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Israel Securities Authority
سلطة الأوراق المالية

Investment Department

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Israel Securities Authority

Directive to Mutual Fund Managers and Trustees Concerning Funds Whose Investment Policy Includes a Commitment to a High Exposure to Assets and Concerning Frequency of Rebalancing Required in Index Funds

Directive under Section 97(b) of the Joint Investment Trust Law 5754-1994

Explanatory Note

Background

In recent years the Israel Securities Authority has received several permit applications for prospectuses of funds with very high leverage ratio (e.g., several funds whose proposed investment policy included potential leverage ratio of 7x) that track the US dollar or various indexes. These applications triggered a need to examine the classification of these funds as mutual funds, in view of the role of mutual funds as a means of diversifying the investments of the general public, and specifically on their accessibility and comprehensibility by all investors, and their suitability for investors who do not necessarily have sufficient expertise in the capital market, all taking into consideration the regulatory framework that regulates the operations of mutual funds, including the duty of caution and fiduciary duty of the fund managers and the trustees.

Changes in the legal framework in the matter of leveraged ETNs

In the ETN sector, restrictions on leverage, if any, are regulated under the Tel Aviv Stock Exchange Companies Rules and Regulations. In the past, leveraged ETNs could be listed for trading under provisional TASE guidelines, which were not included in the TASE Companies Rules and Regulation due to the concern that leveraged ETN issuers' tracking of local indexes to cover their commitments might adversely affect the fairness and efficiency of trading on the TASE. The validity of these guidelines was not extended, and since February 2009 no additional leveraged ETNs may be listed for trading. Beginning from January 2013, following provisionary guidelines and, subsequently, an amendment to the TASE Companies Rules and Regulations and an extension to the validity of the guidelines, it became possible once again to list leveraged ETNs for trading, subject to restrictions designed to limit their effect on trading in securities included in indexes tracked by these ETNs and to maintain market fairness. The revised guidelines defined restrictions on the rebalancing mechanism, the leverage ratio, the exposure direction, and with respect to ETNs on Tel Aviv 25 Index — also on the value of the issued ETNs. Restrictions on leverage ratios were also imposed on ETNs on foreign indexes, where the purpose of these restrictions was to reduce the number of complex and leveraged products traded on the TASE, and their degree of complexity, in order to protect investors.

ISA Staff has concluded that the leverage ratios in mutual funds should also be revisited, with emphasis on mutual funds that are committed to the use of leverage to maintain constantly high exposure rates over time.

Potential implications of commitments to maintain high exposure

1. **High volatility** - Mutual funds that use leverage to maintain a constantly high exposure to an asset and may exhibit extremely high volatility (reaching double-digit positive or negative returns on a daily basis), represent multiple risks as they require the extensive use of financial instruments such as derivatives. Their risk is even greater where the exposure rate to a specific asset is subject to the fund manager's discretion and to the manner in which the exposure is created as part of the fund manager's duty of caution and fiduciary duty. Riskiness is further heightened when the fund's investment policy includes a commitment to maintain a high rate of exposure, which demands that such activities be performed continuously in order to achieve the fund's goals.

2. **Operating and control risks** – The studies performed by ISA Staff repeatedly indicated that management of funds that are committed to high exposure rates, and the oversight of such funds, is extremely complicated, both for the fund manager and for the trustee who must oversee the fund's management by the fund manager.

   Regarding the option of creating high exposure rates in a fund, the regulations refer to this possibility, as described above, and do not limit the a fund's total exposure rate or its exposure rate to specific classes of assets where the fund agreement and prospectus state that it is a leveraged fund. The regulations address the issue of restricting actual exposure rates, yet in view of the above explanation of the risks entailed in the need for coverage at any moment in funds with high exposure rates, the risks of activities involving derivatives, and the operating risks entailed in such operations, it also appears warranted to regulate **the rate of exposure** to shares or foreign currency **to which a fund manager may commit the fund** in the fund's investment policy.

3. **Potential impact on market fairness and efficiency** – Ensuring the fairness and efficiency of trading on the stock market, the primary arena of mutual funds' activities, is part of the ISA's duty to protect the interests of mutual fund unit holders. In terms of their impact on stock exchange trading, ISA believes that there is no substantive difference between ETNs, mutual funds that track Israeli indexes, and open-ended fund whose units are not traded on the stock exchange. Even though its units are not traded on the stock exchange, an open-ended fund that is, according to its investment policy, committed to maintain a high exposure to a certain asset at all times or to manage its investments in a manner designed to achieve results that are a multiple of the percentage change in a certain asset (jointly, "a commitment to maintain exposure"), must cover itself to comply with its investment policy, similarly to ETNs and therefore its potential impact on trading is not substantively different. Reduced market fairness and efficiency naturally impair the proper and fair management of a fund whose investments involve those very securities or financial instruments.

Therefore, due to their potential adverse effect on market fairness and efficiency, and the consequent adverse impact on fair and efficiency management of funds that invest in securities traded on the stock exchange in Israel, the exposure rate that a fund manager may determine in the fund's investment policy and in the related disclosure should be subject to regulation, similarly to the restrictions imposed on ETNs, while taking into account the differences between these two types of instruments.

The ISA Plenary approved an amendment to this directive on July 31, 2018.

When Amendment No. 28 of the Joint Investment Trust Law 5777-2017 came into effect in October 2018, ETNs, which had until then been regulated as bonds under the Securities Law 5728-1968, became mutual funds that are regulated specifically under the Joint Investment Trust Law 5754-1994 ("the Mutual Fund Law"). Amendment No. 28 permits two essentially passive investment instruments – open-ended index funds and closed index funds whose units are listed for trading on the stock exchange ("Index

Funds”).

Today, according to current practice, a mutual fund whose exposure rate to an index or commodity that it tracks is at all times, according to its investment policy, more than 120% of the underlying asset’s value in absolute terms (“leveraged”), performs daily rebalancing of the fund’s assets in order to comply with the leverage ratio stated in the fund’s investment policy. Different restrictions apply to ETNs, which have been obligated to comply with the TASE Companies Rules and Regulations in this respect since they were approved as tradeable products. For example, TASE Companies Rules and Regulations determined that a leveraged ETN that tracks the Tel Aviv 35 index must rebalance its investment position on a monthly (rather than daily) basis, and must do so immediately if the index moves by more than 15%.

Rebalancing is equally relevant for leveraged index funds, both traded and non-traded.

Another class of index funds that are required to perform rebalancing is fund-integrated index funds. In these funds, a fund’s assets must be rebalanced in order to create exposure to its underlying assets, according to their weights as implied in the fund’s investment policy, the description of its underlying assets, and its name.

To facilitate comparisons between various (traded and non-traded) index products, and to create certainty concerning the nature of these products, also for the advisory functions in banks (because rebalancing frequency necessarily effects a product’s behavior and its returns), this Directive was enacted to also regulate the rebalancing frequency required for index products that are not leveraged and are non-traded. Accordingly, the Directive provides:

1. Leveraged index funds will be managed only on Tel Aviv 35 or an index that is not a local index (which is necessarily the outcome of the investment rules that apply to the funds in the matter of their activities in derivatives, and from the fact that future contracts are traded on the stock exchange only on this domestic index), and will perform monthly rebalancing, and will perform immediate rebalancing if, as a result of fluctuations in the index on a specific trading day, the cumulative percentage change in the index from the fund’s most recent rebalancing date exceeds 15%;
2. Fund-integrated index funds will perform rebalancing on the monthly basis, and will perform immediate rebalancing if, as a result of fluctuations that occurred in a specific day in one of the indexes that comprise the underlying asset, the cumulative percentage change in that index from the fund’s most recent rebalancing date exceeds 10%.

Furthermore, with respect to index funds with a commitment to a high exposure to an underlying asset (other than a currency) or to inverse exposure, and that are not currency neutral (e.g., Nasdaq Kiflayim, etc.), the Directive provides that these funds will not contain a commitment to maintain leverage or inverse exposure to currency changes, because this is customary practice in such funds, based on the basic view that the investor who purchases these funds expects to invest in a leveraged asset or to have inverse exposure to a certain underlying asset but does not expect to invest in the currency to which the asset is exposed.

Furthermore, in the past, according to TASE Companies Rules and Regulations, managers of short (inverse exposure) ETNs were required to state in the terms of the ETN that the fund will be immediately liquidated when the index value reaches four times the price of the fund. This obligation was also imposed on index funds after Amendment No. 28 came into effect. Accordingly, the Directive provides that the fund agreement of inverse index funds (including open-ended non-traded index funds, to which the TASE Companies Rules and Regulations are not relevant) will provide that the fund will be liquidated if the index reaches a value at which the ratio of the change in the index and the fund's return is expected to exceed 1:4. The fund manager is required to state this value in the prospectus as well as the fact that the fund will be liquidated when the index reaches that value.

In 2019, following Amendment No. 28 to the Mutual Trusts Law, an additional amendment to the directive was required in order to ensure consistency with the existing restriction in the Options Regulations, by adding the option of rebalancing the assets held by an unleveraged inverse index fund,[1] when the exposure risk to a corporation reaches 25%, rather than liquidating the fund. The amendment also made reference to the reporting dates of rebalancing performed by an inverse index fund, a fund-integrated index fund, and a leveraged index fund. The fund manager was also given the option of rebalancing an unleveraged inverse index fund that reached the liquidation threshold, allowing it to realign the assets to the leverage ratio defined in the fund's investment policy (-1), rather than liquidating the fund. The amendment is designed to allow the fund manager of an short index fund to define in the fund's prospectus whether to liquidate the fund when it reaches the liquidation threshold defined when the fund was issued, or rebalance it to realign the assets with the leverage ratio defined in the fund's investment policy (-1) and publish a new liquidation threshold index accordingly. The option to rebalance the fund will allow interested unit holders to continue to hold units in the fund without forcing them to liquidate their units, and will save the fund manager the procedure of establishing a new fund. A

[1] Recall that for the purpose of this Directive the term "leveraged fund" is defined differently than its definition in the law. In this Directive, a leveraged fund is a fund whose leverage is a function of the fund's goal to beat the results of the index by more than a ratio of 1:1.

similar amendment was also made to the TASE Companies Rules and Regulations.

Also added to the directive was the obligation of a fund manager of a leveraged index fund and an unleveraged inverse index fund to provide daily reports to the public on the value of an indicative unit (iNAV) and the leverage ratio, or alternatively to publish a calculator on the fund manager’s website that can be used to obtain that information. ISA Staff will take steps to ensure that this information is also published on the ISA website.

iNAV is the value based on the fund’s most recent known asset value and the change in its underlying asset. The disclosure about the daily leverage ratio and iNAV will create transparency for the market and increased certainty for investors, who will be able to assess the fund’s unit value at the beginning of the trading day, and will establish a basis for the prices quoted on that day.

In October 2020, the directive was amended once again, adding the option of rebalancing the assets held in an unleveraged inverse index fund or liquidating the fund when the liquidation threshold is reached. This amendment also added references to the reporting dates of rebalancing in an inverse index fund, a fund-integrated index fund, and a leveraged index fund.

At present, in view of the needs highlighted by the Association of Mutual Fund Managers, the following two amendments were added to the directive, and came into effect s one month from the publication date of this amendment on the ISA website:

1. Amendment to the definition of “immediate rebalancing” – the definition will be amended such as the leverage ratio will be measured from the actual date of rebalancing and not from the date of the event that triggered the rebalancing, to prevent a tracking difference (a difference between the fund and the underlying asset). On this occasion, the definition will also be revised to ensure that it refers explicitly to terms that are relevant for fund-integrated index funds in this context.
2. In view of the operating challenges that were noted by fund managers, sections 4.3, 5.3, 5.6, and 5.8 of the Directive will be amended such that rebalancing and reporting dates will take place in the subsequent price calculation date, shortly after the information is available to the fund manager, and not prior to the beginning of the subsequent price calculation date, as the directive currently provides. This amendment is required because grounds for immediate rebalancing frequently emerge only late in the night of the day the event occurred or on the following day. Furthermore, fund managers have asked to be allowed to perform a thorough check of the relevant information and verify that such grounds do indeed exist, and they should be given adequate time to do so, which may require obtaining information from external service bureaus that frequently send such information only on the

price calculation day that is one day after the occurrence of the grounds for immediate rebalancing and not prior to the beginning of that date.

The text of the Directive follows:

In accordance with the resolution of the Israel Securities Authority by the power vested in it under Section 97(b) of the Law, the following Directive is issued:

In this Directive:

"Rebalancing" – realignment of a fund's assets to achieve the leverage ratio defined in the fund's investment policy. In a fund-integrated index fund – realignment of the fund's assets to create exposure to the underlying assets integrated in the fund, based on their weights defined in the fund's investment policy, the description of its underlying assets, and its name.

"Immediate rebalancing" – rebalancing that is not performed at the end of a month, but where the fund manager adjusts the composition of the fund's assets to ensure that the weights/leverage ratio on the rebalancing date reflect the weights/leverage ratio defined in the fund's investment policy.

"Leveraged index fund" – a fund whose exposure rate to the index or commodity that it tracks, according to its investment policy, exceeds 120% in absolute terms at all times.

"Reverse index fund" – a fund that committed, in its investment policy, to achieve its target, as stated in the definition of an "inverse index fund" in the Joint Investment Trust Regulations (Options, Future Contracts, and Short Sales) 5761-2001.

"Options Regulations" - Joint Investment Trust Regulations (Options, Future Contracts, and Short Sales) 5761-2001.

1. A fund manager may, in the investment policy of the fund it manages, commit to a rate of exposure to an asset class (shares or foreign currency) that that is not greater than 320% or lower than -220% (minus 220%) of the fund's net asset value.
2. A fund manager will, if necessary, limit the number of outstanding units of a leveraged fund under its management, where its benchmark asset or underlying asset is an index of securities traded in Israel, taking into account the trading volume of the benchmark asset, the underlying asset and/or the assets included therein, and will review this issue regularly.
3. Leveraged index funds that track a domestic index other than the Tel Aviv 35 will not be offered to the public.

4. Rebalancing dates in index funds –

4.1. In a leveraged fund, the fund manager will rebalance the fund's assets on a monthly basis on the final price calculation date of the month, and in a leveraged fund that tracks Tel Aviv 35 — on the price calculation date preceding the Tel Aviv 35 option exercise date and according to the rebalancing mechanism defined in the TASE Companies Rules and Regulations, all with the aim of achieving the leverage ratio defined in the investment policy. Furthermore, if the cumulative percent change in the index from the fund's most recent rebalancing date exceeds 15% on any price calculation date, the fund manager will immediately rebalance the fund's assets on the price calculation date following said date.

4.2. In a fund-integrated fund -

4.2.1. On the final price calculation date of the month, the fund manager will perform a monthly rebalancing of the fund's assets;

4.2.2. Furthermore, the fund manager will perform immediate rebalancing on the price calculation date that follows one of the following events, only if with respect to the index that triggers the need for rebalancing, the difference between the index's weight in the underlying asset and its weight as defined in the fund's investment policy exceeds 1%:[2]

4.2.2.1. The cumulative percentage change in any index that comprises the underlying asset, from the most recent rebalancing date or the most recent immediate rebalancing date performed in the fund, to the end of a given price calculation date exceeds 10%;

4.2.2.2. The percentage change of a weight of an index comprising the underlying asset, revised at the end of a given price calculation date, exceeds 10% of its weight, as defined in the fund's investment policy.

4.3. If grounds for immediate rebalancing occur, the fund manager will, on the following price calculation date, shortly after the information is available to the fund manager, report its intention to perform rebalancing.

5. In an inverse index fund that is not a leveraged fund -

5.1. The fund manager will state in the prospectus and in the fund agreement that when the benchmark asset or the underlying asset reaches a value at

[2] For the purpose of Section 4.2.2 – the commencement date was determined to be six months from the publication date of the amendment to this Directive on the ISA website (the amendment was published on October 11, 2020).

which the ratio of the change in the asset's value and the fund's return ("Fund Leverage") is expected to exceed 1:4 ("the liquidation threshold"), the fund will be liquidated or rebalanced. The fund manager must state in the fund agreement that a new liquidation threshold will be determined when the fund is rebalanced, and the component in the fund's name that reflects this liquidation threshold will also be amended accordingly.

5.2. The fund prospectus will state the value of the index at which the fund is expected to reach the liquidation threshold and at which the fund will be liquidated or rebalanced.

5.3. The fund manager will issue a report when the fund reaches the liquidation threshold, as described in sections 5.1 and 5.2, on the subsequent price calculation date, shortly after the information is available to the fund manager.

5.4. If the weight of the underlying asset in the fund deviates from the target weight, the fund manager will take steps to liquidate the fund or, alternatively, rebalance the fund's assets. For this purpose, "deviation" means when the weight of a corporation in the fund's underlying asset, multiplied by the Fund's Leverage, is greater than 25%.

5.5. The fund manager will state in the fund's prospectus and in the fund agreement how it will act in the event of a deviation. A fund manager that elects not to rebalance the fund's assets in the event of a deviation will state in the fund's prospectus and in the FUND agreement, that upon the occurrence of such event the fund will be liquidated; and if the fund manager elects to rebalance the fund it will state in the fund agreement that when the fund's assets are rebalanced, a new liquidation threshold will be determined and the component that reflects the liquidation threshold in the fund's name will be amended.

5.6. If a fund manager is in non-compliance of the provisions of Regulation 5(b) or 5A(c) of the Options Regulations as a result of a deviation, yet on the price calculation date subsequent to the date the deviation occurred the fund manager issued a report of its intention to liquidate the fund or rebalance its assets and then rebalanced the fund's assets as stated in paragraph 5.4 or liquidated the fund in accordance with the law and regulations, such non-compliance will not be deemed a violation of said Regulations.

5.7. Immediate rebalancing under section 5 will be performed on the third trading day after the date of the fund manager's report about rebalancing.

5.8. On the price calculation date following the immediate rebalancing date as stated in section 5, the fund manager will report the new liquidation threshold of the value of the underlying asset, and will also report the corresponding change in the fund's name.

6. In a leveraged index fund and in an unleveraged inverse index fund[3] –

6.1. Before the beginning of each price calculation date, the fund manager must perform one of the following two alternatives: report the indicative unit value (iNAV) and the fund's Leverage, or publish a calculator on the fund manager's website that can be used to obtain information on the indicative unit value (iNAV) and the fund's Leverage.

6.2. Said information will be calculated in the following manner:

6.2.1. The fund's leverage – the fund manager will calculate the fund's leverage as at the end of the most recent date on which the price of the underlying asset was published.

6.2.2. In a foreign securities limited fund, leverage will be calculated according to the fund's exposure rate to the underlying asset on that date.

6.2.3. In a foreign securities unlimited fund, notional leverage will be calculated according to the fund's exposure to the underlying asset on the most recent date for which the fund's prices were published, adjusted to the changes that occurred in the underlying asset until the calculation date. The calculation formula is:

$$L_t = L_0 \times \frac{Y+1}{Y \times L_0 + 1}$$

where:

L_t - the current leverage rate

L_0 - the exposure rate to the underlying asset on the most recent date on which prices for the fund were published

Y – The return on the underlying asset from the most recent date on which the fund's prices were published to the most recent date on which the price of the underlying asset was published.

6.2.4. Indicative net asset value (iNAV) – In a foreign securities

[3] For the purpose of Section 6 - the commencement date was determined to be six months from the publication date of the amendment to this Directive on the ISA website (the amendment was published on October 11, 2020).

unlimited fund, the fund manager will calculate iNAV according to the most recently published price, multiplied by the fund's leverage on that date and by the change in the underlying asset from the most recent price publication date to the calculation date.

7. A leveraged index fund whose investment policy creates exposure to foreign currencies, and an inverse index fund (either leveraged or unleveraged) will be managed in such manner as to create a 100% currency exposure rate.
8. Disclosure requirement – The fund manager of a leveraged fund, a fund-integrated index fund, and an inverse index fund will also include the following information in the fund's prospectus and in the fund's annual report, under the heading "unique risk factors of the fund's investments and their management," with reference to rebalancing dates (if relevant):
   8.1. The fund's management is designed to achieve a daily return that is approximately equal to the daily percentage change in the underlying asset, multiplied by the leverage rate. The cumulative effect of the leverage rate on the fund's return over time may cause the fund's return for that period to differ from the product of the percentage change in the track asset price and the leverage rate.

   Following is an illustrative example, where the fund is a triple-leveraged long fund: on Day 1, the index that is the fund's underlying asset is equal to 1000 points, and the price of the fund is 1000. On Day 2, the underlying asset increased by 10% and is 1100 points. The price of a fund unit increased according to the leverage rate and is 1300. On Day 3, the price of the underlying asset fell by 9.09 percent and is 1000 points once again. The price of the fund unit decreased according to the fund's leverage rate by 27.3 percent and is 945.5. This example illustrates that while the price of the underlying asset returned to its original value after three days, the fund's unit price declined by 5.5 percent. The difference between the price of the underlying asset and the price of a fund unit after three days is the result of the cumulative effect of the leverage rate.

Day	**Index**	**Change (%)**	**Unit price of triple-leveraged fund**	**Change (%)**
Day 1	1000		1000	
Day 2	1100	10.00%	1300	30.00%
Day 3	1000	-9.09%	945.5	-27.27%

8.2. The prices of the derivatives used by a fund manager to create leverage are affected by interest costs, which may also cause the fund's return to be less than the product of the percentage change in the price of the underlying asset and the leverage rate determined in the fund's aims.

Transition provision

This Directive will be implemented in the transition reports to be submitted by funds that will become ETFs, and ETNs that will become funds when Amendment 28 of the Joint Investments Trust Law 5777-2017 ("the Amendment") comes into effect; and with respect to other existing funds - no later than the determining date for the conversion of ETNs and index funds of an identical classification, into ETFs. For this purpose, "determining date" – as this term is defined in the Joint Investments Trust Order (Determining Dates for Conversion of ETNs into Fund Units) 5778-2018.

Application

In the matter of an amendment to the definition of "immediate rebalancing" – The new definition will apply beginning from January 27, 2022 (one month from the publication date of the amendment to the Directive on the ISA website). A fund manager may elect early adoption, beginning from the publication date of the amendment to the Directive.