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Att:

Ely Bavli, Chair

Association of Mutual Fund Managers

By email

Greetings,

Re: Temporarily refraining from enforcement actions against tracking funds' non-compliance with collateral requirements for investing activities in future contracts

As part of the ongoing conversation between the Association and the ISA, in your letter of May 7, 2020, you requested that the ISA refrain from enforcement measures against tracking funds in respect of non-compliance with collateral requirements for their derivative transactions. Following are details of the request and the reasons for the request.

### **Background to the request**

The economic implications of the coronavirus remain evident, and are notably reflected in the high price volatility of securities and various risk assets. It is well known that the mutual fund sector faced a flood of redemptions, unprecedented in scope and scale, even in comparison to past crisis events. In addition, funds' AUM declined, in line with market trends.

### **Reasons for the request**

Regulation 7 of the Regulations of Joint Investments in Trust (Options, Future Contracts, and Short Sales) 5761-2001 (“the Options Regulations”) defines limits on the collateral permitted to be posted by funds for their derivative activities, such that the total value of the collateral posted for these activities does not, at any time, exceed 20 percent of the fund’s net asset value — and in leveraged funds, 40 percent. The aim of Regulation 7 is not to limit the collateral that fund managers effectively deposit, but rather to limit fund managers’ activities in derivatives. The limits specified in the Regulation are based on the collateral requirements used by the TASE for similar activities (the cash deposit that the TASE Clearing House requires of a TASE member in respect of activity in derivatives that is identical to fund managers’ activity in derivatives on a stock exchange).

The Regulation also determines that posting collateral in excess of above collateral limits will not be deemed a violation of the limit, provided that the following two conditions obtain:

- (a) The value of the required collateral subsequently declined to the permitted level by the end of the second price calculation date after the date on which the value of the collateral exceeded the permitted level; and
- (b) The value of the required collateral did not exceed the permitted level more than five times in any 12-month period.

Due to the recent crisis that has been affecting the capital market, European exchanges significantly raised their collateral requirements for activity involving tradable contracts due to the declines in the underlying indices of those contracts. As a result of the new collateral requirements, collateral constituted an increasing share of tracking funds’ net asset value.

In the event that tracking fund managers, in order to maintain their permitted exposure rates, are forced to sell future contracts because their collateral requirements are approaching the limit defined in Regulation 7, they will be forced to use other methods to track the fund’s underlying index change, which may have an adverse impact on fund returns, both due to the costs and because the economic returns may be significantly lower than if the fund managers had not been forced to sell said contracts.

The rationale for having no limits on collateral value for tracking funds’ swap transactions is also applicable to their activity involving future contracts. Furthermore, the quantitative limits on collateral determined for future contracts were, in principle, designed to restrict activities in active funds and not to create barriers for tracking funds, which are in any case required to track the indices that constitute their

underlying assets, based on the leverage ratio defined in their investment policy. Furthermore, in view of the ISA's Directive on Investment Management in Tracking Funds, it is in any case not possible to increase the risk stemming from a fund's underlying asset, and therefore the collateral limit on derivative activity is not relevant for these funds.

It is the Association's position that acceding to its request will create, in this current period, a better balance between the potential to achieve optimal returns for fund unit owners, and the caution necessary to comply with the collateral limits to which tracking funds are subject.

### **ISA Staff Position**

We are experiencing a crisis of unusual proportions, with lasting financial implications that affect the normal course of business and call for flexible solutions.

Therefore, and in view of all information and reasons presented in your letter, ISA staff will refrain from initiating proceedings in respect of non-compliance with collateral limits derivative activities by tracking funds, provided that a fund's deposited collateral does not exceed 25% of its assets under management, and 50% in leveraged funds.

This position will remain in force until July 31, 2020, and its extension will be reassessed from time to time according to the circumstances.

Without detracting from the above, fund managers are obviously required to continue to maintain extra caution and vigilance with respect to the risks entailed in the activities of the funds under their management, and to make their best efforts to meet the provisions of law and reduce non-compliance with said limits as far as possible.

Our position is based on the facts and representations made in your letter and on the assumption that your requests all the details and information necessary to assess the issue that you raised. Any change in the facts or circumstances presented to us may lead us to conclude otherwise on this issue.

This letter reflects the position of ISA staff on enforcement actions, and is not intended to express any conclusion of other legal position on the question posed to us. This ISA staff position does not constitute a defense for the initiator of the request or for any third party that relied on its decision, against any legal exposure that may arise, including third party claims or court rulings that are inconsistent with the ISA's decision.

Furthermore, we wish to notify you that pursuant to the procedure for handling preliminary requests addressed to the ISA (published on the ISA website in June 2008), the preliminary request and the response to it may be published on the ISA website.

Sincerely,

Maya Gerty Gilboa

Legal Counsel

Supervision of Mutual Funds Unit