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28 Adar 5780

March 24, 2020

To: Eli Bavli, Chairman of the Association of Mutual Fund Managers

By email

RE: **Temporary no-action letter due to deviations from restrictions pursuant to the regulations**

As part of the ongoing dialogue that the Association is currently holding with the Israel Securities Authority (hereafter: the ISA) staff, we have been asked to refrain from taking enforcement measures due to deviations from restrictions specified in the regulations according to the Joint Investments Trust Law, 5754 – 1994, that are created passively due to excessive redemptions or declines in the value of the funds' assets. The details of the request and its reasons are presented hereafter.

The world is currently experiencing an event with macroeconomic implications which is the result of the spread of the COVID-19 virus in many countries throughout the world. The State of Israel is taking significant and unprecedented steps as a result of this event in an attempt to stop the spread of the virus, as in other countries.

Recent weeks have been characterized by sharp declines in the prices of securities in many of the leading stock exchanges around the world, including the Tel Aviv Stock Exchange, accompanied by an increase in volatility in the prices of commodities and various risk assets. The mutual funds industry is experiencing an exceptionally large volume of redemptions, on a scale that has not been seen in the past, even in previous crises. Furthermore and in view of the trend in the market, the funds' assets are suffering declines in value.

**Reasons for the request**

1. **Restriction regarding dispersion between banks** – Regulation 11a(c) of the Joint Investment Trust Regulations (Assets that May Be Purchased and Held by a Fund and their Maximum rates) 5755-1994(hereafter: the Asset Regulations) establish that the rate of cash and term deposits at a particular bank will not exceed 25 percent of the net value of

a fund's assets. Sub-regulation (d) establishes that if the value of the cash and fixed-term deposits at a particular bank exceeds 25 percent, this will not be viewed as a violation if the cumulative number of trading days during which the value exceeded the aforementioned rate, does not exceed 12, during a 12 months period.

Due to the sharp declines in the markets, fund managers are finding it necessary to transfer money on a daily basis in order to meet the dispersion restriction. The request submitted by the Association states that even when the fund manager manages to carry out the transfer on the same trading day, as required, the sharp declines in the value of the fund's assets on foreign stock exchanges lead to a situation that even after the transfer, the exposure to a bank can exceed the rate set by the regulations. In view of the aforementioned, the "allotment" of 12 days of deviations over a 12-month period that is currently not considered a violation, is not sufficient.

Furthermore, both the banks and the fund managers are working in small groups due to the directives of the Ministry of Health and therefore it is difficult operationally for the fund manager to fulfil all of the requests for the transfer of money and for the bank to assimilate these transfers; this situation is also liable to lead to errors in some of the transfers.

- 2. Restrictions regarding credit leverage and collateral required for activity in options in Israel which are part of a synthetic forward contract** – Regulation 3 of the Joint Investment Trust Regulations (Use of Credit to Execute Transactions and Redemption of Units) 5761-2001.(hereafter: Credit Trading Regulations) establish restrictions regarding the maximum credit leverage that is permitted to a fund – 20 percent of the net value of a fund's assets and 40 percent in the case of a leveraged fund. Furthermore, the regulation establishes that a deviation from these rates will not be deemed as a violation if it was corrected by the end of the second price calculation day, and the total instances of deviation do not exceed 5 times during a 12 months period.

Regulation 7 of the Joint Investment Trust Regulations (Options, Future Contracts, and Short Sales) 5761-2001 (hereafter: Options Regulations) establishes a restriction on the maximum percentage of the required collateral – 20 percent of the net value of the fund's assets and 40 percent in the case of a leveraged fund. Here again the regulations set up a similar mechanism of 5 deviations during a 12-month period. If each deviation is corrected by the end of the second price calculation day then it is not deemed as a violation.

Credit leverage in a fund includes the amount of debt due to purchase on credit made by the fund, with the addition of the amount of credit due to redemption of units, and an addition of the leverage of activity in derivatives (less the total proceeds from sale on credit, which are expected to be received into the fund's account, and less cash and deposits in the fund).

Leverage of activity in derivatives in a fund includes the total of all collateral required due to the activity in derivatives.

In tracker funds and funds which according to their investment policy are essentially like tracker funds, the existing positions in option transactions have significantly higher strike prices than the price of the asset being tracked. As a result, and in view of the high volatility in the markets, the rate of collateral required for existing positions of this type exceeds the rates specified in the regulations. As mentioned in your request, although the

fund manager has the possibility of correcting the position by “rolling over” the synthetic forward contract into a synthetic forward contract with a strike price closer to the index price, this involves costs that are liable to cause a significant loss to the unit owners.

3. **The maximal value of options** – Regulation 4 of the Options Regulations establishes that the value of options held by a fund will not exceed 10 percent of the net value of the fund’s assets and 30 percent in the case of a leveraged fund.

It is difficult for funds that hold dollar-shekel foreign currency options, to carry out transactions due to the current situation in the foreign currency market thus, there trading is insufficient. As a result, the fund manager finds it difficult to constantly reduce the percentage of holdings in options in order to meet the requirements of the regulations. Therefore, the fund manager has no way to correct the deviation even by the end of the second price calculation day, as mentioned in clause 61 of the law.

4. **Restriction regarding the maximal exposure rate to the base asset in a forward contract and in an unfunded swap (hereafter: swap) transaction** – Regulation 8a of the Assets Regulations establishes that the maximal exposure rate to an asset in a swap transactions will not exceed the maximal exposure rate to shares as determined by the fund’s investment policy; and if it is not determined - then it will not exceed 200 percent; and exposure to a currency in a forward contract will not exceed 110 percent.

In certain funds, the fund manager is required to make corrections to foreign currency exposure each day in order to fully adjust the fund’s exposures. When the fund manager exceeds the exposure limit of 110 percent due to a forward contract, he has no other option to operate in foreign currency, and is forced to carry out a forward contract that is the reverse of the existing position, in order to reduce the exposure and to comply with the aforementioned regulation. In view of the current situation in the foreign currency market, it is difficult to carry out forward trades. Therefore, the fund manager needs the flexibility to make adjustments to his foreign currency exposure also by means of other foreign currency transactions. Thus, the fund manager will be at the required overall foreign currency exposure, but will deviate from the 110 percent limit set down in the aforementioned regulations regarding the maximal exposure through forward transactions.

There is a similar rationale but different circumstances also with respect to exposure to a foreign tracked asset in the case of a swap. When the fund manager operates by means of both swap transactions and future contracts in order to create exposure to the tracked asset, it is currently difficult for him to carry out adjustments due to the recurring cessation of trading in future contracts and the difficulty in carrying out transactions. Thus, the fund manager is trapped in a higher exposure to the tracked asset by means of the swap beyond the permitted rates in the regulations.

### **ISA staff position**

We are currently in the midst of a major crisis that is affecting the normal course of business and requires a flexible response.

Therefore, and based on the arguments that were presented, the ISA staff will refrain from proceedings due to passive deviations from the restrictions set down in the regulation in circumstances as described above, due to the excessive redemptions in a fund or due to the current decline in the value of a fund's assets, subject to the following conditions:

1. **Restriction regarding dispersion between banks** – A deviation to beyond the permitted 12 days according to Regulation 11a of the Assets Regulations will not be deemed as a violation, on the condition that any deviation beyond the dispersion limit between banks will, from this point onward, be corrected by the end of the second price calculation day.
2. **Restrictions regarding credit leverage and collateral required for activity in options in Israel which are part of a synthetic forward contract** – Deviation from the limits established in Regulation 3 of the Credit Trading Regulations and Regulation 7 of the Options Regulations will not be deemed as violations in the circumstances described, which create a prolonged deviation until the date of expiry; on the condition that the fund manager will monitor and document the rates of deviation and will notify the trustee and the fund's managing board of directors of the rates of deviation at frequent intervals.
3. **Maximal value of options** – A deviation from the limits specified in Regulation 4 of the Options Regulations will not be deemed as a violation, on the condition that this involves a shekel-dollar foreign currency option, as mentioned above, which is part of a synthetic forward contract (which reduces the fund's credit risk), and the fund manager monitors and documents the rates of deviation and notifies the trustee and the fund's managing board of directors of the rates of deviation at frequent intervals.
4. **Restriction regarding the maximal exposure rate to the base asset in a forward contract and in an unfunded swap (hereafter: swap) transaction** – A deviation from the limits established in Regulation 8a of the Assets Regulations will not be deemed as a violation, on the condition that the fund manager monitors and documents the rates of deviation and notifies the trustee and the fund's managing board of directors of the rates of deviation at frequent intervals. If the rate of exposure by means of a swap or a forward contract exceeds the maximal rate of exposure permitted by the regulations by 50 percent, then the fund manager will report this to the ISA by means of form k206.

**Without detracting from the aforementioned, fund managers are, of course, required to continue to be particularly vigilant with regard to the risks implicit in the activity of the funds under their management and also to make every effort to comply with the instructions of the law and to minimize to whatever extent possible these deviations from the limits established by the law.**

This position will remain valid until May 31<sup>st</sup> 2020 and its extension will be considered from time to time according to the circumstances.

This position is based on the facts and evidence presented in your request and on the assumption that your request includes all of the details and data required to respond to the question you submitted. Any change in the facts or circumstances submitted to us may lead to a different conclusion with respect to the question submitted.

This letter expresses the position of the ISA staff regarding enforcement activity and is not intended to express any other conclusion or legal position regarding the question presented to

us. The position of the ISA does not constitute any defense for the inquirer or a third party that relies on its decision in response to legal exposures that are liable to arise, including claims made by third parties or decisions of the courts that are not in alignment with the decision of the ISA.

In addition, we hereby inform you that according to the procedure for dealing with pre-ruling inquiries made to the ISA (published on the site of the ISA in June 2008), this pre-ruling inquiry and the response may be published on the ISA site.

Yours sincerely

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