Israel

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1. THE HISTORY OF HEDGE FUNDS IN ISRAEL

Israeli investors have demonstrated strong interest in hedge fund investment. Their seemingly ever-increasing financial sophistication, coupled with little to no restrictions on capital outflow or currency exchange, have naturally led Israeli investors – institutions and others – to alternative investments around the world. On the hedge fund management side of things, however, Israel has lagged. Regulators have made no significant efforts to encourage a hedge fund management industry in Israel. As a result, relatively few large hedge funds are managed in Israel, despite a strong financial services sector generally, and hedge funds that are managed in Israel must be structured precisely to avoid application of otherwise fund-spoiling regulations.

Hedge fund investment opportunities attract many types of Israeli investors. These include various institutional investors, such as provident funds (tax-preferred savings plans devised to promote long-term savings and, as such, are essentially investment funds with limited redemption risk), pension plans and insurance companies, as well as high-net-worth individuals. Regardless of investor type, however, local hedge funds are, practically as a rule, privately offered.

Fundraising in Israel for local hedge funds has traditionally been conducted by the managers themselves, as opposed to intermediaries. Occasionally, independent third party 'finders' are employed, in particular to obtain investment by foreign investors. Commonly, an Israeli institutional investor will condition its significant investment in an Israeli-managed hedge fund on receipt of a 'side letter' from the fund manager, granting terms of investment better or different from those in the fund's offering documents. These letters typically focus on fee reduction, liquidity restriction relaxation – especially in connection with regulatory strictures applicable to the investor – and increased access to information. So far, the appropriateness of these letters has not been tested in Israeli courts, nor has a regulator explicitly addressed them. No doubt, however, differentiated treatment of investors, if challenged, will be measured at least by the yardstick of Israel's meaningful and well-established contract law principle of 'good faith'.

2. HEDGE FUNDS TODAY

The history and extent of Israeli hedge fund management is not well documented and no reliable public body provides Israeli industry-wide

statistics or systematically surveys the field. A 2005 survey by a local financial newspaper concluded that, at the time, less than 20 hedge funds were managed in Israel. This number, if reliable, almost certainly increased in the next year, but also almost certainly declined with the onset of the global financial crisis in the latter half of 2007.

A 2012 private sector survey by a hedge fund services provider concluded that, as of July 2012, up to 100 fund managers were active in Israel. The survey further estimated total assets under management at such time by 'approximately' 60 hedge funds in Israel amounted to just below $2 billion. The survey also concluded that as, of Q1 2012, 75% of assets under management were held by 20% of the local fund managers, indicating that the largest funds manage the bulk of assets. It bears noting that the survey was based on polling by written questionnaire of surveyor identified managers and the survey author reported that 34 of all funds contacted participated in the survey.

Israeli law defines 'hedge fund' only in regulations promulgated under the Joint Investments in Trust Law, 1994 (Joint Investments Law) for the purpose of regulating the extent of investment in hedge funds by, effectively, mutual fund managers. The rather limited definition of 'hedge fund' in these regulations and the lack of a definition of 'hedge fund' in more pertinent regulations sometimes raise an issue for Israeli institutional investors (leaving aside mutual funds). For example, one issue to which certain Israeli financial institutions investing in hedge funds pay attention is whether the institutional manager can charge the hedge funds' management fees to the investment pool managed by the institution. By regulation, if the target fund constitutes a hedge fund, the management fee charged by that hedge fund can qualify as an 'external management fee' and, as such, would not decrease the management fee of the provident fund manager. Similarly, regulations, as clarified by the Finance Ministry's Capital Markets, Insurance and Savings Section, allow pooling across affiliated hedge fund entities managed by the same fund manager when measuring the rate of investment permitted to the institutional investors. Thus, the understanding of what is a 'hedge fund' for these purposes is a perennial concern of these investors.

3. REGULATION OF ONSHORE MANAGERS/INVESTMENT ADVISERS

3.1 Investment Services Law Regime

Israel's Regularisation of Investment Advice, Investment Marketing and Investment Portfolio Management Law, 1995 (Investment Services Law) regulates provision of each of the financial services of portfolio management, investment advice and investment marketing. As a general matter, the Investment Services Law establishes threshold requirements for entry into either of these activities and addresses sundry issues such as licensing, client relations and even permitted fees, benefits and charges. The Investment Services Law does provide certain exemptions from its licensing requirements, but certain disclosure and client relation provisions apply nonetheless.

Generally speaking, the Investment Services Law describes portfolio management as the provision of discretionary investment services; investment advice as the counselling on the worthiness of investments in securities or financial assets; and investment marketing as the rendering of such investment advice when the adviser is affiliated with a financial asset.

The portfolio management licensing regime proves particularly relevant to hedge fund managers. Under the Investment Services Law, execution of transactions, with discretion, for the account of another qualifies as 'portfolio management'. Accordingly, investment managers of classically organised hedge funds may well be considered to be engaged in portfolio management, notwithstanding the potential argument that, formally, a fund manager manages a fund account and not separate investor portfolio accounts.

In principle, to engage properly in portfolio management in Israel, one must obtain a licence and be subject to the supervision of the Israel Securities Authority (ISA), as well as to certain mandatory instructions of the Investment Services Law. However, the Investment Services Law fits poorly with hedge fund structures commonly adopted around the world, as the law prohibits portfolio managers who or which are licensed, and under certain exemptions unlicensed, from sharing in the profits earned by clients – that is, no performance or incentive compensation is permitted to them. Additionally, the law requires portfolio managers who or which are licensed, and who are individuals unlicensed by virtue of a certain exemption, to provide services tailored to the individual needs of each client, something obviously not suited to managers of classically structured hedge funds.

While the nature of a fund investor and the structure of its investment are arguably different from those of a portfolio management client to some extent (assuming ordinary facts), in July 2010 the ISA published a pre-ruling in which it stated its position that management of a hedge fund constitutes portfolio management under the Investment Services Law. Under the pre-ruling, however, the ISA stated overtly what some legal advisors in the industry had previously advised as a matter of practicality and reason, that is, where the hedge fund is organised as a registered limited partnership, which is considered a separate legal entity, and the general partner manages the fund portfolio, the general partner would be considered exempt from licensing due to an exemption available to a person that manages the portfolio of corporate entity in the course of its role in such entity.

3.2 Expert clients funds

Israeli law does not accommodate expert investor funds *per se*; rather, as of April 2010, the Investment Services Law provides that the provision of investment advice, investment marketing and portfolio management services to certain types of 'qualified clients' are exempt from licensing requirements. These qualified clients are listed in the First Addendum to the Investment Services Law. The list includes certain types of sophisticated, high-net-worth individuals who have provided their advance consent to be regarded as qualified clients.

4. DISTRIBUTION OF HEDGE FUNDS IN ISRAEL

4.1 Investment marketing

The Investment Services Law, together with regulations promulgated thereunder, found regulation of the provision of investment services – investment, advice, portfolio management and investment marketing – in Israel. The investment marketing licensing regime under the Investment Services Law proves particularly relevant to hedge fund marketers or distributors. Under the Investment Services Law, 'investment marketing' is the provision of advice regarding the worthiness of an investment, holding, purchase or sale of securities or financial assets, when the adviser is affiliated with a financial asset'. Affiliation with a financial asset occurs when the advice provider manages or has issued the financial asset or when the advice provider, or a person acting on its behalf, is entitled, directly or indirectly, to receive a benefit (excepting certain fees) from someone other than the acquirer or holder of the financial asset, in connection with performance of a transaction involving the financial asset or the continued holding of the financial asset.

The ISA has taken the position that the provision of any information that is selected at the discretion of the service provider and can lead the recipient of the information to conclusions regarding the worthiness of investment in securities or financial assets, constitutes investment advice. In 2001, the Israeli Association of Banks, a banking industry trade group, challenged this expansive approach in Tel Aviv District Court. The court noted its impression that the ISA position was too strict, but left it to the ISA and to the banks to reach an arrangement as to what sorts of information a bank can provide its customers with while not triggering 'investment advice' under the Investment Services Law. Both parties appealed that decision. In September 2009, the parties reached an agreement, whereby it was determined, *inter alia*, that provision of information regarding a security or financial asset (either, as defined in the Investment Services Law), when the choice of information provided is made at the discretion of the information provider or the entity in which he or she is employed, and the information may lead to a conclusion regarding the worthiness of investment in a specific security or financial asset, constitutes investment advice, even if investment advice has not been explicitly granted, but excluding cases where the information regarding the security or financial asset is purely factual and provided as a response to a query by the receiver of information, including by telephone or fax. As a result, the District Court ruling was cancelled.

Notably, the definition of the term 'securities' under the Investment Services Law does not include securities that are not registered for trade on the Tel Aviv Stock Exchange or a foreign regulated market, but the term 'financial assets' does include units, as defined in the Joint Investments Law (see section 5.2 below) and shares or units in a fund which is registered outside of Israel. Hence, marketing in Israel of interests in a typical hedge fund may not implicate the investment marketing licensing requirements under the Investment Services Law, depending on the structure of the fund and its units.

4.2 Public offering

Israel's Securities Law, 1968 (Securities Law) defines a public offering as an action intended to solicit the public to purchase securities and further provides that a person may not offer securities to the public without a prospectus approved for publication by the ISA. Accordingly, marketing activities in Israel intended to solicit investors to purchase hedge fund units may trigger public offering requirements under the Securities Law, unless an appropriate exemption is available.

One such exemption can be the private offering exemption. Under this exemption, an ISA-approved prospectus is not required for the sale or offer of securities to not more than 35 offerees, provided that the number of Israeli investors to whom the offeror sold securities during the 12 months prior to the offer in question, together with the number of Israeli investors to whom the offeror sells securities under the offer, does not exceed 35.

Furthermore, the Securities Law provides that, among certain other investor types, accredited investors are not counted as offerees for the purpose of determining whether the number of offerees is such that a prospectus is required. Accredited investors include certain types of organised entities and high-net-worth individuals, as listed on the First Addendum of the Securities Law. In any event, the offer of securities (not just shares or notes, as 'securities' is a concept widely defined and understood) in a hedge fund need not necessarily constitute a public offering, if the offering is managed carefully.

5. REGULATORY TREATMENT OF FOREIGN HEDGE FUNDS

5.1 Portfolio management

Conceptually, the Investment Services Law is territorially limited, meaning it should not apply outside of Israel. Nonetheless, the ISA has taken the position that, even without Israeli investors, the conduct of portfolio management in (or into) or from Israel does trigger application of the Investment Services Law. Thus, a foreign hedge fund, if not structured to avoid application of the Investment Services Law, could well be subject to Israeli regulation, if all or part of its portfolio is managed in Israel, even if the fund contains no Israeli investors.

One alleviation provided by the ISA is the ISA's position that the Investment Services Law will not apply to the provision of investment services by a foreign entity to an Israeli customer, under certain conditions, which include the Israeli customer having independently initiated the relationship with the foreign entity. Thus, an Israeli investor initiating contact with a foreign hedge fund and, as a result, investing in the fund would not necessarily draw the hedge fund into the Israeli regulatory regime.

5.2 Marketing

Marketing or provision of investment advice on foreign hedge funds to Israeli investors may well require an appropriate licence, absent any applicable exemptions from the licensing requirement. That is because, under the Investment Services Law, the interests of a foreign hedge fund,

registered outside of Israel, may well qualify as 'financial assets'.

As noted in section 5.1 above, the ISA has taken the position that the Investment Services Law will not apply to the provision of investment marketing services by a foreign entity to an Israeli customer under certain limited circumstances involving the customer independently approaching the services provider. This means, however, that if a customer approaches a foreign hedge fund following marketing activities conducted by or on behalf of the fund in or to Israel to which the customer was exposed, the ISA can be expected to consider the Investment Services Law to apply to those activities.

As noted in section section 3.1 above, the Investment Services Law does exempt certain investment services activities from the investment adviser's licensing requirement. One such exemption applies to the provision of investment advice, investment marketing or portfolio management to qualified clients.

Importantly, if a person is relieved of licensing requirements under the Investment Services Law, say because such person provides its services to qualified clients only, such person must nonetheless comply with certain other requirements of the Investment Services Law and certain provisions of the Investment Services Law normally applicable to licensed marketers would apply also to such exempted marketer.

5.3 Public offering

Conceptually, the Securities Law is territorially limited, meaning it should not apply to an offering of hedge fund interests, which likely constitute securities under Israeli law, made entirely outside of Israel, even if the offerees abroad are Israeli citizens. Marketing of these interests to or in Israel, however, could trigger application of the Securities Law and, if it does, would require a prospectus approved by the ISA. Private placement exemptions under the Securities Law are available.

6. FUND STRUCTURES COMMONLY USED FOR HEDGE FUNDS DOMICILED IN ISRAEL

6.1 Joint investments in trust

Israel's Joint Investments Law generally regulates Israeli mutual investments in trust funds (akin, in some respects, to 'mutual funds'). Israeli hedge funds are typically structured to avoid application of the Joint Investments Law – application of this law is not considered desirable for a classic hedge fund manager, given the highly regulated nature of the joint investments in trust regime. For example, the Joint Investments Law further provides that it will not apply to any arrangement otherwise subject to that law if the investment scheme contains less than 50 participants, and if the offering does not involve an approach to the public.

6.2 Limited partnerships

Israeli hedge funds are often structured as limited partnerships, established either in Israel or abroad. The general partner of such limited partnership

will usually be a corporate entity (the management company) and the investors, the limited partners. This architecture is tax favourable due to the transparent tax treatment of a partnership, although gains and losses will be recognised by the investors when they occur, regardless of distribution. Notably, Israeli law does not provide for LLC formation.

Organisation as a limited partnership under Israel's Partnerships Ordinance [New Version], 1975 (Partnerships Ordinance), as opposed to the laws governing limited partnerships of certain other jurisdictions in which hedge funds commonly organise, carries some relative disadvantage. For example, the mandatory rule of the Partnerships Ordinance is that a limited partner withdrawing its investment before the partnership is liquidated continues to be liable for the partnership's liabilities up to the amounts so withdrawn. Additionally, the Partnerships Ordinance is considered by fund formation cognoscenti somewhat outdated: for example, it fails to provide an extensive list of specific activities that limited partners may take with the certainty of not jeopardising limited liability.

7. ISRAELI TAXATION ISSUES

Under Israeli tax rules, a partnership's ordinary income and expenses are usually allocated among the partners. A partner will generally be subject to income tax on its share of the partnership's taxable income as if such income were realised directly by the partner, regardless of whether such income was distributed. Thus, partners in a partnership can avoid to some extent the double taxation applicable to shareholders in corporate entities, which pay a corporate tax. One issue that arises is whether each partner should be allocated its share of net income of the partnership by source, or its share of the net income of the partnership.

Classification of income from a partnership can be determined at the partnership level. Since a hedge fund may be deemed a trader in securities, individual investors in a fund structured as a partnership are exposed to the argument that their income from the fund should be characterised as business income, the tax rates for which are higher than those generally applicable to capital gains passive interest and dividends. Thus, for instance, an Israeli individual taxpayer with a 25% or 30% (depending on the facts) tax rate on capital gains can become liable for a marginal tax rate of, in 2013, 48% (with a possible surtax of an additional 2%, depending on income levels, making for a total possible income tax obligation, in 2013, of 50%), if such gains are characterised as business income.

Income earned by an individual investor, however, can be classified according to that investor's overall activity. Accordingly, investment in a hedge fund structured as a partnership by an individual investor whose overall portfolio is passive and where only the fund's management company actually performs the trades, can, under certain circumstances, raises an issue of whether the investor's income from the fund should be considered passive, even if the fund is considered as engaged in the business of trading.

Additionally, Israeli financial institutions that enjoy a tax exemption when investing for beneficiaries enjoy that exemption only to the extent

that the income is not business income. Accordingly, these institutions may find their hedge fund income taxed if such income is characterised as business income.

The possible classification of limited partners' income as business income may create additional problems for limited partners that are foreign residents. In general, foreign residents are not liable for most capital gains incurred on the sale of securities traded in Israel. However, if, for example, the Israel Tax Authority deems the activities of the fund's general partner to constitute a permanent establishment in Israel for such limited partners, the entire amount of these limited partners' income from the fund can be taxed in Israel.

Notwithstanding, well-structured hedge funds have in the past obtained from the Israeli Tax Authority 'pre-rulings', that is, written tax rulings, often of limited duration, prior to fund launch, that resolve many of the tax uncertainties. Many such pre-rulings for hedge funds address and resolve conclusively the foregoing issues.