



ISRAEL SECURITIES AUTHORITY

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Alternative Mutual Funds: Hedge Funds in Trust and Fund of Hedge Funds Specification of Core Features

Format for Public Comments

Comments and responses will be accepted until May 31, 2020

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We would like to direct your attention to the procedure published by the ISA in the matter of initiating regulation. See http://www.isa.gov.il/Download/IsaFile_7067.pdf. Pursuant to this procedure, key public comments and the names of the commenters, will be presented in a document that summarizes the regulation. For information on submitting a request to preclude publication of one's name in the aforesaid summary document, see Section 7 of the above procedure.

Background

On July 17, 2019, the ISA published "a Request for Public Suggestions and Comments for the purpose of developing an outline for an alternative mutual fund of the type "hedge funds in trust" ("the Request for Public Comments"), in which the ISA requested the public's comments on an outline for offering alternative mutual funds under the Joint Investment Trust Law 5754-1994 ("the Trust Law" or "the Law"); the development of which was being considered by the ISA. The Request for Public Comments is one of a series of steps by the ISA to increase the efficiency of the public capital market and extend the mix of available investment products, in the interests of the general public.

ISA Staff received various comments in response to the Request for Public Comments, both with respect to the feasibility of launching this product and with respect to the

product's features proposed by the ISA. ISA Staff commends the sizable response to the Request.

After studying the comments, the ISA presents below an updated Outline, which includes a more detailed description of the proposed features of two products: **hedge fund in trust, and fund of hedge funds.**

Based on their proposed features, hedge funds in trust are expected to have features and modes of operations that are similar to existing hedge funds, which are not supervised investment products. Funds of hedge funds will, in the future, allow the public to gain exposure to unsupervised hedge funds through funds of hedge funds which will be supervised products under the Trust Law, provided that they meet the conditions proposed in the Outline.

The features of the proposed products reflect the insights gained by ISA Staff from the comments it received, taking into consideration the desire to make available to the public products that are typically offered only to sophisticated investors and not to the general public, with the additional benefit of investing in a supervised mutual fund.

It is proposed to exempt these products from various investment restrictions to which "ordinary" mutual funds are subject. For example, as the proposed model does not require hedge funds in trust to maintain daily liquidity, it is therefore proposed to exempt hedge funds in trust from the various restrictions that are designed to protect investors against liquidity risks, such as a limit on the percentage of nontraded assets. It is also proposed to relax the restriction on the maximum percentage of securities per corporation for hedge funds in trust. At the same time, hedge funds in trust may purchase and hold only assets that are permitted to other mutual funds, and will also be subject to all the provisions designed to limit credit risks in entirety (including, for example, the provisions in the Custody Directive¹). Furthermore, hedge fund in trust managers will be required to manage the fund's risks in a manner that compensates for the elimination of the above restrictions and to comply with all the statutory corporate governance requirements that, among other things, guarantee that all the required controls of the fund's investment activities are implemented.

¹ Directive to Fund Managers and Trustees on Regulation in the Matter of Custodial Services and disclosure on a Fund's Exposure to Credit Risk Factors.

In making investment decisions involving these two products, the investing public must take into account their unique features, including the fact that they are exempt from several of the investment restrictions that apply to other mutual funds.

The objective of the following Outline is to describe the key features proposed for these two products, based on adjustments and relaxed application of the legal provisions that currently apply to mutual funds. We clarify that all other relevant legal provisions that are not mentioned in the Outline will apply to the new funds, without change. We further clarify that the proposed adjustments and relaxation of restrictions entails legislative amendments. After the final Outline is developed, a proposal for a legislative amendment will be published for public comment. Note that the Outline is currently under consideration by the ISA, and the ISA is under no obligation to take action to implement the Outline in its current format.

The ISA invites the public to comment on the features of the proposed products described above. Please send your comments by mail to adyl@isa.gov.il no later than May 31, 2020.

Specifications of Hedge Funds in Trust

1. Fixed-Date Fund

- a. Hedge funds in trust will be open fixed-date funds.²
- b. The interval between consecutive fixed dates will be no less than three months (and no more than six months, pursuant to the relevant provisions of law).

2. Advance notice

Orders of units and redemption orders will be submitted to the distributor no later than 14 trading days prior to each fixed date. Any such orders that are received by the distributor fewer than 14 days prior to the fixed date, will be executed by the fund manager on the forthcoming fixed date.

3. Calculation and publication of unit prices and redemption

- a. The fund manager will calculate the purchase and redemption prices on each price calculation day.³

² See Section 47 of the Joint Investment Trust Law.

³ As defined in the Definitions of the Law.

- b. On each price calculation day, the fund manager will submit to the ISA a report that includes the unit and redemption prices that the fund manager calculated as set forth in (a).
- c. The fund manager will publish the unit and redemption prices seven price calculation days prior to the final date for giving advance notice (as set forth in Section 2 above), and on the price calculation day that occurs on the fixed date. For example, in the case of a hedge fund in trust that is a fund limited in foreign securities and whose fixed date is June 30, 2020, the fund manager will publish the prices on June 2, 2020 and on June 30, 2020.

4. Investment policy

The hedge fund in trust's investment policy will include the provision that the fund's maximum percentage exposure to any asset type (foreign currency or shares) will not exceed 320% and will not be lower than -220% of the net value of the fund's assets.⁴ This does not prevent the fund manager from determining lower exposure rates than these maximum rates.

5. Investing rules

- a. The provisions of Regulation 5 (Maximum Percentage of Corporate or Government Securities), 6A (Maximum Percentage of Options), 6B (Maximum Percentage of not listed commercial papers), 8 (Maximum Percentage of nontraded assets), 8A (Maximum Exposure to Underlying Asset Due to unfunded swap), and 9 (Maximum Percentage of Units in Funds That Are Not Funds of Funds) of the Asset Regulations⁵ will not apply to hedge funds in trust.
- b. The restriction on the percentage value of securities and foreign securities issued by a single corporation and that the fund manager sold short on behalf of the fund, of the net value of the fund's assets, as set forth in Regulation 5(B) of the Options Regulations,⁶ will not apply to hedge funds in trust.

⁴We note that the ISA intends to apply this restriction on the maximum leverage rate to all leveraged funds without distinction.

⁵ Joint Investment Trust Regulations (Assets that May Be Purchased and Held by a Fund and their Maximum Percentages) 5755-1994 ("the Asset Regulations").

⁶ Joint Investment Trust Regulations (Options, Future Contracts, and Short Sales) 5761-2001 ("the Option Regulations").

- c. The restriction in the percentage of collateral, set forth in Regulation 7 of the Options Regulations will not apply to hedge funds in trust.⁷ Accordingly, a deviation from the fund's credit leverage restriction⁸ stems from a deviation from the fund's credit leverage restriction in derivatives, it will not be deemed a violation of this restriction.
- d. Notwithstanding Regulation 9 of the Options Regulations, the lending period for securities and foreign securities, for which the fund manager does not have a contractual obligation regarding the return of the securities to the fund on demand before the end of the loan period, will not exceed the interval between fixed dates, or three months, the shorter of the two periods.

6. Disclosure

A manager of a hedge fund in trust that submits to the ISA and the TASE a report including the information contained in the due disclosure file concerning the assets held by the hedge fund in trust (exposure data) no later than seven trading days after the first day of each month, may submit the monthly report to the ISA only, and notwithstanding Regulation 22(C) of the Reporting Regulations,⁹ these monthly reports will not be available for perusal by the public.

7. Expenses Payable from the Fund's Assets

It is proposed to permit the manager of a hedge fund in trust to charge a performance-dependent fee ("success fee"), similarly to the practice of hedge funds that are not offered to the public. However, a success fee collection mechanism should be determined taking into consideration the unique features of hedge funds in trust. For example, in contrast to the situation in hedge funds that are not offered to the public, management fees in mutual funds are paid by the fund in entirety, and are transferred directly to the fund manager by the fund's banker (who is unaware of the identity or holding period of the fund's unit holders); As a result, these funds cannot pay the differential management fees based on the returns attributable to each unit holder according to each holder's holding period.

⁷ Accordingly, Section 2 of the Directive on Rules for Transactions in OTC Derivatives is also irrelevant for hedge funds in trust.

⁸ Defined in Joint Investment Trust Regulations (Use of Credit to Execute Transactions and Redemption of Units) 5761-2001.

⁹ Joint Investment Trust Regulations (Reports) 5755-1994 ("Reporting Regulations").

ISA Staff is considering a mechanism in which success fees are calculated on the basis of the fund's performance in the intervals between two consecutive fixed dates, and the fees will be priced into the fund's purchase and redemption order prices.

Furthermore, the fund manager will be permitted to determine the mechanism for calculating the fund's performance, in which the success fee is a function of the fund's success compared to the returns on a reference index (such as a benchmark or the fund's goals) defined by the fund manager, or a function of the fund's success compared to returns on a reference index plus a fixed additional margin ("hurdle rate") determined by the fund manager.¹⁰

Accordingly, the public is invited to propose mechanisms regarding success fees.

8. Qualified participants in the fund's investment decision making

A fund manager may, for the purpose of making investment decisions concerning the management of the hedge fund in trust's investment portfolio, appoint an individual who is not a licensed portfolio manager, provided that they have proven experience of at least one year in managing portfolios with features similar to the features of hedge funds in trust.

9. Name of the fund

To ensure that the name of the fund is not misleading and represents to the investing public that the fund has a specific risk profile, fund managers will include the words "hedge fund in trust" in the fund's name. Hedge funds in trust will also be classified under a super-category designated for such funds.

Specifications of Funds of Hedge Funds

1. Fixed-date Fund

A fund of hedge funds ("FOHF") will be an open, fixed-date fund. It is proposed that the FOHF's unit creation and redemption dates be synchronized with the creation and redemption dates of the hedge funds held by the FOHF. The public is invited to comment on this proposal, taking into consideration an FOHF is subject to a liquidity risk management requirement.

2. Assets that an FOHF may purchase and hold

¹⁰ A hurdle rate is the minimum returns a hedge fund must earn before it can charge an incentive fee.

The FOHF manager may purchase and hold in the FOHF the following types of assets, subject to the following conditions:

- a. Units of hedge funds, term deposits, and cash, only. For the purpose of this section, a hedge fund is any of the following:
 - (1) An arrangement whose purpose is the joint investment in the securities traded on the TASE or on a regulated market and the generation of earnings from holding or from transactions involving said securities, and which is not subject to the provisions of the Trust Law because it meets the conditions of Section 2(B) of the Law;
 - (2) A foreign fund whose purpose is the joint investment in securities traded on the TASE or on a regulated market, where the investment may be made on terms that deviate from the amounts and terms permitted to mutual funds according to the law of the country in which the fund was established;

And excludes funds of hedge funds (“Hedge Funds”).

- b. Hedge funds held by a FOHF must meet all the conditions that must obtain in a hedge fund that is permitted to be purchased and hold by a unique fund.¹¹ For the purpose of the condition listed in Regulation 3A(2)(a) of the Asset Regulations,¹² if the price of the hedge fund units is not published by a corporation as defined in said Regulation, the manager of the FOHF has a contractual obligation from the hedge fund manager to report the hedge fund unit prices to the FOHF at a frequency of at least once a month.
- c. The total value of the hedge fund units held by an FOHF will not be lower than 75% of the net value of the FOHF’s assets.
- d. The value of a single hedge fund’s units held by an FOHF will not exceed 25% of the net value of the FOHF’s assets.
- e. The value of a single hedge fund’s units held by an FOHF will not exceed 25% of the net value of the assets of the held fund.

3. Publication of prices of an FOHF’s unit purchase and redemption prices

¹¹ Regulation 3A(2) of the Asset Regulations.

¹² Regulation 3A(2)(a) of the Asset Regulations – “The share price is published on predetermined dates and at least once a month by a corporation that is engaged, among other things, in publishing hedge fund share prices based on information received from hedge fund managers.”

- a. The provisions of Section 3A and 3C of the Outline of Hedge Funds in Trust will apply.
 - b. On the final price calculation day of each month, the FOHF manager will submit to the ISA, a report that contains the unit and redemption prices calculated by the FOHF manager.
4. In the matter of advance notice, the provisions of Section 2 of the Outline of Hedge Funds in Trust will apply.
 5. Name of the fund

To ensure that the name of the fund is not misleading and represents to the investing public that the fund has a specific risk profile, fund managers will include the words “fund of hedge funds” in the fund’s name. Funds of hedge funds will also be classified under a super-category designated for such funds.

6. FOHF manager’s fee
 - a. In view of the FOHF’s added value in selecting the held hedge funds, the FOHF manager may charge the FOHF a fee. For the purpose of calculating the FOHF manager’s fee, the following elements will be not included in the value of the FOHF’s assets:
 - (1) Assets that are not hedge funds; that is, cash and deposits held by the FOHF;
 - (2) Hedge funds held by the FOHF that meet the conditions of the definition of related funds, as defined in Section 49 of the Law.
 - b. The FOHF manager may not charge a performance-based fee (success fee).