creates and extinguishes the fund units through the market maker, as it receives the securities comprising the index in exchange for the issuance of the fund units, as well as the case in the case of amortization where it delivers the securities, and the first subscription in the units of the index fund is done through one of the banks licensed to receive the subscription. As for the market maker, he can subscribe to the units of the fund, either in cash, through one of the banks licensed to receive the subscription; or, in kind, by assembling the basket of securities comprising the target index and depositing it with the custodian for the account of the fund, and the differences between the values are redressed by using cash, without prejudice to the prescribed ratios with regard to the components of the portfolio or the basket of stocks that reflect the components of the target index. After the subscription is closed, the investment manager contracts with one of the licensed brokerage firms or the market maker to purchase the basket of securities that make up the fund's portfolio, which in its composition follows the target index of the issuance process at a certain percentage, and then deposits the securities that make up the portfolio with one of the custodians for an account box. Then, in return for the

investors' money, the fund issues securities in the form of new traded investment units or documents.



**Figure 2. Basic Structure of an Islamic ETF**

Sources: Alam, 2013.

- at the secondary market level: the investment manager registers the index fund units in the stock exchange's tables in accordance with the rules of listing and delisting securities, and depositing the fund units in the central depository system with the clearing company, and the index fund units are exchanged on capital market in the secondary market screens, in same way as the listed shares in the market, therefore, individual investors can buy and sell units during daily trading hours through authorized financial brokers, and they can be traded at any time during trading hours using all stock trading strategies applicable in the stock exchange such as types of orders and borrowing for the purpose of selling and buying on margin. Execution of transactions the stock exchange sends them to the clearing and settlement company to settle the transactions on the scheduled dates. The settlement process usually takes two days from the date of trading, which is known as the T+2 system.

#### **4. Sharia controls for Islamic exchange-traded funds**

It is required that all investments of ETFs be in compliance with the provisions of Sharia, and the investment policy and criteria for the selection process of investments should be approved by the sharia Board of the Fund. Accordingly, the sharia Supervisory Team, under the supervision of the Sharia Board of the Fund, is responsible through Sharia audits for verification from the extent to which the contents of the fund conform to the provisions of Islamic Sharia.

The most important criteria for the selection process of investments approved by Fatwa and sharia Supervisory Boards are usually:

#### 4.1. Corporate Activities and Business Nature

Companies whose main activities include one or more of the following businesses and activities are excluded:

- dealing with interest rate or illegal financial instruments, including prohibited activities of conventional banks;
- producing, distributing and marketing prohibited goods such as smoke and the like, alcohol, drugs, pigs and their meat, and meat not slaughtered according to Sharia, as well as the gambling industry, resorts, hotels and restaurants that engage in prohibited activities;
- production and dissemination of means and publications that advocate taboos;
- derivatives including futures instruments, options, swaps and preferred shares;
- dealing in currency futures.

Securities issued by companies whose sources of income are related to the following sectors:

- conventional banks, insurance companies or interest rate related activities;
- production and distribution of alcohol, weapons and gambling products;
- production and distribution of pork and pornography-related products and services;
- hotels and resorts that provide illegal services;
- production and distribution of alcohol and drugs.

We would need to look out for the following things to determine whether an ETF complies with sharia law:

- constituents who adhere to Sharia: an ETF can only include sharia-compliant components. This applies to any other kind of asset that the ETF holds, as well as the shares that make up an ETF;
- Sharia screening compliance: every ETF must be periodically screened to ensure ongoing sharia compliance. The following screening requirements must be met by an ETF in order for it to adhere to sharia principles:
  - it's business activity monitoring;
  - it's financial monitoring.

A company that satisfies all the criteria for business activity screening will be subjected to a financial ratio screening process.

#### 4.2. Financial ratios

The fund excludes companies that do not meet the following financial criteria:

- if the overall debt as a percentage of market value for a period 36 consecutive months is fewer than 33 %;
- if the ratio of receivable accounts to the average market value over the previous 36 months is less than 49 %;
- if the ratio of liquidity and interest-bearing securities to the 36-month average market value is less than 33 %;
- if the percentage of income from non-compliant operations and unlawful loans (other than interest income) is less than 0.5 % of total revenue.

The fund manager must fully comply with the directives issued by the supervisory team assigned by the sharia Board, in accordance with the Board's directives, decisions and directives.

#### *4.3. Compliance with sharia principles for gold, silver and currencies*

Any ETF that trades in gold, silver, or currencies should be able to adhere to the sharia trading guidelines for these commodities (Asaria 19th – 22nd September, 2011):

- gold can be swapped for silver at any price that both parties can agree upon, regardless of variations in the counter-values' weight. In each instance, it is necessary to swap the counter-values for the deal in accordance with sharia;

- however, selling gold for anything other than gold, silver, or money is also authorized at any price without having to immediately exchange the counter-values, including selling gold for goods, services, etc.;

- along the same lines, the two counter-values must be supplied during the transaction, either physically or constructively, in the event of selling gold for gold, silver, or currencies. Deferral of one of the counter-values is allowed if gold is sold for something other than the aforementioned prices. However, unlike in the case of forwards and futures, it is not allowed to specify the definition of both counter-values when selling gold;

- TFs can be purchased in cash or deferred price, with the exception of gold and silver ETFs, which cannot be sold at a deferred price;

- for these types of ETFs (gold and silver), it is also necessary that redemptions be carried out in kind, at the investor's request.

### **5. The Islamic exchange-traded funds and Financial Markets**

#### *5.1. Importance of Islamic ETFs for financial markets*

Financial markets, especially in Islamic countries, need new tools and mechanisms to activate them, foremost among which are Islamic ETFs, and their importance lies in:

- Islamic ETFs play a major role in activating trading, as they are listed funds whose basket contains legitimate securities (stocks – sukuk – commodities). These funds aim to track the movement of the Islamic index;

- the units of Islamic ETFs are more diversified, including: real estate, commercial and industrial, and this is extremely important for the financial markets. It is also distinguished by being deeper than investing in real estate contributions directly, as it is built on professional foundations and directly supervised by the state;

- fund units deeply benefit small investors who do not have experience in the financial market and encourage them to invest in the financial markets and guarantee their rights. They also work to attract liquidity and reduce the level of risks in investing;

- the units of Islamic ETFs contribute to expanding the investment base of investors and diversifying their investment options, as they are based on raising funds in a professional manner, which provides investors with the appropriate means to invest their money;

- the units of Islamic ETFs are a hybrid combination of stocks and investment

funds, and therefore have the properties of both, that is, they combine two characteristics, namely liquidity and diversification, as they are traded in the secondary market, and that what determines their price is the volume of supply and demand;

- the idea of finding shares for tradable investment funds, like ordinary shares, has a high attractiveness, as it allows trading a large group of shares in one share, thus reducing the risks to the trader, and this differs from traditional investment funds, which are traded outside the stock market at a higher cost and through slow trading mechanism;

- the interest in the Islamic ETFs sector comes from finding new legitimate products and expanding the base of Islamic financial market, furthermore to existence of different channels than it is to preserve assets.

### 5.2. A look at the exchange-traded funds listed in the Saudi Stock Exchange

As part of its efforts to strengthen the Saudi financial market and support it with new and diversified products that meet the needs and orientations of different segments of investors, the Saudi Capital Market Authority launched the second secondary market after the bonds and sukuk market, which is the exchange-traded funds market.

Until the end of 2020, the Saudi stock market includes six ETFs, three of which are new, launched in 2020, that invest in government sukuk and gold, five of which are sharia-compliant funds (Table 2).

*Table 2*

**Compliant index funds on the Saudi Stock market, 2020**

Name of the ETF	Manager of ETF	Guiding indicator
FALCOM Saudi Equity ETF	Falcom Financial Services	FALCOM 30 Saudi Stock Index (F30)
FALCOM PETROCHEMICAL ETF	Falcom Financial Services	FALCOM Petrochemical Sector Index FSPE
Albilad Saudi Sovereign Sukuk ETF	Albilad capital	Albilad IdealRatings SAR Saudi Sovereign Sukuk Index
Short-maturity Alinma Saudi Government Sukuk ETF Fund	Alinma Investing	iBox short-term sovereign sukuk trading index iBoxx Tadawul SAR Government Sukuk 0–5 indicator
Albilad Gold ETF	Albilad capital	DGCX spot gold price (DGSG)

*Source:* Saudi Stock Exchange, 2023.

As for the asset values and the number of participants in the Saudi stock market's exchange-traded funds during the years 2019 and 2020, they can be explained as follows (Table 3).

It is noted that Islamic ETFs assets value in the Saudi market increased in 2020 by a very large percentage amounting to about 4747% compared to the 2019, as it increased from about 33 million riyals in 2019 to about 1.59 billion riyals in 2020. This is due to the launch of three ETFs New for the year 2020 invests in government sukuk and gold, namely: Albilad Saudi Sovereign Sukuk ETF, Albilad Gold Trading ETF, and Alinma ETF for Local Saudi Government Sukuk – short-term, the latter, whose assets alone amounted to 1291.4 million riyals, and the number of subscribers increased

These funds combined amounted to 4706 subscribers by the end of 2020, compared to 368 in 2019, where the number of subscribers to FALCOM Saudi Equity ETF increased from 266 in 2019 to 527 in 2020. The number of subscribers to FALCOM ETF for the petrochemical sector increased from 102 in 2019 to 211 subscribers in 2020, while Albilad Gold ETF had the highest number of subscribers, amounting to 2,494 in the year of its launch.

*Table 3*

**Asset values and number of participants in ETFs during, 2019–2020**

Name of the ETF	Asset values (million riyals)			Number of the investors		
	2019	2020	Degree of change, %	2019	2020	Degree of change, %
FALCOM Saudi Equity ETF	24	19.4	-19.2	266	527	98.1
FALCOM Petrochemical ETF	9	3.2	-64.4	102	211	106.9
Saudi Sovereign Sukuk ETF Albilad	-	1291.4	-	-	187	-
Saudi Government Local Sukuk ETF Alinma – Short Term	-	166.8	-	-	1,287	-
Albilad Gold ETF	-	118.8	-	-	2,494	-
The total	33	1599.4	4746.6	368	4706	1178.8

*Source:* Saudi Stock Exchange, 2023.

It is clear from the Table 4 that the trading value of exchange-traded funds units has increased from about 2.5 billion riyals in 2020 to about 1.6 billion riyals in 2019, and the amount of traded units of exchange-traded funds increased by 263.6 % compared to 2019, which amounted to about 173 million in 2020. In addition, the number of executed deals increased by 2706.5% from 4,033 deals in 2019 to 113,199 deals in 2020. This significant increase is due to the support of the Saudi stock market with the three new funds launched in 2020, which will have an added value to structuring the markets. The Saudi secondary market, which will give the Saudi stock market, which includes 21 sectors in the trading indices, a deeper dimension.

*Table 4*

**Trading activity of compatible ETF units during the period, 2019–2020**

Name of the ETF	Number of traded, units		Value of traded, units		Number of executed transactions	
	2019	2020	2019	2020	2019	2020
FALCOM30	47,516,946	24,820,430	1,592,530,689.85	816,022,402.75	3,405	5,713
FALCOM Petrochemicals	240,076	701,049	7,185,523.35	18,094,586.68	628	1,774
Al bilad sukuk	-	50,677,449	-	516,744,916.39	-	19,275
Sukuk Alinma	-	827,816	-	84,830,742.80	-	1,287
Al bilad for gold	-	96,640,627	-	1,052,909,330.27	-	85,150
The total	47,757,022	173,667,371	1,599,716,213.2	2,488,601,978.89	4033	113,199

*Source:* Saudi Stock Exchange, 2023.

The performance of these funds can be measured compared to the market index, and their performance can be measured by following the development of the indicative indicator for each fund (Table 5).

*Table 5*

**Performance of Islamic ETFs compared to the Benchmark Index, %**

Name of the ETF	2016	2017	2018	2019	2020
FALCOM 30	11.81	0.71	8.16	8.27	6.99
Indicator	9.40	-1.35	6.09	5.74	5.51
FALCOM Petrochemicals	27.00	6.63	11.05	-8.68	14.33
Indicator	22.32	4.43	8.82	-11.00	11.60
Sukuk al bilad	-	-	-	-	0.40
Indicator	-	-	-	-	3.20
Al bilad for gold	-	-	-	-	7.48
Indicator	-	-	-	-	9.04

*Source:* Saudi Stock Exchange, 2023.

Referring to the last five years (2016–2020), we find that the performance of the funds experienced fluctuations around the indicative indicator, In the case of stability or boom, performance improvement is recorded more than the indicator, and vice versa in cases of stagnation and decline.

**Conclusions.** Exchange-traded funds, in general, have attracted a large number of investors as one of the most inventive financial concepts. They have gained popularity throughout the world, particularly as the demand for trading ETF shares, their spread, and their number have increased. It should be noted that, despite their importance in the financial markets, traditional index funds are currently surrounded by some Sharia caveats, especially that the majority of these funds deal in short selling, whether for the units of these funds or the shares that make them up. On this basis, market makers benefit from this concept, for instance, selling what a person does not own, which is prohibited by law, and it is a type of gambling. Therefore, the competent authority, specifically the Capital Market Authority in countries that wish to establish or convert to Islamic financial markets, such as Dubai and the Kingdom of Saudi Arabia, must consult legal scholars who are experienced and specialized in this field, before offering this concept and allow it, so that the introduction of this financial concept is Sharia-compliant, free from all Sharia violations and prohibitions, which would contribute to the establishment of a Sharia-compliant financial market.

This study focuses on the general framework of ETFs, which aims to focus on Islamic ETFs by providing advantages and its most important dealers in addition to the mechanism of how Islamic ETFs work. The results of this study can be used in several financial markets, taking into account everything related to compliance with Islamic law. After studying the case of the Saudi financial market for Islamic exchange-traded funds as a modern mechanism to activate the financial markets, these funds can be studied in the future in the Malaysian and UAE markets to compare them with the Saudi market in order to reach the most important and effective methods applied in this field.



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