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Investments by Israeli Non-Banking Financial Institutions in Investment Funds - Points to Consider Ahead of the Expiration of the Temporary Directive

On 31 December 2019, the temporary directive allowing Israeli non-banking financial institutions ("**Institutional Investors**") to pay certain external management fees out of their assets under management, will expire. This might affect, among other things, the scope and nature of investments made by Institutional Investors in investment funds.

The temporary directive was enacted under the Israeli Control of Financial Services Regulations (Provident Funds) (Direct Expenses in Respect of the Performance of Transactions), 5768-2008 (the "**Regulations**" and the "**Temporary Directive**," respectively). The Regulations set out various types of direct expenses arising out of investments made by Institutional Investors for the savers' benefit, which may be paid from the assets under management of the provident funds.[1]

According to the Temporary Directive, "External Management Fee" is also deemed to be a direct expense of the Institutional Investor which can be paid from assets under management. External Management Fees include, among other things, expenses deriving from the Institutional Investor's investment in certain investment funds in Israel and abroad (such as payments of management fees to the funds' general partners) and payments to asset managers. The External Management Fees are deducted from the total return achieved from assets under management, and not directly from the savers' accounts. In addition, the fees are not paid to the Institutional Investors, but rather, they are transferred, directly, to the relevant external managers for their services.

Commencing from 2014 and to the present day, the Temporary Directive (which has been extended from time to time) capped the External Management Fees that can be paid out of the assets under management to an amount not exceeding 0.25% of the total of the entire re-evaluated value of the provident fund's assets, as of the expiration of the previous financial year (apart from certain exceptions) (the "**0.25% Limitation**").

[1] The Regulations also apply to investments made by an insurer in assets covering yield-dependent liabilities.

At the basis of the Regulations lies, among other things, the desire to encourage diverse and optimal investments by the Institutional Investors, while eliminating costs considerations in relation to the investments, in order to maximize returns for the savers.

In addition, at least insofar as pertains to investments in investment funds, the Regulations appear to resolve, to a certain degree, two investment barriers that face the Institutional Investor. The first is the lack of experience and skill, and the second is the regulatory limitation. For example, Institutional Investors do not deal in or specialize in the acquisition of companies in distress undergoing operational or financial changes, or in the acquisition, management and sale of European entities specializing in medical devices. The smaller the Institutional entity is, the less likely it will have the ability to develop departments with expertise in the fields and sub-fields of such or similar investments. In addition, in most cases, the Institutional Investors are prohibited from making such investments directly. Institutional Investors are subject to various regulatory investment restrictions relating, among other things, to the management and control of portfolio entities. These two barriers are interrelated: an Institutional Investor cannot gain expertise in investment types or structures of the kind in which such Investor is unable to invest.

This issue becomes even more important in view of the trend of the significant growth of the assets managed by Institutional Investors in recent years, together with a low-interest environment, which create, among the Institutional Investors, a need to invest ever-increasing portions of the financial savings outside of Israel, and in long-term and higher return instruments (such as hedge funds, structured products, secondary funds, and so forth).

Indeed, according to the 2017 Bank of Israel Report “The percentage of investment in private capital out of the total funds under management in pension and provident funds has risen in the last decade…”. As of December 2017, the value of the Institutional Investors’ holdings in investment funds had reached 56.9 billion shekels – approximately 3.6% of the total asset portfolio of the Institutional Investors in Israel.

Nevertheless, the Institutional Investors still invest only a small part of their assets in investment funds, relative to investments made by institutional entities from OECD countries.

Some people attribute this, among other things, to the 0.25% Limitation that might possibly deter Institutional Investors from investing in investment funds (the 2016 Bank of Israel Report). It is noteworthy in this regard, that in most cases, the Institutional Investor’s bargaining power with respect to the rate of management fee payable to the fund managers is not strong.

In addition, reading the protocol of the Knesset Finance Committee on this matter, one can conclude that, the “temporary” classification of the “External Management Fees” as direct expenses was determined, among other things, under the assumption that during such temporary period, Institutional Investors will acquire experience in new investment fields and products and would eventually be able to make these investments themselves. However, the experience and skill barriers, as well as the regulatory restrictions, are not about to change in the near future. On the contrary, the investment products around the world are becoming increasingly complex and, as time passes, there is an ever-growing abundance of the regulations, investment rules and various circulars that apply to Institutional Investors with respect to their investments. In addition, as stated above, the passing of time will not change the fact that neither experience nor expertise can be acquired in investment areas or structures in which the Institutional entity is prohibited from investing.

Therefore, ahead of the expiration of the Temporary Directive, and before the 0.25% Limitation is once again temporarily extended, it would be advisable for all of the parties involved to carefully examine, ways of encouraging the Institutional Investors to reach an optimal investment level in such investment structures and products, which have a direct impact on the quality of the savings portfolio in Israel. It would appear that the granting of an annual expenses "budget" for the payment of management fees to the relevant external expert managers does not encourage these types of investments.

One possibility is to make the transition from a quantitative restriction mechanism (i.e., the 0.25% Limitation) to an environment that encourages a qualitative examination of these investments by the Institutional Investors. Qualitative control, on the one hand, would encourage the Institutional Investors to examine, on the merits, the investment managers of the funds, their portfolios, their teams, their investment models and strategies, and so forth, in a professional manner and with due care, and on the other hand, it will retain the aspiration of eliminating cost considerations. In addition, focusing on quality control eliminates the investment barriers discussed earlier.

In this regard, one can learn from the renewed circular of the Capital Markets, Insurance and Savings Authority on "Outsourcing by Institutional Entities" 2018-9-19, dated June 3, 2018.[2] The Circular sets forth rules for taking the activities that are included in the core business of the Institutional Investors and transferring them to an external entity (outsourcing). For this purpose, investment management is defined as a core activity. Among other things, the Circular requires the Institutional Investors to establish a policy for transferring core activities to outsourcing and a mechanism for the monitoring and control of significant outsourced activities.

Finally, the regulators would probably examine the effectiveness of the Temporary Directive thus far by reviewing the returns achieved from private investments made by Institutional Investors in recent years. This examination should be carried out with great caution, while taking into account the special investment pattern of private investment funds; according to the "J Curve", the first years of the fund are characterized by low, or even negative, returns, and only at a later stage do the returns become positive and exceed the market returns, due to the added value that is contributed by the fund managers in the long term.

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[2] Regardless, and without determining whether, the circular applies to investments in investment funds.

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