רשות ניירות ערך
Israel Securities Authority

מחלקת השקעות

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Directive to Fund Managers and Trustees on the Conditions and Tests Required for Approving a Benchmark and Entering into an Agreement with a New Index Provider

Directive according to Section 97(b) of the Joint Investments Trust Law 5754-1994 ("the Law")

Explanatory Note

A. Background

The universe of passive investments has experienced accelerated growth in recent years, and in Israel, passive products offered to the Israeli public includes ETFs and open index funds (jointly, "tracker funds"), which track a diverse range of indexes that include general market indexes, segment and sector indexes, and composite indexes. Many of these indexes are tailor-made — They were created to fit the specific requirements of a fund manager, and gave a specific fund manager exclusivity to track the index. This trend triggered a flurry of growth and innovation in this field, reflected in the emergence of "smart" funds and funds whose benchmarks represent various sectors or market trends, but has also raised several concerns on which the ISA staff has been required to express its position, including: the required alignment between the name of an index and its composition of securities, the way securities are classified in indexes, the scope of the index provider's discretion within their ongoing management of the index, and the transparency of the information available about the index and its composition.

In tracker funds, management of the fund's underlying asset is extremely important. The fund manager is required to achieve a return that is as close as possible to the return on

the fund's underlying asset. As a result, the fund's investment policy is effectively dictated by the index provider. Therefore, determining the composition of an index and modifying it over time are critical for a fund's management and performance, and have a considerable effect on the fund's investors. This is also true regarding the index provider whose actions directly affect the composition of the indexes that it creates. For example, a conflict of interest may affect an index provider's decisions when it updates the composition of an index or the weights of its components. Another example of the impact of index providers is when an index provider discontinues its operations, which might negatively affect the funds that track the indexes provided by the index provider and significantly harm the investors in those funds. In view of these concerns, some degree of oversight over index providers and indexes used by funds as underlying assets is becoming increasingly common.

Today, domestic and foreign index providers operating in the local market are not subject to direct supervision, except with respect to Tel Aviv Stock Exchange ("TASE") indexes, which are regulated under the TASE Rules and Regulations and are supervised by the ISA within its authority to supervise TASE activities. ISA Staff does not directly approve each and every index that functions as a benchmark for tracker funds and does not issue licenses to index providers. In practice, the tracked assets of tracker funds are approved indirectly and incompletely, when the relevant funds' prospectuses are approved.

The ISA believes that in order to ensure that investors' interests are protected, and to ensure that underlying assets meet proper standards, the current regulatory framework should be expanded and adjusted to global developments in this field.

B. The Regulatory Framework Around the World

Until several years ago, index creation and use were not subject to any regulation or supervision. In recent years, several incidents occurred in which parties involved in benchmark-setting process manipulated the process, with harmful effects on the financial products and contracts that tracked these benchmarks and their trustworthiness. These incidents triggered investigations and enforcement actions by

several financial regulators, and had a negative impact on the status of several indexes, both on their trustworthiness and potential continuity, potentially affecting trust in the market and causing harm both to investors and to the economy.

In response, IOSCO appointed a special task force to examine the risks related to benchmark-setting activities and published its conclusions for public comments. In 2013, at the conclusion of the project, IOSCO published its Principles for Financial Benchmarks. Subsequently, the EU also issued the Benchmarks Regulation ("the European Regulation"), which serves as a comprehensive regulatory framework for benchmark-setting, and effectively adopts IOSCO Principles with the aim of reducing the risk of conflict of interest effects on benchmark-setting activities, among other risks.

C. Key Points of the Directive

The Directive addresses the following topics:

1. **Explicit duties of the fund manager and the trustee, primarily a requirement to conduct a thorough comprehensive evaluation of the benchmark before submitting an application to the ISA to approve publication of a tracker fund's prospectus**. Today, fund managers already conduct examinations of their benchmarks, but the Directive is designed to emphasize this requirement and its scope and is therefore expected to enhance the quality of the examination, and especially the scope of the examinations performed by the trustee.
2. **Tests that a fund manager is required to perform when contracting with a new index provider**. The list of tests defined in the Directive was developed on the basis of ISA staff's experience, especially in recent years in which the aforementioned developments occurred, and on the basis of the requirements defined in the European Regulation. A fund manager will be required to examine the index provider's suitability for its position based on a (non-exhaustive) list of topics. A fund manager may contract with an index provider even if they identify a weakness related to any of these conditions, but must provide a reasoned explanation of their decision.

3. **Requirement to examine how the index will be tracked and the risks related to each alternative**. Tracking niche indexes may occasionally entail a narrow geographic focus or investment in indexes that include low trading volume companies. Therefor the fund manager must conduct a more stringent examination of the potential tracking methods and the risks each entails.
4. **Minimum diversification on types of indexes**: Adequate diversification of the securities that comprise a benchmark is critical for the fund's proper management and to prevent potential violations of the quantitative limits that apply to all funds in general. Due to the concentrated nature of specific sectors of the market in Israel, the Directive excludes several leading indexes in the domestic market from the minimum diversification conditions in order to allow the Bank Index and the TA Insurance Index, which do not meet the minimal degree of diversification defined in the Directive.
5. **Transparency and disclosure requirements regarding the benchmark and its methodology**: Benchmark composition is based exclusively on index providers' classification methodologies, which occasionally involve considerable discretion on part of the index provider in determining the index composition. Therefore, the index methodology must include all the relevant information on the index, and the index provider should have as limited discretion in determining the composition of the index. The Directive also addresses the need to ensure the transparency of the composition and the weights and prices of the benchmark, to support informed investment decision-making by the public.
6. **Defining an alignment rule for sector-based funds**. In recent years, and especially following the Covid-19 pandemic, the number of thematic indexes (indexes that do not invest in traditional investment sectors) increased, resulting in an increase in the number of funds that track such indexes. The benchmarks of these indexes were designed to reflect non-traditional segments or sectors. In some cases, the classification of such indexes is not well established. The index provider classifies companies into various niches, and sometimes, due to the low trading volume of the companies operating in the relevant segment, the index provider defines flexible classification criteria that do not necessarily have a strong link to

the index. To strengthen the alignment between an index's name and its composition of companies, the Directive defines an alignment rule, requiring that a minimum percentage of an index's components must be companies whose **primary operations** are in the niche or segment that appears in the index's name. The rules in this Directive will create greater certainty for fund managers, index providers, and trustees with respect to the tests required before establishing a new tracker fund, and the minimum conditions that the benchmarks and index providers must meet. We stress, without detracting from this Directive, that when contracting with an index provider, the fund manager is subject to the duty of caution and fiduciary duty determined in the Law, and the trustee is subject to the duty of supervision that is imposed on it according to Section 78 of the Law.

The Directive

Definitions

Index - For the purpose of this Directive, an index that serves or is expected to serve as a benchmark for a fund.

Responsibility of the Fund Manager and the Trustee

1. The fund manager of a new tracker fund will perform a thorough, comprehensive examination of the features of the index that is expected to be used as the benchmark of a new tracker fund, and will verify that it is not, or is potentially not inconsistent with the provisions of law that apply to mutual funds. For example, a tracker fund whose benchmark is a composite index comprising stocks and bonds must comply with the requirements that apply to composite tracker funds.
2. The trustee must verify that the features of the benchmark are consistent with the principles defined in this Directive, and that the fund manager conducted a thorough, comprehensive examination as required by this Directive. For this purpose, the fund manager will make available to the trustee all the materials relevant to the performance of its said duties.

3. A fund manager will submit an application for a permit to publish a prospectus for a new tracker fund after the board of directors of the fund manager conducts a discussion on the benchmark's compliance with the rules defined in this Directive, and in the case of contracting with a new index provider—after the board of directors is satisfied that the examinations of the new index provider that are necessary to assess the new index provider's qualifications were performed as set forth in this Directive.
4. The fund manager and the trustee will incorporate the provisions of this Directive into its internal procedures.

Contracting with an Index Provider or Index Calculator

5. A fund manager will not contract with an index provider before the fund manager's board of directors is satisfied that the index provider is a qualified and fitting entity. The decision on whether it is a qualified and fitting entity may be based on the index provider's compliance with the regulation that applies to index providers in the EU[1] (EU Benchmark Regulation, or "BMR Rules"). If the index provider does not comply with the BMR Rules, the decision will be based, among other things, on satisfaction of the following conditions (Compliance with conditions 5.1, 5.3-5.7 may be assessed primarily on the basis of the index provider's declaration). A fund manager shall perform periodic tests of the index provider's compliance with the conditions listed in this paragraph, and shall ensure that, under the contract with the index provider, the fund manager is entitled to receive regular relevant updates on any changes related to these conditions:
    5.1. The index provider is adequately skilled in creating indexes that are used as benchmarks for tracker funds; experience in the benchmark-setting field; adequate financial, staffing, and technological resources that support proper benchmark management by the index provider;

[1] Benchmarks Regulation (EU) 2016/1011

5.2. Compliance with proper professional standards defined by the fund manager, or standards defined for index providers under applicable foreign regulatory rules.

5.3. The index provider has an orderly policy on identifying and handling potential conflicts of interest, including those involving company employees, controlling shareholders, information providers, and all other related parties;

5.4. In the event of a potential conflict of interest between the index provider's benchmark-setting activities and its other activities, there is proper separation ("Chinese wall") between its benchmark-setting operations and its other activities;

5.5. The index provider has a business recovery plan and an acceptable procedure for information back-up;

5.6. The index provider uses trustworthy information sources in setting and calculating the index;

5.7. The index provider has an internal oversight function that monitors the composition decision procedure and the ongoing management of the index;

5.8. The index provider complies with the requirements defined in paragraphs 7.4-7.6 of this Directive, which refer to the index methodologies;

5.9. The index provider has a reasonable policy on advance publications of index events, changes in index methodology, revisions to the index, and other material events related to the index.

Conditions for approving an index as a benchmark for a tracker fund

6. The fund manager must verify that the type of fund it plans to issue (open tracker fund or ETF) matches the tradability of the tracked index.

7. An index that serves or will in the future be used as a benchmark for a tracker fund must meet the following conditions:

7.1. The index was published on a public site at least once a day on no fewer than 25 trading days, prior to an offering of the fund's units. The publication must

include the price of the index, its complete composition, the weights of its components, and its complete methodology;

7.2. The price of an index that serve as benchmarks for tracker funds shall be published at no cost, on a well-known information site or on the index provider's website;

7.3. The price of the traded index may be calculated in one of the following methods: GTR, NTR, PR, or any other accepted method;

7.4. The complete benchmark methodology is available at no cost on the index provider's website. The methodology contains a complete, detailed explanation of the manner in which the index was determined and is calculated, the procedure used to update the index and the weights of its components, the procedure used to select the securities included in the index, and the scope of the index provider's discretion. The methodology has clear rules that were defined in advance;

7.5. The index methodology gives the index provider discretion to select securities that are added to or removed from the index or to make changes in the index methodology only in exceptional cases, and such actions will be made in a fair, independent, orderly procedure that is documented such that it may be retrieved. For this purpose, securities may be classified to a specific area of operations by the index provider or by a third party, provided that the classification methodology is clearly and fully described in detail in the index methodology;

7.6. Where a fund manager has exclusivity to use the index as a benchmark, and the index does not serve as a benchmark for index products that are not under the fund manager's management, no changes shall be made after the tracker fund is issued, not including changes that the index provider is required to perform in order to ensure proper calculation of the index;

7.7. The index's full composition and weights are published in an information system, as this term is defined in the Joint Investment Trust Regulations (Buy and Sell Prices of Fund Assets and Value of Fund Assets) 5755-1994 or on the index provider's website;

7.8. The index shall be calculated for a period of at least two years prior to the date of the application to establish a tracker fund on the benchmark ("back test"). If the index comprises companies whose operating period is insufficient and does not meet this condition, the index will be calculated for the longest possible period;

7.9. The prospectus of a new tracker fund and any annual report of such a fund shall include a disclosure of the names and weights of the ten shares with the highest market values in the index, including the sectors to which they belong. If the index comprises fewer than 10 securities, the disclosure will provide information on the full composition of the index;

7.10. The index is adequately diversified, depending on the nature of the index;

7.11. Without limiting the provisions of paragraph 7.10, to achieve the minimum of diversification, the index includes at least the following number of securities:

7.11.1. government bond index – at least two bonds;

7.11.2. corporate bond index – at least 10 bonds issued by at least 6 issuers;

7.11.3. sector index - at least 10 equities;

7.11.4. other indexes - at least 20 securities.

For this purpose, a "sector index" is an index comprised exclusively of securities classified in a specific sector, defined by the index provider or a third party;

7.12. Notwithstanding paragraph 7.11, a sector index that does not meet the required number of securities may serve as a benchmark for a tracker fund, subject to the following conditions:

7.12.1. the index reflects a major sector of the Israeli economy;

7.12.2. the total market value of the companies in the index exceeded NIS 30 billion on the fund issue date;

7.12.3. The fund manager doesn't have another tracker fund of the same type (open or closed) with the same benchmark - market cap or equal weights.

7.13. The composition of securities included in an index is updated at least once a year;

7.14. The method of selecting the securities comprising the index, which is defined in the index's methodology, must ensure a strong link that establishes a fit between the name of the index and its composition, over the entire life of the fund;

7.15. In a sector index, the weight of the companies whose primary operations are in the area of operations that appears in the index's name is at least 75%;

7.16. An index whose name includes a combination of several operating segments shall serve as a benchmark for a tracker fund provided that the index's methodology or the fund's prospectus include a criterion that ensures that all the operating segments that appear in the index's name have a minimal significant weight;

7.17. If a third party other than the index provider is involved in classifying securities for the purpose of determining the composition of the index, the fund manager must verify that the share of said third party is clearly regulated in the index's methodology and is not inconsistent with the rules defined in this Directive. The findings of the examination of said third party performed by the fund manager shall be brought before the fund manager's board of directors within a discussion on the fund's prospectus;

7.18. The fund's prospectus may include a disclosure of a third party, as set forth in paragraph 17.7, including a disclosure of any potential conflicts of interest, if any, that might arise as a result of the third party's involvement in creating the index.

Disclosure on the index's concentration

8. If five securities account for more than 60% of the value of the index, the fund manager shall issue a report in the form of a public immediate report. The report

shall include information on the concentration of the index, the potential implications of the index's concentration on the holders of the units, and the risks stemming from this concentration. The fund manager shall also provide details of the risks stemming from said concentration under the chapter on risks in the prospectus and in the fund's annual report.

Conditions for establishing a similar tracker fund

9. No approval shall be given to an open-end tracker fund that is similar to another open-end tracker fund managed by the same fund manager, or to an ETF that is similar to another ETF managed by the same fund manager (the new fund – "the Similar Fund"), unless the following conditions obtain:
   9.1. The board of directors of the fund manager approved the establishment of the Similar Fund after it examined the justifications for its establishment and the performance of the benchmarks of the Similar Fund and the existing fund and found that the Similar Fund will have no negative impact on the holders of the units of the existing fund;
   9.2. The fund manager will notify the public of its decision to establish the Similar Fund. The notification will include the reasoning that led to the establishment of the Similar Fund, a comparison table that includes information on the benchmarks' returns and standard deviations over various periods (one, three and five years) and all additional information that ISA Staff determines for this purpose;

For this purpose, a "similar fund" is a fund whose benchmark composition in terms of the securities and their weights, has an overlap of at least 85% with a second fund managed by the same fund manager, unless one of the funds contains a non-benchmark component such as currency hedging, distribution of proceeds; or funds tracking equal-weighted indexes; or a short tracker fund.

Tracking method

10. If it is not possible to track the index by purchasing the securities included in the fund's benchmark, the fund manager must verify that it has at least two effective

available tracking options that ensure that the fund's returns will be as close as possible to the benchmark's returns. The fund manager must consider the costs and risks of each alternative, including credit risk, liquidity risk, and market risk.

Changing a Benchmark

11. The voluntary framework prohibiting a radical change in the investment policy of a fund, which fund managers adopted, prohibits fund managers from changing a benchmark of a tracker fund. However, the voluntary framework allows ISA staff, under certain conditions set out in the framework, to approve a substitution of benchmarks for tracker funds. A substitution of a benchmark for a fund as a result of the provisions of this Directive will be permitted within the same circumstances defined in the voluntary framework, but only if the new benchmark has similar features to the existing benchmark.

Commencement

This Directive comes into effect 3 months after the publication of a notice in Reshumot. Notwithstanding the above, with respect to index providers with which a fund manager had an agreement in place on the eve of the commencement date, and with respect to indexes that already serve as benchmarks for existing tracker funds - the commencement date of this Directive is two years from said publication date.



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