



Israel Securities Authority

Directive for Fund Managers concerning Disclosure on Behalf of a Fund on its Potential Exposure to Non-Investment-Grade Bonds and to the Banking Corporation that Holds the Fund's Cash and Deposits (Provisional Directive)

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

General

The world is currently experiencing an event with macroeconomic implications, stemming from the worldwide spread of the Coronavirus. Like many other countries, the State of Israel has responded by taking significant steps to contain the spread of the virus.

Recent weeks have seen sharp declines in prices in many of the world's major stock exchanges, including the Tel Aviv Stock Exchange, as well as increasing volatility in commodities prices and various risk assets. The mutual fund sector has been the target of redemptions at a scale unprecedented even compared to past crises; Fund asset values are falling in line with market trends.

In addition, we are beginning to see downgrading of bond credit ratings, and it is reasonable to assume that this trend will become more significant in the near future, in view of the effects of the spread of the Coronavirus. This trend will also have a direct impact on mutual funds whose investment policies prohibit or limit exposure to non-investment-grade bonds to a percentage that does not require the addition of an exclamation point to the fund's name.

Explanatory Note

The Directive for Fund Managers concerning Disclosure on Behalf of a Fund on Its Potential Exposure to Non-Investment-Grade Bonds and the Banking Corporation that Holds the Fund's Cash and Deposits ("the Directive") formalized the ISA Staff position on the duration that fund managers may determine in an investment policy of funds that limit the fund's exposure to non-investment-grade bonds, during which the fund is permitted to continue to hold the downgraded bond in contrast to the fund's obligations on this matter, and the terms on which such bonds may be held, without requiring the addition of an exclamation point to the fund's name. In general, the Directive determined that a maximum period of 10 trading days from the deviation date may be deemed to be a "permitted deviation" rather than a violation of the fund's investment policy. The Directive determines that a fund manager may not determine a longer

period for holding said bonds in the fund's investment policy. Nonetheless, the Directive determined that in specific conditions, the permitted deviation period may be three months, specifically in the case of funds that are considered to be less conservative and are classified as "Domestic bonds – general," "Domestic bonds – corporate and convertible," or "Foreign bonds," and whose investment policy includes a commitment to refrain from any exposure to non-investment-grade bonds, subject to the following conditions ("the conditions for a permitted deviation"):

(a) The fund manager reported the deviation to the ISA and the TASE by the end of the second price calculation date after the date on which the deviation commenced, provided that the deviation was not rectified by that date;

(b) The board of directors of the fund manager (or a committee to which the authority is delegated) conducted a discussion on and approved the deviation, no later than the tenth price calculation date after the date on which the deviation commenced, after having been satisfied of arguments to continue to hold the bonds based on updated economic information such as analyses and valuations, and the deviation and details of the discussion were reported to the fund trustee;

(c) The value of all the bonds held by the fund whose credit rating was downgraded to non-investment grade does not exceed 2.5% of the fund's net asset value, and the value of all such bonds issued by a single corporation does not exceed 1% of the fund's net asset value;

(d) The description of the fund manager's obligations to refrain from exposure to non-investment-grade bonds, which appears in a prospectus or a report, also includes reference to the stipulation that in the event that a bond held by the fund is downgraded to non-investment grade, causing the fund to deviate from its investment policy, the fund manager will adjust the fund's investments to its investment policy within a period not to exceed 3 months from the date the deviation commenced;

In view of the probability that the crisis will persist and trigger a downgrading of bonds on a large scale, the need for balance between (a) the need to define a clear, unambiguous investment policy with no exceptions, in funds in which unit holders have an expectation of conservative and less volatile management, and (b) the need to prevent losses to the unit holders, which might be caused by a requirement to rapidly sell bonds where the fund manager has no discretion to determine the optimal timing of the sale. The balance between these two elements will be achieved by permitting additional funds to extend their "permitted deviation duration," which currently ranges from 10 to 30 days, provided that the funds meet the above conditions for a permitted deviation. Such an extension will be available only to funds whose investment policies preclude any exposure whatsoever to non-investment-grade bonds, because in funds whose investment policy allows the fund manager to create limited exposure to non-investment-grade bonds, the fund manager has, in any case, an intrinsic degree of flexibility to maintain such exposure, because the fund manager has the discretion to select the bonds that must be sold in order to comply with the restrictions.

For the sake of clarification, the Directive did not and does not apply to money market funds, because the restrictions on the credit ratings of bonds that money market funds are permitted to hold originate from the Joint Investment Trust (Assets that may be

Bought and Held by a Fund and their Maximum Amounts) Regulations, 5755-1994, rather than an independent determination by the fund manager in the fund's investment policy.

Nothing in the above detracts from fund managers' obligation to maintain vigilance and prudence with respect to the risks entailed in the fund operations under their management, or from their obligation to take action to assess and mitigate these risks.

The Amendment

In the period commencing on the publication date of this Directive and ending on 10 Av, 5780 (July 31, 2020), the following will be added after the words: "will be three months" in Section 1 of the Directive: "and in funds classified as 'Domestic bonds – government,' 'Domestic bonds – shekel,' or 'Domestic bonds – foreign currency,' whose investment policy includes a commitment to refrain from exposure to non-investment-grade bonds — will be one month, all," such that the text of the amended Directive will be as follows:

"1. In the event that a downgrading of bonds held by a funds and their rating falls below investment grade, causing a deviation from the fund's investment policy, continued holding of these bonds by the fund for a period of 10 trading days from the commencement of the deviation will not be deemed a violation of the investment policy ("Permitted Deviation"). Fund managers may not determine in the investment policy a longer duration for holding such bonds. Nonetheless, the Permitted Deviation period for funds classified as 'Domestic bonds – general,' 'Domestic bonds – corporate and convertible,' or 'Foreign bonds,' whose investment policy includes a commitment to refrain exposure to non-investment-grade bonds — will be three months, and one month for funds classified as 'Domestic bonds – government,' 'Domestic bonds – shekel,' or 'Domestic bonds – foreign currency,' whose investment policy includes a commitment to refrain from exposure to non-investment-grade bonds, all provided that the following conditions obtain...."

Furthermore, the words "or one month as the case may be" will be appended to paragraph (d), after the words "from three months," such that the text of the amended Directive will be as follows:

"The description of the fund manager's obligations, in a prospectus or a report, to refrain from creating exposure to non-investment-grade bonds was extended to include the comment that in the event that in the event that a downgrading of bonds held by funds falls below investment grade and causes the fund's investments to deviate from the fund's investment policy, the fund manager will adjust the fund's investments to its investment policy, within three months or within one month from the date the deviation commenced, as relevant."

Effect

This Provisional Directive comes into effect upon its publication.