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Israel Securities Authority
Investment Department
22 Kanfei Nesharim St., Jerusalem 95464
Tel: 02-6556555
Fax: 02-6513169
www.isa.gov.il

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Circular for Managers of Funds and Trustees

Regarding the position of the ISA staff on several topics related to the findings of a broad audit on investment management and the use of "allocation accounts"

To
Managers of Funds and Trustees to Funds
by email addresses in Magna system

Dear Sir/Madam,

Background

Section 18(8) to the Joint Investment Trust Law, 1994 (hereinafter: "the Law") prescribes that the board of directors of the fund manager shall determine a procedure intended to ensure the management of the funds managed by the fund manager, while preventing discrimination among them. Such procedure should address, *inter alia*, the use of the allocation accounts by the fund manager. In this circular, an allocation account shall be any centralising account through which trade orders can be given for several funds collectively.

The use of an allocation account has several advantages, *inter alia*, convenience and the option to average the price when operating widely for several funds, overcoming the minimal order limitation, lower payment of minimal commissions, performance of a coordinated transaction intended for several funds, etc. However, the use of an allocation account implies also several disadvantages, including the concern of giving preference to a specific fund when performing splits (quantity preference, price preference, preference when allocating accumulated earnings), difficulties in performing certain controls during the trading day (for example credit purchase, short sale, monitoring the compliance with the restrictions imposed by the Law and its Regulations and with the investment policy), difficulties in monitoring collaterals (for example regarding operations in derivatives abroad) and issues regarding the identification of material coordinated transactions, which require prior approval (since the materiality of the transaction is determined by its scope relative to the fund assets value, while the identity of the relevant fund is known retroactively upon the allocation).

Purpose of the audit

During the period between July 2009 and May 2010, the department staff performed a wide audit on investment management and the use of allocation accounts. The audit was performed with the aim of mapping the usage of allocation accounts by fund managers, including the controls applied by them during the process; this in order to identify exceptional use of such accounts and controls not present during the process. Additionally, the audit examined the decision making process within the fund managers, and the identity of managers of nostro accounts of the fund managers and the companies related thereto.

Method and scope of the audit

Initially, the audit was performed using an audit questionnaire, which was sent to all the active fund managers at the time. The responses to the audit questionnaire, part of which were verified by the trustees to the funds, were processed and analyzed by the department staff.

During the second stage of the audit, certain fund managers were approached, whose responses to the questionnaire had apparently indicated possible exceptions or deficiencies.

In the third stage, the activity of allocation accounts of several fund managers was sampled (stressing the testing of preference/discrimination existence), who were characterized by relatively intensive use of such accounts.

Audit findings

Following are the principal audit findings, found in respect of several fund managers:

1. Lack of details in the procedure intended to ensure the management of the funds managed by the fund manager, while avoiding discrimination among them.
2. Absence of a clear policy regarding the use of allocation accounts.
3. Absence of a procedure intended to ensure the management of the funds managed by the fund manager, while avoiding discrimination among them, where the fund manager decided not to use allocation accounts.
4. Use of allocation accounts, where there is no significant advantage in performing transactions with securities through such accounts.
5. Lack of details in the procedure intended to ensure a proper process of decision making in respect of the investments of the fund.
6. Absence of thorough discussion of the board of the fund manager (or absence of documentation of such discussion, if any), on the procedures according to section 18(8) to the Law, prior to their approval.
7. Involvement in the management of investment portfolios of the funds, of senior officers in the fund manager, who are involved in the management of the nostro account of the fund manager, as opposed to section 22(1) to the Law.
8. Involvement of investment managers of the funds in the management of the nostro accounts of companies related to the fund manager, where such involvement wasn't taken into consideration by the board of the fund manager and no appropriate controls were determined in respect of such situation.

Position of the ISA staff on several topics related to the audit findings

In light of the audit findings, the Isa staff found it appropriate to publish its position on several topics related to the examined matters:

Procedure intended to ensure the management of the funds managed by the fund manager, while avoiding discrimination among them

The duty of carefulness of the directors requires them to determine, in the framework of a procedure intended to ensure the management of the funds managed by the fund manager, while avoiding discrimination among them, a policy regarding the use of allocation accounts, ***including restricting their usage to situations where the use of such accounts provide an advantage to the fund manager***, similarly to the advantages listed above. In order to reduce exposures arising from the existence of disadvantages, aside the advantages, of such accounts, as exemplified above, the board of the fund manager should determine restrictions regarding the use of allocation accounts, in the framework of the permitted usage policy, and establish controls, accordingly. In this respect, the board of the fund manager should consider, inter alia, the following matters: The types of transactions which in order to perform them, the fund manager is allowed to use allocation accounts, the timing and manner of decision making on the manner of allocation, the criteria for allocation, the timing and manner of performing the actual splits, the documentation of allocation decisions and its maintenance, the control over the matching between split decisions and actual splits, the control over nullification of allocation accounts, the manner of performing intra-day control over investing limitations, where the investing activities are performed through an allocation account, the determination of prices for split performance (where several transactions were performed in the same security, in the same day, at different prices), the manner of allocating earnings accumulated in an allocation account (resulting from intra-day activities), important points for allocation of transactions in foreign securities (different working hours, the accumulation of earnings in the allocation account as consequence of operations lasting several days due to holidays or settlement), the documentation of deviations from allocation policy, etc.

It should be noted, that the prohibition of the use of allocation accounts, in the opinion of the ISA staff, doesn't make redundant the existence of procedures intended to ensure the management of the funds managed by the fund manager, while avoiding discrimination among them. Even if the fund manager decided not to use allocation accounts, such procedure should establish the prohibition of use of allocation accounts and the manner of performing wide operations for several funds (for example the purchase or sale of the same security for a number of funds) in the absence of allocation accounts. Additionally, the procedure should address several additional matters that aren't related to the allocation account specifically, for example: Transactions between the funds under the management of the fund manager, distribution of accepted offers within an issue, etc.

Additional procedures to be established by the board by virtue of section 18(8) to the Law

To the great importance of the procedure intended to ensure the management of the funds managed by the fund manager, while avoiding discrimination among them, and other procedures to be established by the board of the fund manager by virtue of section 18(8) to the Law, attests the Law's provision which determines that these procedures shall be determined by the board. In the opinion of the ISA staff, the duty of faithfulness of the directors requires them to examine these procedures with serious consideration prior to their approval, and to ensure they enable the accomplishment of the purposes for which they were intended. Such procedures shall describe thoroughly the relevant processes, including details of the controls applied during such processes. The level of detail and clearness of the aforementioned procedures must be such, that shall satisfy the directors regarding the effectiveness of the processes and controls applied, on one hand, and provide working tools to the employees of the fund manager.

Where it is customary that the board approves the whole manual of procedures of the fund manager, the attention of the directors should be driven to the statutory procedures that must be established by them by virtue of law provisions. It is expected that the minutes of the board meetings shall fully reflect the discussions that took place before the determination of such procedures.

Nostro account of the fund manager and entities related to it

While the prohibition of managing a nostro account by anyone involved in the decision making regarding the management of the investment portfolio of funds, refers to the nostro of the fund manager and not to nostro accounts of the entities related to the manager (section 22(2) to the Law), in the framework of the fund manager's duty to operate in favor of the unit owners solely, and in the framework of the fund manager's duty of faithfulness, in the opinion of the ISA staff, the fund manager should examine thoroughly whether someone involved in the management of nostro accounts of companies related to the fund manager should be allowed to be involved as well in the management of the investments of the funds managed by it - and if so, whether to subject it to restrictions that will apply on the management of the nostro and on the remuneration model for the creation of earnings in the nostro account, all that in order to prevent conflicts of interests. Such a decision should be examined by the board of the fund manager and should be justified and documented.

The department staff is at your service to provide additional clarifications, as needed.

Yours sincerely,
Igor Ivnitzky, CPA (Adv.)
Head of the Auditing Unit