

STATE OF ISRAEL

MINISTRY OF FINANCE, CAPITAL MARKET, INSURANCE & SAVINGS DIVISION

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Explanatory notes – Control of Financial Services (Investment Rules) Regulations, 5766-2006 (Draft)

Preface

The rules of investment applying to institutional entities are currently anchored in two different legal provisions.

The investment rules applying to pension provident funds and provident funds are anchored in Income Tax Regulations (Rules for the Approval and Management of Provident Funds), 5724- 1964, while the investment rules applicable to insurance companies are anchored in the [Insurance Business \(Control\) Regulations \(Ways Of Investing An Insurer's Capital And Reserves and Management of Its Obligations\)](#), 5761-2001

The process of establishing investment rules for institutional entities in various legal provisions has resulted, over the years, in various distinctions being drawn between the investment rules applying to provident funds and pension provident funds, and those applying to the moneys of yield-contingent liabilities of insurance companies (hereafter: “moneys of participating policies”).

These distinctions are incompatible with the fact that since the inherent investment risk is borne by the saver, they should be governed by uniform rules in order to create fair competition between them.

As part of the “Bechar Reform” amendments, legislated in August 2005, the legal infrastructure was laid for enabling investment rules governing all institutional entities (including nostro moneys) to be brought under the same legal framework.

The proposed draft eliminated the distinctions between the investment rules applying to the assets of the provident and pension provident funds, and those applying to the moneys of participating policies, and changes were also made in some existing investment rules in order to adapt them to the Ministry of Finance’s policy regarding the modus operandi of the capital market in general, and the modus operandi of institutional investors in particular.

The draft amendment proposed removing a not inconsiderable number of quantitative restrictions currently existing in the investment rules, while on the other hand boosting the level of involvement of the investment committee in institutional entities in general and those of the external representatives therein in particular.

Likewise, the draft amendment relates to restrictions that will apply to contractual business engagements between institutional entities and their related corporations, and all in respect of the change that has come about in the ownership of the institutional entities and in particular, the conversion of insurance companies into financial corporations with a broad range of activities.

The following is an explanation of the structure and essential elements of the proposed draft:

1. Structure of proposed draft

The accompanying Kovetz Hatakkanoth is composed of five Chapters:

A. Chapter I – Definitions

The definitions in this Chapter relate to all rules of investments set forth in Chapter II – V unless expressly otherwise indicated.

B. Chapter II – Investments in pension provident funds

The investment rules in this Chapter relate primarily to the rate of investment permitted in designated debentures.

C. Chapter III - Investments in institutional investor

The investment rules in this Chapter apply to:

- A) Provident funds;
- B) That portion of the moneys of pension provident funds that is freely available for investment (the portion not invested in designated debentures);
- C) Moneys of participating policies.

D. Chapter IV - Investments in a managing company as against its shareholders' equity

E. Chapter V – Investments by an insurer as against non-yield contingent liabilities, including shareholders' equity and other liabilities

It will be emphasised that the conditions and restrictions per this Chapter relate solely to moneys designated for covering non-yield contingent liabilities. Where it is also necessary to relate to the moneys of participating policies or to another institutional investor, an expression provision is included.

2. **Essential changes in the proposed draft**

A. Chapter II – Investments in pension provident funds

The distinctive restrictions currently applying to the freely available portion of long standing pension provident funds have been eliminated. The investment rules that will apply to the free portion will be identical to the investment rules applying to provident funds and to the moneys of participating policies. This change will enable the long standing pension provident funds to diversify their investments in Israel and abroad.

B. Chapter III - Investments by an institutional investor

1) Regulation 1 – Definitions

One new definition has been added: Institutional Investor. The following entities are included in this definition:

- A) Provident funds
- B) Pension provident funds in respect of the free portion of the investments
- C) An insurer in respect of moneys of participating policies

Similarly, the definition of a group of investors has been expanded to include also the moneys of participating policies.

- 2) The restrictions applying to short selling transactions, to the lending of securities and to a buyback agreement have been eliminated. Accordingly, the concluding of such transactions is permitted subject to the limitations of other laws, insofar as they exist.

3) Regulation 9 – Deviation from investment volumes

- A) The Regulations relate to each type of deviation, whether passive, active or a deviation deriving from the transfer of means of control in the institutional investor.
- B) A mechanism is established for correcting deviations from the rules of investment such that in some cases, higher involvement and responsibility of the outside representatives is required.

- C) A distinction is drawn between a passive deviation (a deviation eventuating from a change of rating, an increase in value and so forth), and a deviation deriving from the transfer of means of control, and an active deviation (eventuating from a new investment in an asset).

If the deviation is passive or derives from the transfer of means of control (Regulation 9(B)(2)) – the sanction whereby management fees are not collected from members of insured - will apply only after the end of the period respecting which it was determined that the institutional investor must correct the deviation.

If the deviation is active (Regulation 9(C) (1)) – then the sanction whereby management fees are not collected from members of insured will apply commencing from the date on which the deviation was created.

4) Regulation 11 – Investment in a particular corporation and loans to an individual

The interdependence between the rate of investment permitted in a single corporation (out of total assets of the institutional investor), and the rating level, has been eliminated. This being so, it is determined that investment may be made in a single corporation of up to 10% , all as compared to current regulations, which provide that investment may be made in a single corporation of 10% of the assets of the institutional investor, provided that the rating level is at least AA-.

5) Regulation 12 - Investment in a group of borrowers

The permitted volume of investment in a group of borrowers has been expanded to 15% of the assets of the institutional investor regardless of any particular rating. Today this volume may be invested provided that the rating level is at least AA. Likewise, the restriction applies also to a holding of securities of a group of borrowers and not only to loans and deposits.

6) Regulation 13 – Investment in means of control of a corporation

Regulation 13(A) – the rate of holding of means of control in a single corporation has been equalised in respect of all institutional investors to a rate of 20%, whereas today, a fund is entitled to hold up to 10% of the means of control of a single corporation. Likewise, the restriction in relation to a holding in mutual fund units has been eliminated by reason of the high

level of spread existing in the investments of a mutual fund. Accordingly, 100% of the units of a mutual fund may be held.

- A) Regulation 13(B) - the option of investing in a corporation by means of investment in an interim fund has been added.
- B) Regulation 13(D) – the need to obtain the Commissioner’s approval, which was applicable in respect of the investment of the moneys of participating policies in partnerships, has been eliminated. A number of conditions for investment by an institutional investor in a partnership have been stipulated in its stead.

7) Regulation 14 – Investment in land through a subsidiary

The Regulation enables an institutional investor to hold a right in land through a subsidiary.

8) Regulation 15 – Investment in marketable debentures

The nexus between the permitted rate of investment and the debenture rating has been eliminated. Instead, the rate of investment by an institutional investor or by a group of investors is restricted to 40% of the series. Today, a single institutional investor is entitled to hold up to 15% of a particular series and a group of investors is entitled to hold up to 25% of the series.

9) Regulation 16 – Non-negotiable loans and deposits

Provisions governing the grant of loans shall apply in the Commissioner’s Circular as regards the provision of non-negotiable credit.

10) Regulation 17 – Loans to a member and an insured

- A) The volume of the loan that may be granted to a member or an insured shall stand at 50% of the redemption value of the insurance policy or the amount in the provident fund. The redemption value or the amount in the provident fund shall be computed net of the tax that would have been applicable had the member or the insured withdrawn the moneys on the date of the loan was granted.
- B) The institutional investor shall not be entitled to grant a loan as against the insurance policy or as against the amount in the provident fund to an office holder.

11) Regulation 18 – Investment outside Israel

Permission is given for investment outside of Israel in countries with at least a BB- rating. Today, investment outside Israel is permissible in countries with at least an A- rating.

12) Regulation 19 – Right in land

The permitted volume of investment in one property has been increased to 50% of the revalued value of the institutional investor's assets. Today, up to 3% may permissibly be invested in a single property.

13) Regulation 20 – Investment in options

The volume of investment in options acquired subject to compliance with certain conditions may permissibly be increased.

14) Regulation 25 - Transactions with and through related parties

Today numerous distinctions are made in respect of investment in related parties between the rules of investment applying to provident funds and the rules of investment applying to the moneys of participating policies, whereby the rules of investment applying to provident funds are more stringent than those applying to the moneys of participating policies.

The proposed amendment establishes uniform restrictions on all types of institutional investors and enables institutional investors to invest in some of their related parties while imposing an overall limit on the amount of the investment.

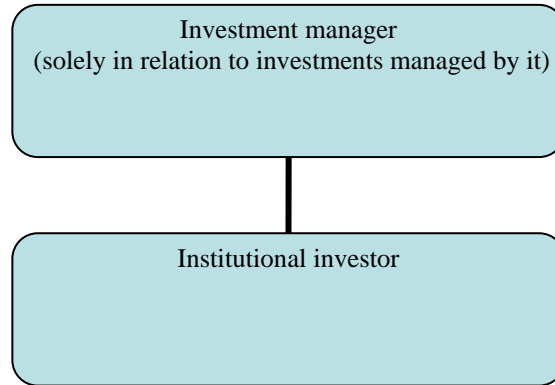
Similarly, the amendment relates to restrictions that are to be imposed on transactions by an institutional investor with its related party, providing for greater involvement of the external representatives on the investment committee in such transactions.

The following is the proposed amendment:

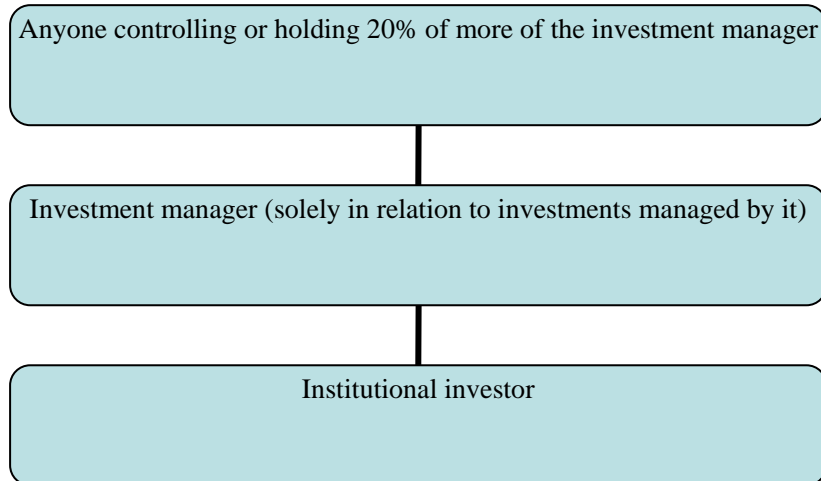
A) The proposed amendment defines 5 related parties:

- (1) A party at interest in the institutional investor;
- (2) A related party of the institutional investor;
- (3) A person managing the investments of the institutional investor – solely in relation to moneys managed by it. which is to say, if an institutional investor has transferred part of its investment portfolio to external management

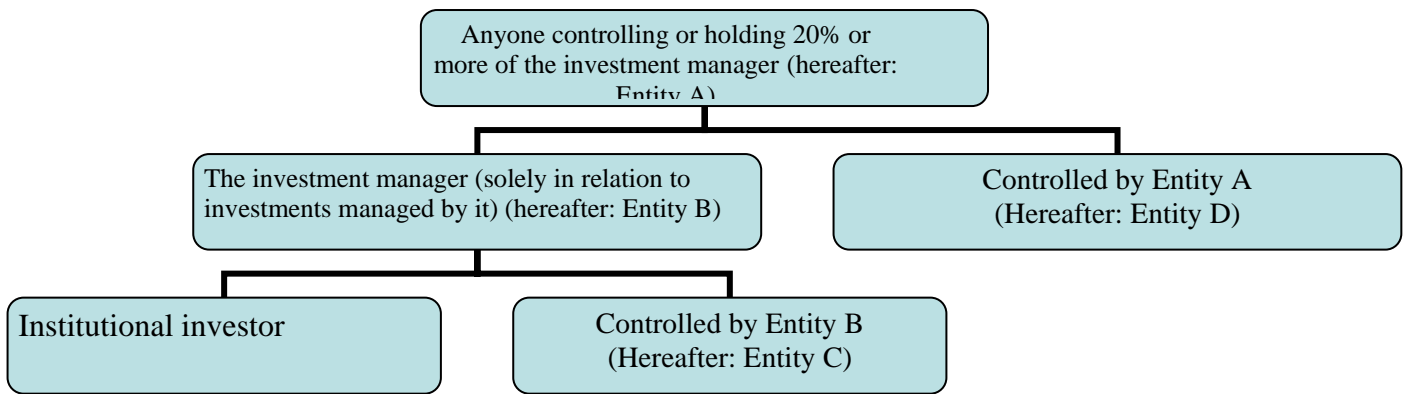
by a portfolio manager, then the portfolio manager shall be deemed a related party of the institutional investor for the purpose of upholding the various restrictions solely in relation to an investment it manages for the institutional investor;



- (4) A person controlling or holding twenty percent or more of a particular type of means of control in a person managing the investments of the institutional investor – in relation to the moneys managed by the investment manager.



- 5) Anyone controlled by one of those enumerated in sub-paragraphs (3) or (4) (Entities C, D)



B) Regulation 25(B) – establishes the conditions whereby the institutional investor may conclude transactions with the various types of related parties.

C) Regulation 25(C) – prohibits the following transactions:

- (1) With anyone controlling (or holding 20% or more in) the institutional investor other than a transaction with a principal market maker.
- (2) With another institutional investor controlled by the same corporations or whose investments are managed by the same corporation (for example, two provident funds controlled by the same corporation may not transact between them).
- (3) With an insurer being a related party of the institutional investor (for example, prohibition on a transaction between a provident fund and an insurance company controlled by the corporation controlling the provident fund).

B) Regulation 25(D) - establishes conditions whereby a related party marketing the issuance may place an order for securities;

C) Regulation 25(E) – prohibits the lending of securities through a related party.

14) Regulation 26 – Investments in related parties

- A) Regulation 26(B) - establishes a comprehensive quantitative restriction of 50% on an investment in an interested party and in related parties.
- B) Regulation 26(C) – prohibits investment in certain entities;
- C) Regulation 26(D) - provides the option of investment in marketable securities in an entity controlled by an entity in which investment is prohibited as per Regulation 26 (C).

15) Regulation 27 – Transactions in an insurer

Prohibits an insurer from concluding transactions that involve the moneys of both its participating policies and its nostro account.

16) Regulation 30 – Purchase and sale of securities

Establishes the duty of holding a competitive process for selecting the brokers with whom the institutional investor is to work. Likewise, similarly to the restriction imposed as regards the concluding of transactions vis-à-vis related market makers, a quantitative restriction is imposed in relation to the volume of transactions that an institutional investor may permissibly make vis-à-vis a broker being a related party.

17) Regulation 31- Concluding foreign currency transactions, non-marketable options and non-marketable future contracts

At present, an institutional investor is entitled to conclude transactions in foreign currency, in non-marketable options and in future contracts vis-à-vis a single entity. This reality often prevents the institutional investor from requesting a quotation from other entities operating in the market, since this would involve onerous administrative deployment for the institutional entity. This state of affairs may be inconsistent with the best interest of savers, who are prevented from deriving the benefit from a transaction concluded on more preferential terms (even if the transaction is concluded vis-à-vis an entity not being a related party).

It is accordingly stipulated that an institutional investor shall conclude transactions in foreign currency, in non-marketable options and in non-marketable future contracts, subject to a procedure to be established by the investment committee. The procedure shall stipulate, in alia, that the institutional investor must obtain three quotations from at least three concerns. A quantitative restriction is also stipulated as regards the volume of the transactions that the institutional investor will be permitted to conclude with a related party.

C. Chapter IV – Investment by a managing company as against its shareholders' equity

- A) The rate of investment in liquid assets out of minimal shareholders' equity has been modified to 70%.
- B) It is stipulated that a managing company shall not be entitled to control or to hold more than 20% of a particular type of means of control in a corporation, except in certain types of corporation and subject to the approval of the Commissioner.

D. Chapter V - Investments by an insurer as against non-yield contingent liabilities

- A) Regulation 34 - an express distinction is drawn between moneys the investment risk inhering in which is borne by the insured and moneys the investment risk inhering in which is borne by the insurance company. Accordingly, moneys for coverage of a Class 20 obligation, will include solely moneys the investment risk inhering in which is borne by the insured.
- B) Regulation 37 – regulations pertaining to certain investment rules applicable to an institutional investor under Chapter III, are made applicable to moneys for covering non-yield-contingent liabilities, mutatis mutandis. However, some of the restrictions, such as the restriction on investment in a single corporation, are measured in relation to the shareholders' equity of the insurance company.
- C) Regulation 38 - a restriction is imposed on investment in certain related parties (control by a controlling entity, holding twenty percent or more or the means of control in the insurance company and controlled by it), up to 10% of the shareholders' equity of the insurance company. It is also stipulated that investment in such concerns or a transaction with them is subject to the approval of the audit committee. A prohibition is imposed on investment in an office holder and whoever controls the insurance company, and on the conclusion of a transaction with them.
- D) Regulation 39 – a prohibition is imposed on control or a holding of twenty percent of a certain type of means of control in the hands of an insurance company, except in certain types of corporations whose activity is related to the activity of an insurance company and with the prior approval of the Commissioner. Notably to be reckoned with in this context is a holding of means of control in a corporation out of the moneys of a yield-contingent liability and out of the moneys of certain other entities which, jointly with the insurance company, constitute a group of investors.
- E) Regulation 40 – a prohibition is imposed on a holding of means of control in another insurance company if the insurance company's rate of holding of the means of control of the other company exceeds 1% and if the insurance company's total holding in the means of control of other insurance companies exceeds 5% of its shareholders' equity. In addition, it is stipulated that investment in another insurance company is subject to the Commissioner's prior approval. However, and subject to the aforesaid overall prohibition, circumstances are designated in which there is no need for the Commissioner's prior approval for investment in another insurance company's securities.

- F)** Regulation 43 - abolishes the need for the Commissioner's prior approval for investing in an asset under joint ownership, subject to restrictions and conditions provided in the Regulations.
- G)** Regulation 45 – stipulates that provisions governing the transfer of moneys to re-insurers will be anchored in the Commissioner's directives.
- H)** Regulation 49 – permits investment in options and future contracts, for hedging purposes, in yield-assured life insurance obligations, against all or any of which there are no designated debentures.
- I)** Regulations 53, 57 – establish a classification of the moneys designated for covering actuarial liability in long-term care, and moneys designated for covering other non-yield contingent life insurance obligations or in which the yield is not assured. The average duration of the assets in such obligations will be determined by the investment committee to be non-yield-contingent in accordance with the recommendation of the appointed actuary.
- J)** Regulation 60 – provides that the rate of liquid assets in a Class 70 type obligation (minimal shareholders' equity) will stand at 30% rather than 15%. It will be noted that the definition of "liquid assets" has been expanded to include also units in a fund.