Israel Securities Authority

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Circular for Mutual Fund Managers and Trustees

Concerning the credit rating downgrade of bonds held by funds in violation of investment policy

To:

Mutual fund managers and trustees

By: YAEL system

Background

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 an unprecedented scale, even compared to past crises, and fund asset values are falling in line with market trends. In addition, there is a considerable chance that many bond credit ratings will be downgraded, which would have a direct impact on mutual funds whose investment policy prohibits exposure to bonds below a predefined credit rating.[1]

The investment policy of these funds determines an adjustment period. That is to say, if the credit rating of a bond in the fund's portfolio is downgraded below the permitted rating, the fund manager may continue to hold the downgraded bonds for a period ranging from 10 trading days to 30 trading days, as the case may be. In view of the short duration of the adjustment period, which is consistent with investment policies' objective to limit the fund's exposure to bonds of a specific credit rating, ISA staff did not intervene in the determination of the adjustment periods in funds' investment policies, and did not consider such adjustment periods as effectively constituting approval of deviations from a fund's investment policy.

However, in view of the anticipated massive downgrading of bonds, concerns have emerged that the length of the adjustment period will be insufficient to allow fund managers to examine the optimal timing for the sale of these bonds in a manner that protects the fund unit holders' interests, and will lead to technical sales rather than sales based on economic interests. Therefore, fund managers have expressed a desire to extend the adjustment periods defined in their investment policies.

Staff Position

We are currently undergoing an unusual crisis that affects the ordinary course of business and requires a flexible response to this issue. It is the position of the ISA Staff that, in order to strike the correct balance between upholding the fund's investment policy and preventing the losses to fund unit holders that might be caused if fund units must be sold within a short period, the adjustment period defined in the investment policy should be extended by an additional period that does not exceed three months from the date of deviation from the investment policy, provided that the fund meets the conditions for a deviation, currently defined in Section 1 of the Directive on Potential Exposure to Non-Investment-Grade Bonds and to the Banking Corporation that Holds the Fund's Cash and Deposits.[2] The extension will allow funds to balance their increased credit risk stemming from the extended adjustment period by conducting a discussion by the board of directors and by maintaining rules of diversification and reporting. The extension does not detract from fund managers' obligation to maintain vigilance and prudence with respect to the risks entailed in the

[1] This does obviously not apply to mutual funds whose investment policy limited their exposure to non-investment-grade bonds. With respect to such funds, see the ISA Directive on Potential Exposure to Non-Investment-Grade Bonds and to the Banking Corporation that Holds the Fund's Cash and Deposits.

[2]

fund operations under their management, or from their obligation to take action to assess and mitigate these risks.

Fund managers who intend to use this provisional extension are required to report a change in the investment policies of the relevant funds to reflect the above change. Fund managers may use Fund Event Form (K123) to file a single report for multiple funds under their management, and issue a newspaper publication in the same manner, in coordination with ISA Staff.

This Staff Position will remain in effect until July 31, 2020, and its extension will be reviewed from time to time, as circumstances evolve.

Sincerely,

Maya Garti Gilboa

Legal Advisor

Mutual Funds Supervision Unit