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Directive to Mutual Fund Managers regarding Risk Management

Directive according to paragraph 97(b) of the Joint Investments in Trust Law, 5754 – 1994

Background

A mutual fund is exposed to a variety of risks, including market risk, liquidity risk, credit risk and operational risk. In order to ensure the prudent and appropriate management of risks that lie at the core of the fund's investment management, the fund manager is required to apply clear rules and principles in the identification, estimation, management, monitoring and control of exposure to risks and the trustee of the fund, who oversees the fund manager, must ensure that these processes are taking place.

The obligation of risk management is mandated in various regulations that apply to fund managers. The Joint Investment in Trust Law requires the establishment of a procedure for risk management in funds that will be approved by the board of directors and even imposes on the board of directors an obligation to approve the internal monitoring systems of the fund management. The staff of the ISA has related to the obligation of risk management, the supervision of the board of directors in this matter, the updating of the risk management map, etc. This directive, although it is not intended to establish arrangements that necessarily change the actual practice used by fund managers, is meant to establish basic standards for the way in which the fund manager is required to maintain a full and professional risk management process for the mutual funds under his management and it is not intended to detract from the other instructions of the law that deal with this matter, but rather to add to them.

During 2018, an amendment to the Joint Investments in Trust Law (amendment no. 28) (Traded Tracker Funds), 5754 – 1994 (herein: Amendment 28) went into effect which significantly changed the landscape of mutual funds and also expanded the scope of risks that the fund manager is to manage. The trading of Traded Tracker Funds units, the possibility of acquiring non-traded products, such as swaps and forwards, and the large amount of deposits and cash require fund managers to formulate procedures and processes for prudent risk management, in view of the new challenges they face.

In addition to Amendment 28, there have been other major changes in the capital market in recent years. The variety of financial assets has expanded, their complexity has increased, financial risks have become more challenging and the digital and cyber world, which is a major engine of growth, has brought new risks that must be dealt with. Therefore, it is expected of a fund manager, as well as other officers responsible for risk management in the fund, to carry out a full and well-thought out evaluation of the diversity of risks – financial, operational, and others – that characterize the fund's domain of activity. An examination should be carried out, within the fund's realm of possibilities, of the activity that is consistent with the level of risk that is appropriate to the fund, after it has been examined and defined by the fund manager, both in official reports and according to its positioning by him in marketing materials.

The publication of this directive gives expression to, among other things, the ISA's desire to strengthen the culture of proper management among the entities it regulates in a variety of domains and in a way that will limit its intervention in their day-to-day management.

The goal of this directive is to assist fund managers, by means of formalized processes and an appropriate organizational culture, in identifying major failures and minimizing them and encouraging the establishment of norms for risk management in funds. These measures will make it possible for the fund manager to identify and discuss major ongoing risks in a systematic way and in a common language, such that the managers and the board of directors will possess managerial tools of the first order for identification, focusing and prioritization of resources. The fund manager is expected to create a process that will make it possible to routinely evaluate risk whose realization is liable to harm the unit owners of the fund under his management. Accordingly, this directive is being proposed based on the authority of paragraph 97(b) of the law.

Directive

In this directive –

"Risks" – including credit risk, market risk, liquidity risk and operational risk.

1. **Principles of risk management**

A fund manager will act to manage risk in each of the funds under his management according to the following principles:

1.1 **Identification** – Identification and mapping of non-negligible risks that stem from the activity of the fund.
1.2 **Estimation** – Maintaining a model to estimate each of the types of non-negligible risks to which the fund is exposed.
1.3 **Management** – Management of the risk according to a policy that has been approved by the fund manager's board of directors and subject to restrictions and procedures, and with the appropriate controls .
1.4 **Reporting** – Maintaining an ongoing framework for risk reporting to the relevant parties.
1.5 **Documentation** – Ongoing documentation of significant assessed risks and of failures and flaws that have been exposed, in a way that will allow for control and retrospective checks.

2. Risk Management Culture

The fund manager will act to assimilate into the activity of the funds under his management an optimal risk management culture that will facilitate efficient risk management. Among other things, the fund manager will ensure that the following objectives are achieved:

2.1 Communicating with all of the workers and the creation of awareness on this issue.
2.2 Strengthening the position of risk managers and risk controls.
2.3 Maintaining detailed and clear procedures.
2.4 Involvement of managers on all levels in risk management processes.
2.5 Active involvement of the management and the board of directors in the risk management processes.

3. Organizational Structure

3.1 The CEO of the fund manager will be responsible for the implementation of this directive by appointing a person[1] for this purpose or by outsourcing this activity (herein: the risk manager).
3.2 The fund manager's board of directors will approve the eligibility of the risk manager with respect to his professional capabilities and will also approve the quantity of resources that will be put at his disposal in order to allow him to apply the risk management principles in

[1] It is also possible to divide the function of risk manager among a number of individuals, on the condition that the efficacy of the process is not compromised.

an optimal matter, with emphasis on the characteristics of the funds under the management of the fund manager and the scope of their activity.

3.3 The risk manager's activities, including those mentioned above, will be carried out in partnership with the other parties that serve as gatekeepers and lines of defense in the company, including the auditing committee, the compliance officer, the internal auditor, etc.

4. Mapping of Risks

4.1 The fund manager will by March 31, 2021 present to the auditing committee and the fund manager's board of directors the results of a full risk survey carried out by a professional with proven experience in preparing similar risk surveys and the insights gained from them. The survey will also include the risk stemming from outsourcing activity, if there is any.

4.2 The result of the risk survey and the insights gained from it will be submitted for the trustee's review.

4.3 The risk survey will include at least the following processes:

4.3.1 Gathering of initial data on the company from various sources.

4.3.2 Interviews with relevant workers and managers.

4.3.3 Identification and mapping of main activities and the significant risks to a particular fund or a number of funds, according to the circumstances.

4.3.4 Analysis of the existing procedures and controls.

4.3.5 Examination of the fundamental risk, the effectiveness of the controls and the residual risk.

4.3.6 Presentation of the findings to the management of the company and putting together a risk map for the fund manager.

4.4 The risk survey is not a one-time event, but rather constitutes the start of a process of routine maintenance of the fund manager's risk map and that of the funds under his management. The fund manager must carry out an assessment of the company's risk map annually and once every four years a full risk survey will be carried out.

5. The Risk Management Process

The risk manager will ensure that in applying the risk management principles, the fund manager will carry out the following processes:

5.1 Identification and mapping of all the main risks to which a single fund or a group of funds, according to the circumstances, is exposed, including a mapping of all the activities that create or are liable to create exposure (including use of external data sources and the bottom-up approach).

5.2 Estimating the exposure to each of the major risks at the frequency required by the characteristics of each type of risk and in a way that will permit the identification of a major change in the level of risk, its characteristics or its realization.

5.3 Reporting on the fund's major risks to the relevant workers and managers, the external gatekeepers (trustees, the auditing accountant, the regulatory authorities, etc.) and the gatekeepers within the fund management (the board of directors and/or its committees, risk managers in the investment house, etc.).

5.4 Ongoing documentation of the fund's "end of day" positions, in a way that will facilitate monitoring and a retrospective assessment.

5.5 Valuation of the assets and liabilities on a daily basis according to an accepted model of valuation in this domain.

5.6 Establishing a policy of exposure in the fund, with respect to the variety of risks and activities, within a trading day and at the end of a trading day.

5.7 Establishing procedures and restriction with respect to risk exposure.

5.8 Approval of the fund's risk management policy by the board of directors.

5.9 Documentation of any deviation from the fund's procedures and policy and the way in which they are handled.

6. Liquidity Risk

The realization of liquidity risk is liable to undermine the ability of a mutual fund to redeem units in an orderly fashion or to prevent the adjustment of the composition of assets in order to comply with the instructions of the law.

6.1 The fund manager will operate in the funds under his management according to the model for managing and estimating liquidity risk, as approved by the fund manager's board of directors. The liquidity model should take into account the liquidity needs that are liable to stem from, among other things, the trends in the market and the level of redemptions from the fund, while taking into consideration the characteristics of the assets held in it.

6.2 The liquidity model will be approved by the risk managers and by the fund manager's board of directors.

7. Market Risk

The management of market risk in the fund, including estimating the exposure to market risk, will be carried out for a single fund or a group of funds, according to the circumstances, using economic parameters to be decided on as part of the risk management model approved by the board of directors, while taking into consideration the purpose of each of the funds, its categorization, its risk profile, its investment policy and its characteristics as defined by the fund manager in official reports and in marketing publications.

7.1 Investment in non-tradable assets will be carried out after an examination of the entire range of risks implicit in such an investment, while taking into consideration the following issues: rating, maturity, trading volume and liquidity (if relevant), at various points in time, the value of outstanding units, etc.

7.2 The management of interest rate and currency risk which stem from the fund's assets and liabilities, and their monitoring will be done on an ongoing basis, including the analysis of stress scenarios and shifts in the yield curve.

8. Credit Risk

8.1 The fund manager will establish procedures and work processes for the ongoing monitoring and control of the fund's compliance with the credit risk management policy that was decided on and will ensure on an ongoing basis that the parties connected to the fund are operating within the criteria and restrictions that have been defined. With respect to entities that are a source of significant exposure for the fund, the monitoring will include ratings, the CDS prices (if they exist) and other parameters that can support the evaluation of their financial stability. In addition, any event in which the control of an entity has changed hands and/or is expected to change hands will be discussed by the company's board of directors.

8.2 In the assessment of credit risk and its management, the fund manager and the risk manager will relate to, among other things, the various instructions of the law in this matter, including the directive to mutual fund managers and trustees regarding custodial risk and credit risk, in its latest version as of August 28, 2018.

9. Operational Risk

9.1 As part of its activity, the fund is exposed to a variety of operational risks, such as: fraud and embezzlement, failures in the computer systems or in the services of service providers, poor corporate governance, etc. The fund manager should ensure that he is operating according to the directives that have been issued by the ISA staff in the following matters, among others:

9.1.1 Receiving services from service providers (bulletin dated October 7, 2010).

9.1.2 Employing external investment managers (bulleting dated February 12, 2008).

9.1.3 Continuity of the provision of services, backup and retrieval of data and storage of information (bulletins dated December 21, 2011 and January 15, 2014).

9.1.4 Corporate governance (bulletin dated April 19, 2015).

9.2 The fund manager must assess the exposures of the fund to operational risks, based on past experience of the fund, of the fund manager and of other fund managers and based on events that have occurred in similar funds. Once the exposures have been identified, the fund manager should ensure that there are sufficient controls at a reasonable level, in order to significantly reduce the risks implicit in the aforementioned exposures.

10. Documentation

The fund manager will maintain documentation of any non-negligible deviations from this directive, including from a policy that has been decided on and procedures that have been put in place as a result of this directive, and in real time to whatever extent possible and no later than by the end of the trading day, and will document all non-negligible deviations that occurred on a particular trading day on that same trading day and will record, among other things, when the deviation was discovered, when the deviation occurred, who was notified, whether the deviation was corrected and what were the reasons for the deviation.

11. Validity

This directive will go into effect on July 1, 2020.