

Israel Securities Authority

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Directive to Mutual Fund Managers and Trustees on Rules for Executing Transactions involving OTC Derivatives

**Directive under Section 97(b) of the Joint Investments in Trust Law
5754-1994**

Explanatory Note

Amendment No. 28 to the Joint Investments in Trust Law was published in August 2017 (“the ETF Amendment”), and in May of this year the Knesset passed various regulations promulgated under this amendment. To complete the ETF Amendment, the ISA, under the powers vested in it, is required to publish supplementary provisions that determine new, more detailed arrangements applicable to tracking funds. One of the proposed amendments under the ETF Amendment is designed to permit unfunded swaps and the purchase and holding of forward contracts (“OTC Derivative Transactions”), subject to various conditions that are designed to minimize the risks that such transactions entail. Accordingly, it is proposed to determine various directives on this matter, such as —

It is proposed that the Joint Investments in Trust Regulations (Assets That May be Purchased and Held by Funds and their Maximum Amounts) 5754-1994 will determine that fund managers may purchase and hold in funds under their management forward contracts whose underlying asset is foreign currency and rights and liabilities under unfunded swaps whose underlying asset is a foreign securities index, commodity, or foreign currency, all subject to conditions that limit funds’ credit risks from said transactions and protect fund managers’ rights to terminate transactions and exercise their rights under them.

It is proposed that the Joint Investments in Trust Regulations (Buy and Sell Prices of Fund Assets and Value of Fund Assets) 5754-1994 determine, with respect to the method for evaluating said transactions, that “the value of a right or liability under a forward contract or unfunded swap will be equal to the

amount that would have been paid to the fund or that the fund would have been charged had the transaction been terminated at the end of that day.”

The aim of this Directive is to create certainty and uniformity in the market with respect to the conditions of OTC derivative transactions, to potentially reduce the credit and liquidity risks such transactions entail, and with respect to the valuation of such transactions. Accordingly, it is proposed to determine this Directive under Section 97(b) of the Law, to supplement the Regulations on this matter.

Since the Directive was approved by the ISA Plenary in June 2018, various clarifications were added to the Directive, with the Plenary’s approval. A decision has now been made to introduce an additional amendment to Section 4.4 of the Directive. Prior to the proposed amendment, so as to allow fund managers to avoid settling small MTM differences, Section 4.4 of the Directive allowed fund managers to avoid settling MTM differences (notwithstanding the provisions of Section 4.3) when the fund’s total exposure in respect of its OTC derivative transactions (“Total Exposure”) is less than USD 100,000 for entities in the first credit group, or less than USD 50,000 for entities in the second credit group. Section 4.4 capped the Total Exposure with respect to MTM differences, and not separately for the fund’s exposure to each OTC derivative transaction counterparty. Consequently, funds with a low asset value, in which the limit of MTM differences of the fund’s total assets represents a low sum, and that operate against multiple counterparties, had difficulty to comply with this provision. Therefore, **a decision was made to amend Section 4.4 such that the minimum amount of MTM differences that requires settlement will be defined with respect to each of the fund’s OTC derivative transaction counterparties, up to a Total Exposure of USD 300,000.** Although this amendment seemingly makes it possible to increase a fund’s total exposure to MTM differences, thereby increasing the fund’s credit risk, the limit on the Total Exposure (USD 300,000) corresponds to a smaller proportion of the funds’ current AUM. Furthermore, a fund manager that prefers not to track the total differences from transactions with multiple counterparties may do so by limiting themselves to no more than 3 counterparties, and to include in their settlement agreement a clause that allows effective settlement of amounts permitted by this Section that allow the fund manager to maintain the limit of USD 300,000 of unsettled differences.

Directive

In this Directive —

Collateral for OTC Derivative Operations – the assets used to secure a fund manager’s compliance with their obligations toward a counterparty as defined in the transaction, which may be cash or other assets, excluding amounts of differences.

Custody Directive – Directive for Fund Management and Trustees Regarding Regulation of Custodianship and Disclosure Requirements Regarding Fund Exposure to Credit Risk Factors;

The Law – The Joint Investments in Trust Law 5754-1994;

MTM Differences – The amounts to which a fund is entitled or which a fund owes according to the terms of an OTC derivative transaction as a result of changes in the value of the underlying asset, and in respect of which a settlement order was not yet issued;

CSA Agreement - An agreement that regulates the transfer of funds and collateral between parties to an OTC derivative transaction;

Trade date – as defined in the Joint Investments in Trust Regulations (Buy and Sell Prices of Fund Assets and Value of Fund Assets) 5755-1994;

Reset Dates - The dates during the life of an unfunded swap transaction on which the parties perform periodic reconciliation (settlement), according to the formula and terms defined in the terms of the transaction;

ETF Amendment Date of Effect – October 3, 2018;

OTC Derivative Transaction – an unfunded swap or forward contracts;

Forward Contract, Unfunded Swap, Qualified Swap, Corresponding Fund, Kosher Exchange Tracker Fund – as defined in the Asset Regulations;

Options Regulations - Joint Investments in Trust Regulations (Options, Future Contracts, and Short Sales) 5755-1994;

Asset Regulations - Joint Investments in Trust Regulations (Assets Permitted to be Purchased and Held by Funds and their Maximum Amounts) 5755-1994

Fund managers may perform OTC Derivative Transactions only pursuant to the provisions of the Law and the following rules:

1. Credit risks

- 1.1. Fund managers will enter into OTC derivative transactions only with the following entities:

- 1.1.1. Banks classified in the first credit risk group defined in the Custody Directive;
 - 1.1.2. Banks classified in the second credit risk group defined in the Custody Directive;
 - 1.1.3. Qualitative financial entities, as defined in the Custody Directive.
- 1.2. Collateral for OTC derivative activities will be deposited in a bank classified in the first credit risk group defined in the Custody Directive, in an account that is administered as a collateral account for an OTC derivative transaction.
- 1.3. In the event that the entity with which the fund manager entered into an OTC derivative transaction is downgraded, as a result of which the fund manager is no longer permitted to continue to enter into OTC transactions with that entity according to the Directive, continued activity vis a vis said entity will not be considered a violation of Section 59 of the Law or a violation of this Directive if the agreement ended within 10 trading days from the downgrading date.

2. Required collateral rate for funds other than tracker funds

For the purpose of the required collateral rate for OTC derivative transactions determined in the Options Requirements,¹ the required collateral for funds that are not tracker funds an unfunded swap is 20% of the fund's exposure to the underlying asset that is created by that transaction.

3. Underlying assets of OTC derivative transactions for funds other than tracking funds

Funds that are not tracker funds will enter into unfunded swaps only if the transaction's underlying asset is already a tracked asset in another tracker fund.

4. Conditions of OTC derivative transactions

- 4.1. The lifetime of the transaction will not exceed one year.
- 4.2. The terms of the transaction will establish the fund manager's right to demand settlement of the differences to which the fund is entitled in the event that the differences reach such amount as the fund manager notifies by prospectus of report, but not to exceed the following amounts:

¹ Regulation 7 of the Options Regulations.

- 4.2.1. If the counterparty is an entity as stated in Section 1.1.1 – USD 100,000 for each transaction with said counterparty;
- 4.2.2. If the counterparty is an entity as stated in Section 1.1.2 or 1.1.3 — USD 50,000 for each transaction with said counterparty.
- 4.3. If the Total Differences to which the fund is entitled in respect of all its OTC derivative transactions exceeds the following percentage of the fund’s NAV, the fund manager must settle the differences:
 - 4.3.1. If all the counterparties to a fund’s OTC derivative transactions from which the differences originate are entities as stated in Section 1.1.1 — 3% of the fund’s net asset value;
 - 4.3.2. Otherwise — 1.5% of the fund’s net asset value;
- 4.4. Notwithstanding the provisions of Section 4.3, fund managers is not obligated to settle the differences vis a vis a specific counterparty if the total differences to which the fund is entitled in respect of OTC derivative transactions with said counterparty are less than USD 50,000; or are less than USD 100,000 if the counterparty is an entity described in Section 1.1.1, provided that the Total Differences to which the fund is entitled for all the OTC derivative transactions executed on its behalf do not exceed USD 300,000. For this purpose, “a specific counterparty” including anyone that controls or is controlled by said counterparty.
- 4.5. If an agreement between a fund manager and the counterparty in an OTC derivative transaction contains more restrictive conditions with respect to settling the differences compared to the conditions defined in Sections 4.3 and 4.4., the terms of the agreement will also apply to the settlement of the differences to which the fund is entitled. The amounts that a fund manager is required to transfer from the fund assets to a counterparty in an OTC derivative transaction due to changes in the value of the transaction’s underlying asset, may not exceed the change in the fund manager’s liabilities to said counterparty as a result of said change.
- 4.6. Effective cash settlement — will be executed within three trading days from the date of the settlement order.
- 4.7. Sections 4.2-4.6 will not apply to contracts for OTC derivative transactions between banks and ETF issuers that were in effect immediately before the ETF Amendment Date of Effect, and in respect of which no CSA agreement exists, even if such CSA agreements were not assigned to the fund manager to which that issuer’s activity was

transferred, for a period of no more than one year from the ETF Amendment Date of Effect.

- 4.8. With respect to unfunded swaps, the following will also apply:
 - 4.8.1. The early termination fee charged to a fund according to the terms of the transaction will not exceed the redemption fee defined by that fund;
 - 4.8.2. Reset dates - at least once every three months;
 - 4.8.3. The counterparty's liability will be defined according to the closing price published by the index sponsor;
 - 4.8.4. Transaction termination – According to the terms of the transaction, the fund manager may terminate the transaction on any trading day, and the rights and liabilities according to the transaction will be determined according to a formula that includes components that are objectively calculable based on market data published in acceptable information systems;
 - 4.8.5. In the event that the counterparty also has an early termination option pursuant to the terms of the transaction, the terms of the transaction will determine that the counterparty is required to give notice of transaction termination at least three trading days in advance.

5. Provisions in the matter of qualified swap transactions

- 5.1. Qualified swaps will be defined in transaction units that each represents a right to the redemption price of one unit of the corresponding fund (“Transaction Unit”).
- 5.2. The following rules will apply to calculations of the redemption price for one unit of the corresponding:
 - 5.2.1. The fund's liabilities in respect of the qualified swap will not be taken into account in calculating the fund's asset value for the purpose of calculating the wages of the manager and the trustee,;
 - 5.2.2. Liabilities in respect of a qualified swap will be re-evaluated in the following manner: the sale price of the assets of the corresponding ETF, without deducting the liabilities in respect of the qualified swap, divided by the total number of units, multiplied by the number of transacted units. For the purpose of this Section, “total number of units” is the number of fund units plus the number of transacted units held by the fund.
- 5.3. Orders to terminate a qualified swap issued by a fund manager for a

fund under their management will be settlement within one trading day from the order issue date.

6. Revaluation

- 6.1. Rights and liabilities under an unfunded swap transaction will be revaluated on a daily basis, according to a formula based on parameters that are defined in advance in the terms of the transaction.
- 6.2. The value of the rights and liabilities under a forward contract will be calculated in the conventional manner.
- 6.3. In an open-end fund, on a date on which a surplus of redemptions exists, the value of the rights and liabilities includes the relative share of the early termination fee that is expected to be paid out of the fund assets in respect of the termination of an unfunded swap, and which reflects the ratio between the surplus redemptions and the total redemptions. The amount attributed to selling expenses will be calculated as follows: the early termination fee divided by the number of units in respect of which a redemption order was issued on that day, multiplied by the surplus redemptions. The early termination fee will not be included in the selling costs of fund assets for open-end funds on the date on which no surplus redemptions exist, and for exchange-traded tracker funds. For this purpose “expected to be paid from” – assuming that all fund units are redeemed.
- 6.4. The fund manager will receive documentation from the bank regarding the manner in which the bank revaluated the rights and liabilities, and will record the bank’s revaluation of the transaction on a daily basis. The value of the rights in a qualified swap is the product of the number of transacted units and the redemption price of a unit of the corresponding ETF.

7. Approval of the board of directions and instructions of the investment committee’s instructions

- 7.1. OTC derivative policy will be approved by the fund manager’s board of directors.
- 7.2. The provisions of Regulation 10 of the Options Regulations concerning instructions of the investment committee will also apply to agreements involving OTC derivative transactions, as relevant.
- 7.3. In addition to the provisions of the Options Regulation, the investment committee’s instructions will take into account the following considerations, among others:
 - 7.3.1. The totality of the risks entailed in the activity, including credit

risks, market risks, liquidity risks, and operating risks;

7.3.2. Any alternative investments that are designed to achieve the same investment purpose, including transactions that do not involve OTC derivatives and transaction with other entities;

7.4. The investment committee will regularly monitor the factors noted in Section 7.3.1 with respect to OTC derivative transactions to which the fund manager is a counterparty.

7.5. OTC derivative transactions will be performed only according to the instructions of the investment committee.

7.6. Any transaction with a counterparty entity in the first or second credit group with which the fund manager never previously performed transactions (“New Transaction”) will be performed only after said transaction was discussed and approved by the board of directors and the investment committee. For this purpose, a transaction with an entity with which the fund manager was not involved in an OTC derivative transaction in the preceding 12-month period will be considered a New Transaction.

7.7. Transactions of the following types will be made only after discussed and approved by the investment committee and after the trustee confirmed that the investment committee’s approval of the transaction took into account the considerations set forth in Sections 7.3.1 and 7.3.2:

7.7.1. Transactions whose terms substantively differ from the terms of previous transactions involving the same counterparty;

7.7.2. Transactions involving a new type of OTC derivative or transactions involving an underlying asset in respect of which no OTC derivative transaction was previously performed by the fund manager.

8. Transactions between funds and affiliated entities

For the purpose of OTC derivative transactions, as stated in Section 67(a)(2) of the Law, with a bank or a company controlled by a banking corporation, the receipt of bids for that transaction from at least three entities will be considered a tender process.

9. Commencement

This Directive will come into effect on the date the ETF Amendment comes into effect.