© OECD 2011

Chapter 2

Corporate Governance Review

1. Israel's corporate framework

The Israeli corporate landscape in the decades following the creation of the nation was, for reasons of resource scarcity, strategic imperatives and ideology, dominated by state-owned enterprises and collectively held business groups under the control of the Histadrut trade union movement. Privately owned companies were largely in the hands of either individuals or families. However, efficiency and productivity evolved slowly in the publicly controlled companies and they became a major destination for government subsidies.

The tensions came to a peak during a period of stagflation between 1973 and 1985. A budget crisis in the aftermath of the Yom Kippur war was followed by a banking crisis in the early 1980s (triggered by bank ownership of their own shares at a time of collapsing share prices) which led to the nationalisation of all major banks. In 1985, the government announced the Economic Stabilisation Plan (ESP), whose main elements were: reduction in government subsidies, currency devaluation, relaxation of government controls on capital markets, and privatisation of state-owned assets. The stated objectives of the ESP were primarily lowering government expenditure and public debt.

For corporate Israel, the privatisation element of ESP was transformational. On the eve of ESP, 160 companies were under government ownership, and about 90% of employees in these companies were concentrated in the 10 largest firms (Ben-Bassat, 2002). The SOEs owned by the government itself accounted for approximately 20% of the GDP,[1] with the Histadrut companies accounting for another 20% before the privatisation process begun.

The privatisation of banks gained special prominence, since a widely perceived weakness in the Israeli corporate landscape had been the involvement of banks in industrial conglomerates. The banks were sold and were required to successively reduce their holdings in any Israeli non-financial company to a maximum 15% of their capital. Banks were further required to report any investment in domestic non-financial companies that exceeded 5% of the outstanding equity to the Bank of Israel.[2]

One of the most significant outcomes of the privatisation process was that by the end of 1990s not a single existing group maintained its pre-crisis structure and most of the existing groups either ceased to exist or were no longer under the same ownership (Kosenko and Yafeh, 2007). One might have expected the break-up of the Histadrut-controlled conglomerates to have led to a more dispersed ownership, but this did not happen. At the end of this process, a number of well known Israeli enterprises had found a new home in a restructured or entirely new corporate conglomerate. In other words, business groups remained widespread, but the new owners were in many instances no longer a part of the old business elite (Hanieh, 2003; Yafeh and Kosenko, 2007).

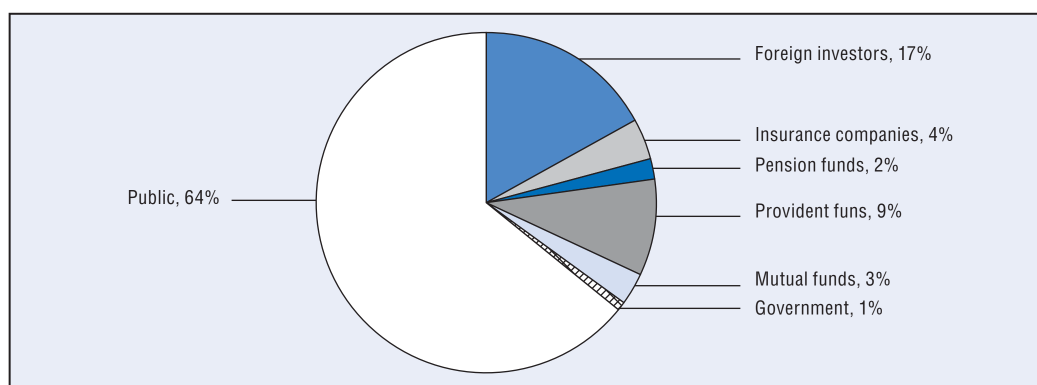
The emergence of new owners of the old companies has coincided with rise of high tech industries in Israel, which in itself created a new generation of influential business people. For as long as these enterprises remain in the hands of the owner/founders (most of whom are still in control), their ownership remains very concentrated. However, these

owners' interests appear to be more narrowly focused on starting and acquiring innovative enterprises, rather than assembling highly diversified business groups.

1.1. *Controlling blockholders in most public companies*

Recent academic research has estimated that three-quarters of Israeli listed companies are controlled by family or individual interests, and that only 6% are widely held[3] (Kosenko and Yafeh, 2007). The vast majority of listed stocks are owned by individuals: in 2007, members of the Israeli public (including blockholders) owned 64% of the shares listed on the Tel Aviv stock exchange (TASE) with foreign investors accounting for another 17% (Figure 2.1). Institutional investors, as a group, owned almost all of the remainder, whereas government ownership accounted for only 1% of the market capitalisation. The low government ownership is attributable to the fact that very few Israeli SOEs are listed.

Figure 2.1. **Ownership of shares listed on the Tel-Aviv Stock Exchange (2007)**



Source: TASE, 2007.

The free float on TASE is limited, despite recent efforts by TASE to increase it. On average, across all listed companies, the figure stood at 31% in 2007. The total free float for the market as a whole was 52%, which is almost entirely ascribed to the dominant size of the widely held pharmaceutical group TEVA. More than 250 companies have a float rate of less than 25%. The ownership of the free float is primarily in the hands of Israeli private investors (35%), institutional investors (16%) and foreign investors (4%).

The tendency toward a concentrated ownership structure applies to even the largest listed companies (again, other than TEVA – Table 2.1). The ownership of the two banks mentioned in the Table is less concentrated than the rest, due to ownership caps in the banking sector. However, the effective control of an Israeli bank is generally in the hands of one shareholder who is licensed to act in this capacity by the Bank of Israel (discussed below).

1.2. *Family ownership and control premiums*

According to data from the Bank of Israel,[4] there are approximately 20 business groups in Israel, nearly all of them family-owned. These groups control 160 publicly traded companies (out of a total 644) with a 40% share of the market. 10 privately owned business groups control 30% of companies listed on Tel Aviv Stock Exchange (TASE). It further

Table 2.1. **Ownership of 10 largest Israeli companies (by market capitalisation)**

Company Name	Market capitalisation (NIS million)	Shareholders			Free Float (%)
		Israeli private (%)	Israeli government (%)	Foreign (%)	
TEVA	141 063	3.8		5.7	90.5
Israel Chemicals	61 996	10.0		52.4	37.6
Israel Corporation	30 646	0.7		72.3	27.0
Bank Leumi	25 648	9.7	11.6	9.7	69.1
Bank Hapoalim	22 180	5.0		26.8	68.2
Bezeq	18 390		4	59.5	36.5
Africa Israel Investments	15 621			74.8	25.2
Makhteshim Agan Industries	14 251	6.9		39.9	53.2
Partner Communications Company	12 250	50.2			49.8
Perrigo Company	11 735	46.8		10.2	42.9

Note: Data provided as of end February 2008.
Source: TASE, 2008.

estimated that the market value of companies that are independent of family groups accounts for only 34% of the Tel-Aviv stock exchange, and that only 87 listed companies have a widely dispersed ownership.

Researchers have, as mentioned, been intrigued by the fact that, after many groups were scattered by the crises of the 1980s and the privatisations of the 1990s, corporate ownership re-settled in a group pattern – with mostly new owners. Indeed, the owners of the controlling groups in the business sector were replaced approximately 3 times within the last 50 years (Yafeh and Kosenko, 2007). However, out of the 20 corporate groupings identified, analysts generally focus on 5 or 6 family-controlled groups that are considered as representing the strongest concentration of economic power in the corporate sector. The new groups have increased their presence in the Israeli economy via a network of social and reciprocal relations (*e.g.* joint directorships in affiliated companies) (*ibid.*) Annex B. provides a mapping of a couple of these groups' holdings by sector, demonstrating the control they exercise over key Israeli companies.

There is little indication that the importance of company groups in the Israeli corporate sector is on the decline – on the contrary, anecdotal evidence points to acquisitions of additional block-holdings by family groups, including in companies where they already have a controlling stake.[5] This naturally raises questions regarding the nature and magnitude of the private benefits of control. One of the relatively few studies of control premiums in Israel focused on the effect of dual class stock unifications in the 1990s. It found that the price exacted for giving up votes in terms of corporate equity is quite high by international standards and concluded that the private benefits of control are large in Israel (Hauser and Lauterbach, 2003). This finding was corroborated by cross-country studies which found control premiums in Israel (estimated at 27%) well above the median of highly-developed economies (Dyck and Zingales, 2004).

However, all such studies relate to a previous decade and Israeli corporate sector practitioners interviewed by the OECD generally held that control premiums will have been significantly reduced by the reforms in recent years. A widely-held perception is that remaining private benefits are largely pecuniary in nature and often linked with family ties as much as pure self interest. One "related party transaction" that attracted attention

in 2008 saw a controlling shareholder in one of the family groups proposing to hire his daughter to a leading position for a salary that was widely criticised as excessive. The shareholders resisted his initial proposal, in particular with respect to remuneration, which was revised when she was hired.

Some academics have suggested that cheaper access to finance serves as a rationale for the maintenance of business groups. Historically, one reason for the formation of groups was clearly a scarcity of external finance, which among other things led to a concentration of companies in the hands of a few families with access to international sources of funding (Yafeh and Kosenko, 2007).[6] According to some corporate sources in Israel, it is still considered easier for a company to obtain bank credits if it is group-affiliated.

1.3. Control enhancing mechanisms

Pyramidal structures, typically with family-controlled holding or investment companies at their apex, are the most widespread mechanism employed to separate cash flow from voting rights of listed companies in Israel. Recent estimates suggest that approximately 80% of companies affiliated to business groups are held under this structure. Aside from historical influences described above, a key reason for this appears to be the unavailability under Israeli law of voting right differentiation of the common stock. The principle of one-share one-vote was enshrined in an amendment to the Securities Law in 1989, which stipulated that the share capital of a listed company must "consist of one class of shares conferring equal voting rights" .

Voting right differentiation existing prior to 1989 were maintained, but as the changes to the Law also implied that new share issuance could take place only in the highest-voting class, almost all listed companies embarked upon a unification of share classes.[7] It follows from the same Law that control enhancing mechanisms (CEMs) such as priority shares and voting right ceilings are not permitted either. A number of control enhancing mechanisms are permitted, but – as is the case in many OECD countries (EC, 2007) – this does not necessarily imply that they are widely used. For example, preferred shares[8] and shareholder agreements[9] are legally permitted in Israel, but not very widespread.

The Israeli pyramids differ in terms of overall structure and gap between control and cash flow rights. In terms of the structure, in a number of pyramids, large holding companies are located at the apex. In some cases, control is exercised through cross-shareholdings, though this is not a widely used mechanism.[10] The discrepancies between ownership and control rights vary greatly between company groups. In an extreme case, one of the corporate pyramids in Israel confers full control over companies at the bottom through a 3% ownership of cash flow rights.

Academic literature on corporate ownership structure in Israel regularly compares it to control structure of the chaebols in Korea (Maman, 2002). Israeli corporate pyramids tend to be quite complex and diversified, spanning a wide range of industries. Several of the large groups include financial concerns such as banks and insurance companies at their lower levels even as the reforms have curtailed banks' ability to play a more "active" role in the pyramids. While company groups have the significant shareholdings in the banks, the ability of banks to play an active role in the pyramids has declined, primarily due the fact that they have been limited in their investments in industrial companies and due to restrictions on related party transactions in the Companies Law.

No specific legal and regulatory measures (*e.g.* inter-group dividends) designed to discourage group pyramids have been taken so far. The regulators do not currently see the need to introduce measures designed to discourage pyramids *per se,* instead preferring to restrict the relations of public companies which comprise them. Given the already concentrated nature of the market for corporate control, they have focused on measures to further reduce disproportionality between ownership and control in Israeli listed companies by restrictions on CEMs, complemented by measures to prevent the abuse of minority shareholders. Nonetheless, informed observers see the concentrated ownership structure as a problem, particularly insofar as company groups may include private companies which are subject to lower transparency and disclosure requirements than public companies.

That being said, the Israeli legal framework has sought to address the existence of private companies in publicly listed groups. Any matter relating to a private company that is considered to be of material importance to a public company (where both companies belong to the same group) has to be reported to the ISA and to the public. Contractual agreements between a public company or its subsidiaries and affiliated companies in the group must be disclosed in detail, if they are substantial for the public company. Existing case law provides evidence of the application of existing legislation.[11]

1.4. Key laws and institutions

The Israeli legal tradition has mostly taken English common law as its starting point. This is reflected both in the nature of its corporate legislation and the role of the judiciary. Recent reforms of the securities legislation have been, however, inspired by American legal practices.[12] In addition, some specific pieces of legislation, for example in the area of contract law, are inspired by the German legal tradition.

The principal pieces of legislation bearing on corporate governance in Israel are the Companies Law (1999) and Securities Law (1968). In addition, sectoral legislation has been introduced to regulate the operation of financial sector participants, including banks (the Banking Licensing Law, 1981), provident funds (Provident Funds, 2005), pension funds (Pension Funds, 1981) and mutual funds (Joint Investment Trust Law 1994). These laws, described in more detail below, outline the governance structure of institutional investors, set maximum ownership limits in them and regulate the investments of these actors.

In general, the mandate for design and enforcement of corporate legislation is shared between the Ministry of Finance, Ministry of Justice and the Israeli Securities Authority. Regulations under the Companies Law are within the power of the Minister of Justice and should be approved by the Knesset[13] Committee for Legislation. If the regulations relate to public companies, the ISA is consulted during their preparation. Regulations under the Securities Law are initiated by the ISA, given force by the Finance Minister and require the approval of the Finance Committee of the Knesset. Circulars issued to the market (as opposed to directives) by the Securities Authority are advisory only. Conversely, the Bank of Israel has a mandate to issue regulations for the banking sector.

1.4.1. The Companies Law

The Companies Law, which applies to all Israeli companies and to a limited extent to foreign companies, came into effect in February 2000 replacing the 1936 Companies Ordinance. It introduced a number of concepts previously absent from the Israeli law in order to make it more conducive to the international business environment. The Law is

structured to allow autonomy of choice in solving corporate governance issues and enable civil enforcement by shareholders, directors and creditors. The Law differentiates between public companies (whose shares[14] have been offered to the public pursuant to a prospectus or listed on a stock exchange) and private companies (all other companies).

The Law attempts to balance, on the one hand, obligation by directors which are specified *vis-à-vis* the company rather than shareholders against, on the other, an overriding obligation to maximise profits.[15] In other words, the Law requires the consideration of the interests of stakeholders in formulating the objectives and strategy of the company, but only insofar as this does not infringe on the pursuit of its principal commercial objectives. At the same time, the concrete duties of the individual board members (duty of care and fiduciary duty[16]) are owed to the company. All office holders are, moreover, required to act in good faith and for the benefit of the company.[17]

The Minister of Justice may prescribe that the provisions of the Companies Law shall not apply, wholly or partially, to public companies whose shares have been offered to the public outside Israel or that are registered on stock exchanges outside Israel. This provision is intended to prevent conflicts between the Israeli Companies Law and the relevant foreign laws. An example of a provision where this power may be important is the requirement that outside directors[18] be Israeli residents. However, the Law provides that a company whose shares are listed outside Israel – can nominate an outside director who is not an Israeli resident.

In the absence of a formal national corporate governance code, the Law incorporates a large number of corporate governance-related provisions. The intention of the lawmakers was in part to compensate for the relative lack of case law in a young nation which has essentially "inherited" a common law system but not an extensive jurisprudence.[19] Moreover, given the risks arising from concentrated ownership and large company groups, the legislators were also intent to enshrine the key provisions in Law, thus making compliance mandatory. An amendment to the Companies Law which includes adding an annex providing a full set of governance recommendations to be implemented on a "comply or disclose" basis is currently being considered.

From a corporate governance point of view, a crucial aspect of the Companies Law is addressing what is seen as the key agency problem in Israel: the relationship between majority and minority shareholders. During the formulation of the Law and after intense consultations, it was decided not to address company groups *per se*. Instead, the Law introduced a number of provisions to prevent the abuse of minority shareholders. These provisions include *ex-ante* measures such as specific procedures addressing the approval of related party transactions, material transactions and mergers and acquisitions. In addition, *ex-post* measures such as legal redress through derivative suits are also provided by the Law.

Some of the above mentioned provisions apply only to "public companies" (listed companies plus others whose shares are offered to the public), whereas others are equally applicable to both public and private companies. For example, all companies are required to establish an audit function, and a public company must, in addition, appoint an internal auditor and establish an Audit Committee. Other important distinctions in terms of corporate governance requirements placed on public, but not on private companies include: the requirement to have an annual general meeting, the obligation to appoint a Chairman of the Board of Directors, the requirement to have at least two outside directors,

as well as the requirement to report to the securities regulator. The ISA and the Ministry of Justice are currently considering an amendment to the Companies Law and Regulations in order to apply higher corporate governance requirements to private companies which offer bonds to the public.

The following text addresses in more detail some of the corporate governance related provisions featured in the Companies Law as they apply to public companies, in relation to protection of shareholders and stakeholders, disclosure and transparency, as well as the structure and operation of the Board. A number of provisions in the Companies Law address the rights, but also the duties, of shareholders. In addition to these duties, specific provisions apply to "holders of control", defined as a party that either has the capacity to direct the company's activities or holds 25% or more of the voting rights if there is no other person who retains over 50%.

A central provision of the Companies Law establishes that all shareholders are required to act "in good faith and in a customary manner" towards the company and towards other shareholders. It specifies that shareholders shall refrain from abusing their power in the company when voting at the general meeting or at class meetings, *inter alia*, in the following matters: alteration of the articles of association, increase in the registered share capital, mergers, approval of acts and transactions requiring the approval of the general meeting. In addition to the duty to act in good faith, the Companies Law places a duty on all shareholders to avoid discriminating against other shareholders.

Specific classes of shareholders – a holder of control in a company, a shareholder who knows that the manner in which he votes is decisive with respect of a resolution, or a shareholder who has the power to appoint or prevent the appointment of an office holder in the company – have an additional duty to "act fairly" towards the company. The requirements to act in good faith and fairly have been interpreted rather broadly by the courts in some landmark cases dealing with protection of minority shareholders. In general, in transactions with interested parties, these categories of shareholders are under an obligation to disclose personal interest. Transactions are considered void if they fail to comply with these approval and disclosure requirements.

The Companies Law establishes a number of essential shareholder rights regarding dividend distributions, approvals of transactions with "interested parties" (persons wielding significant influence in the company and having a personal interest in the transaction), inspection of company documents and voting procedures. Special voting procedures to facilitate absentee voting by shareholders are in place, including proxy voting on "material proposals" and, if the company chooses, voting via the internet. Of particular note are provisions that enable minority shareholders to not only vote on existing proposals but also to place proposals before the general meeting. A single shareholder with at least 1% of the voting rights may request that the board of directors include a matter in the agenda of a future AGM. Any group of shareholders holding no less than 5% of a company's shares may request the convening of an extraordinary general meeting.

Shareholder approval is required for extraordinary related party transactions[20] – following initial approval of these transactions by, first, the audit committee, secondly, the board of directors. To approve such transactions, the majority of the votes in a general meeting is required – including one-third of the votes of the shareholders that do not count as interested parties (provided the total opposition among shareholders does not exceed

1% of all voting rights). A number of defined transactions with 'interested parties' are also subject to special shareholder approval.

In the case of takeovers, the protection of minority shareholder rights is addressed through provisions on special and complete tender offers. A special tender offer is required under the following conditions: 1. a purchase of a control block as a result of which a person becomes a holder of a control block (25% of voting rights), where previously there is no such shareholder in the company; 2. a purchase as a result of which the purchaser's holding increase above 45% of the voting rights, provided there is no other person holding over 50%. A complete tender offer is required when a purchase increases the holding of a shareholder to over 90% of the shares of a company. Shares purchased in contravention to the takeover procedures do not confer any rights and remain dormant as long as they are held by the purchaser.

The Companies Law includes a number of provisions according to which shareholders can take legal action against the management, the board of directors and or other shareholders, (including the holder of control of the company), either individually or collectively. Legal action by shareholders related to the breach of provisions of the Companies Law by the board of directors or management can lead to civil suits only. A proposal to provide the ISA with enhanced authority to levy fines is currently being considered. A more detailed description of the access to class action and derivative suits is provided in a later section.

The Companies Law deals extensively with the boards of directors in Israeli public companies, both in terms of endowing them with duties towards the shareholders and ensuring their capacity and objectivity. Boards are one-tiered and the Companies Law assigns to directors responsibilities in relation to policy making, supervision of the general manager, determining the structure of the organisation, review of financial performance, and special obligations on decisions related to distributions and mergers. The Law specifies that the Board may not delegate these key powers to the management, but can delegate some specific powers (excluding key matters such as dividend distributions, approval of financial reports, etc.) to its committees. Board members are elected individually by shareholder meetings – not on company slates.[21]

Every public company has to include in its board at least two outside directors, one of whom must be a financial expert. At least one outside director is required to sit on every committee and all of the outside directors are required to sit on the audit committee. The definition of outside directors under Israeli law aims at excluding all potentially conflicted parties. Outside directors must not possess any connection to the company or hold any position that gives rise to a conflict of interest – including economic or family relations to corporate management or major shareholders.

The procedure for appointment of outside directors is designed to ensure that majority shareholders cannot abuse their position by controlling the entire board. Outside directors may not have any connection with the company, must not be in position which could give rise to a conflict of interest, and must have no economic or family relations to corporate management or to major shareholders. Director nomination procedures stipulate that approval of a nomination must include a vote of at least ⅓ of the shareholders voting at a given meeting (excluding the holders of control) or that the total number of votes opposing the appointment from among those shareholders is less than 1% of the total voting rights in a company. Outside directors are appointed for 3 years (with

1 possible extension), and their remuneration is regulated by the Ministry of Justice. There is no provision in Israeli law against executive directors, including having the CEO as an ordinary board member, but in the larger companies the practice is not widespread.

The role of outside directors in protecting the interests of investors is perhaps most manifest in the composition and mandate of audit committees. All outside directors must be members of the audit committee, and no holder of control or a relative of such person, chairman of the board or any director employed by the company shall be a member. This point is important since, as mentioned, the audit committee is involved in approving all transactions with "interested parties", including the holder of control of a public company.[22]

The Companies Law makes it mandatory for public companies to separate the roles of the Chairman of the Board and Chief Executive Officer. The Law does allow companies to override temporarily this requirement through a specific procedure which enables the unification of the roles of the CEO and the Chairman for a period of up to 3 years. This procedure necessitates either the approval of at least $^2/_3$ of the voting shareholders, excluding holders of control or the opposition of the shareholders not to exceed 1% of total voting rights. In practice, the unification of these roles is not prevalent.

1.5. The Israeli Securities Authority

1.5.1. ISA's structure and function

The Israeli Securities Authority (ISA) was established pursuant to the Securities Law (1968) with the mandate to act as the primary regulator of public companies, protecting the interests of the public investing in securities in primary and secondary markets. ISA is a statutory corporation reporting to the Minister of Finance and the Finance Committee of the Knesset. It can be considered financially independent from government in that its activities are funded by fees collected from the regulated entities and its budget approved directly by the Minister of Finance and the Finance Committee of Knesset. Conversely, the members of ISA's governing board, including its Chairman and Deputy Chairman, are all appointed by the Minister of Finance and may not be recalled. The Chairman may be reappointed for one, shorter, second term.

The principal areas of activity of the ISA include the following: *1)* granting permits to publish prospectuses; *2)* regulating and supervising the mutual fund industry; *3)* monitoring the disclosure of public companies; *4)* ensuring fair and orderly trade on securities exchanges; *5)* licensing portfolio managers, investment marketing agents and investment advisors, supervising compliance of these investment professionals on a regular basis and enforcing disciplinary violations; and *6)* conducting investigations into alleged violations of the law.

Over time, the ISA has seen its supervisory responsibilities increase, particularly following the 2005 Bachar reform (described below). It is currently responsible for the application of the Securities Law, the Joint Investment Trust Law, Investment Advice Law and, parts of the money laundering legislation. ISA has been active in various judicial proceedings and enforcement, including criminal enforcement in co-operation with the Ministry of Justice.[23]

While ISA already has relatively broad powers of enforcement, it has expressed a wish to further extend its mandate in this area through, for instance, a greater fining capacity. Its inability to issue secondary regulations has also been debated. ISA can independently

issue position papers which, while warning market participants of the regulators' interpretation of Laws, are not strictly legally binding. The ISA may also issue binding directives as to the manner of presentation of items in reports. Secondary regulation proposed by the ISA has to be issued by the Minister of Finance and the ISA claims that this situation somewhat limits its ability to respond to market developments in a timely manner. In 2007, the IMF noted that despite the apparent institutional independence of the ISA, it does not have sufficient independence and rule making power.

Progress is being made in this area, as described in the communication by the Israeli authorities to OECD on 2 October 2009. A new legislative proposal which widens the administrative sanctions that the ISA can impose was published as an official draft law ("Supplementary Enforcement by the ISA Law, 2009") in September 2009. The Law provides for enforcement through an Administrative Enforcement Tribunal chaired by the Chairman of ISA, as well as by voluntary settlement, or penalties for violations in which the maximal level of intent is negligence. Another legislative project ("The Powers of the Israel Securities Authority Law (Amendments to the Law) – 2009") is still under discussions within the government with the goal of distributing a draft law in the foreseeable future. The proposal will enable ISA to independently issue binding administrative directives to regulated entities, without the need to obtain the approval of government ministries or the Finance Committee of the Knesset, as it was previously the case.

1.5.2. The Securities Law

The Israeli Securities Law is to a large extent inspired by securities legislation in the United States. The scope of the Law is quite broad: it sets out the mandate and structure of the ISA and TASE, establishes the rules for issuance of prospectuses, placing orders under the prospectus, and liability for them. It also outlines the rules for securities listed for trade on foreign stock exchanges, limitations on use of inside information, as well as penalties for the various offences outlined in the Law. Violations of the Securities Law are mostly subject to criminal enforcement. This is not seen by market participants as an issue since the ISA possesses sufficient powers of discovery and the burden of proof is not seen to be excessive.

The Securities Law applies to any entity offering securities to the public in Israel – that is, including all public companies – whether or not these are listed on the Tel-Aviv stock exchange. According to the Law, any legal entity without limitations is eligible to offer securities to the public and, if it does, is subject to ISA regulation.[24] That said, central provisions of the Law such as those prohibiting the use of inside information and outlawing market manipulation make sense only in the context of publicly traded securities.

A centrepiece of the Securities Law is the concept of a "principal shareholder", A principal shareholder is defined as a legal person who: *i)* holds 5% or more of the issued share capital; *ii)* is entitled to appoint one or more directors; or *iii)* holds office as a director general manager of the corporation – or in a corporation that holds 25% or more of the issued share capital or voting rights or is entitled to appoint 25% or more of its directors. Principal shareholders must make a timely public disclosure of their interest in the corporation, and subsequently inform of each change in their stake.

The Securities Law addresses, *inter alia*, the contents of a prospectus, the prohibition against the use of insider information, and the penalties applicable for the breach of the

Law. The Law also sets out the contents of annual reporting requirements for listed companies. They mainly include a description of the corporation; the corporation's activities and business environment; a board of directors' report; and financial statements. A public company shall upon demand of the securities regulator, submit an explanation pertaining to any item included in its annual report.[25]

In order to facilitate the disclosure pursuant to the provisions of the Securities Law, an online filing system – MAGNA (*www.magna.isa.gov.il*) – provides the public with unrestricted access to public companies' annual filings, immediate reports and otherwise, made by listed companies to the ISA. The reports are provided also through the online database maintained by the TASE. These filings include incorporation documents and details, filings concerning registration and delisting of securities, reports on general or special meetings, and details of major shareholders, among others. Profit warnings are neither mandated by ISA nor the stock exchange, but some companies publish them voluntarily. The ISA conducts regular compliance checks in relation to company reporting and each reporting company is assigned a case officer. By international comparison, this system can be described as unusually comprehensive and easily accessible.

The Securities Law establishes criminal liability in matters related to reporting, securities issuance, insider trading and other securities-fraud related offenses. ISA's powers under the Law include market surveillance and investigations of violations. Under specific circumstances, the ISA has the authority to suspend or revoke licenses that were issued by it. Likewise, it has the authority to levy fines with respect to the laws it is empowered to enforce. It can also instruct the TASE to halt trading in a given security.

Over the years, the ISA has been involved in a number of civil and criminal cases at the core of which were considerations relating to protection of property rights of shareholders. A number of important cases in which the ISA has been involved deal with matters concerning misrepresentation of financial statements, related party transactions and matters very much relevant to the present review. The ISA's enforcement record speaks to its active involvement in a range of civil and criminal suits. In 2007 alone, 4 criminal indictments have been filed by courts following investigations carried out by the ISA and in the previous year 7 such indictments have been filed. In addition, 19 criminal indictments were awaiting trial in the court of first instance, as well as 12 appeals at the District Court level as of end 2007 (ISA, 2007).

The following examples demonstrate the types of cases in which the ISA has been involved in the past. In one of the successfully prosecuted criminal cases, the accused, a controlling shareholder in a public company transferred funds from the company's accounts to his private accounts or to accounts of another private company without the necessary authorizations, in breach of the Securities Law and the Penal Code. In another case, the accused was successfully sued for the inclusion of misleading information in financial statements and in immediate reports, as well as for non-disclosure with the intent to mislead investors. The ISA is also on its guard against potential related party transactions. For instance, on one occasion a company issued a report regarding the sale of minority rights to its subsidiary, holdings partly owned by the company's controlling shareholder. Since the purchasing company was private, it chose not to submit its financial statements to the ISA – a reasoning that the ISA rejected, forcing the company to broaden the scope of disclosure on various issues.

In addition to being involved in prosecutions, the ISA actively examines different transactions which it deems suspect and has the powers to instruct the company to publish the ISA's position as to whether a transaction is invalid. For instance, last year the ISA examined and subsequently declared invalid a transaction where the votes of disinterested shareholders approving a related party transaction were not counted properly. The review demonstrated that a *bona fide* mistake was made, as a result amending the classification of two shareholders as disinterested parties.

Though the ISA has, as mentioned, broad powers in relation to the enforcement of the Securities Law, the IMF has opined that in view of rapidly developing financial markets, it faces a deficit of resources to effectively discharge this function. It was deemed that the staff of the ISA, which currently includes over 170 employees, may not have sufficient resources to make regular and detailed investigations.[26] The IMF report mentioned that ISA relies on auditors to conduct on-site inspections of mutual funds. This observation may, however, be somewhat tangential to the oversight of public companies more generally. Representatives of ISA have said that the supervision of public companies under the Securities Law is conducted directly by ISA's Intelligence and Investigations Department which is adequately resourced for the task.

1.6. The framework and mechanisms for legal enforcement

1.6.1. The judicial authority and the courts system

The Basic Law on the Judiciary establishes three levels of courts: the Supreme Court, District Courts and Magistrate Courts. The majority of governance related cases in Israel are dealt with at the level of District Courts, although some landmark cases have been heard at the Supreme Court level. Currently, there is no tribunal or specialised court meant to hear cases related to the enforcement of commercial legislation. A number of public and private sector representatives in Israel have suggested that the technical nature of cases necessitates a high degree of financial and commercial competence on the part of the judiciary.

While it is the general practice that specific judges familiar with commercial adjudication address such matters, in some cases judges who may hear specific matters may not be adequately equipped to do so. This is seen as a particular problem when plaintiffs seek immediate injunctions, for instance in takeover cases. It can also be problematic when cases are forwarded to judges specialising in criminal matters, but who may not have a background in commercial litigation. As such cases are rarely appealed to the Supreme Court, there is little case law for judges who are not specialised in commercial matters to refer to.

In order to address this issue, a recent committee (the "Goshen Committee") recommended the creation of a Court for Securities and Company Law Litigation.[27] The Committee argued that, by enhancing the *ex-post* protection of shareholders, a dedicated court would be a cornerstone in long-term efforts at enhancing the quality of public company management and developing capital markets. There has been a certain reluctance within the government to adopt this recommendation, attributed by some corporate governance practitioners as reflecting its experience with specialised Labour Courts in Israel. In addition, in the view of the Ministry of Justice, *ex-post* tools cannot be the emphasis of shareholder protection, particularly in light of the fact that Israeli minority shareholders are perceived as being passive.

New proposed legislation establishing a specialised judicial department within the District Court of Tel Aviv was published as an official draft law during September 2009 ("The Courts Law (Amendments to the Law) – 2009"). The jurisdiction of the specialised department will include claims arising in the fields of Companies Law, Securities Law, Joint Investment Trust Law, Regulation of Investment Advice, Investment Marketing and Portfolio Management Law and regulations under these laws.

1.6.2. Legislative provisions concerning redress

As mentioned earlier, in the Israeli legal and regulatory model most of the corporate governance standards are incorporated in legislation and thus are legally enforceable. A number of provisions in the Companies and Securities Laws explicitly outline the mechanisms of redress shareholders can resort to should they feel their rights to be infringed. These Laws also specify the civil and criminal penalties that may apply to the potential offenders, be it directors, management or controlling shareholders. Again, the Companies Law is subject to civil enforcement, whereas elements of the Securities Law allows for criminal enforcement.

Over the past several years, there have been a number of precedent-setting cases affirming shareholder rights in face of abuses by directors or controlling shareholders. These cases have provided further clarification in a number of important matters such as definition of independent directors or related party transactions. The *State vs. Shlomo Eisenberg* case – considered in Israel as a landmark one – was heard in 2005 by Israel's Supreme Court. In this instance, the controlling shareholder was found guilty of "aggravated fraudulent acquisition" for obtaining shareholder approval of a related party transaction under false pretences.

The ISA and the Ministry of Justice have recently advocated a greater emphasis on facilitating class action and derivative suits in Israel as one of the *ex-post* protection measures at the disposal of shareholders. The Companies Law enables shareholders, directors and creditors to bring derivative suits, though only in the case of prohibited dividend distributions. The Israeli Class Action Law (2006) permits courts to entertain any claims relating to any action stemming from the ownership, holding, or purchase of a security or a trust. Under this legislation, shareholders are entitled to initiate class action suits against other shareholders, officers, and directors for any breach of the Securities Law. The hearing of a class action or derivative suit requires the approval of the relevant Court following the conditions outlined in the Law.[28]

In order to support plaintiffs in class action suits, the Companies Law empowers the ISA to assume the cost of individual suits in connection with bonds issued by the government, or to an option or a future contract or any security of a public company. The funding of class actions by the ISA is contingent on the plaintiffs' case fulfilling specific criteria. In parallel, ISA's potential involvement in shareholder class action suits has been recently enshrined in the Companies Law alongside provisions to further the effectiveness of this mechanism. For instance, ISA is entitled to voice concerns about certain corporate transactions – a fact which the company will then be required to disclose publicly. This disclosure is perceived as a signal of ISA's willingness to support future shareholder action.

To date, the ISA has received a modest number of applications to finance class action suits. In 2006, it made a decision to be principally involved in one class action suit (class action against Dor Chemicals) where the plaintiffs claimed they had been misled with

respect to the financial performance of the company prior to a drastic share price decline. In 2007 it was principally involved in a class action against T.R.D. Ltd (its controlling shareholders, directors and accountants) filed by a bondholder who claimed that he purchased the bonds based on the company's presentations regarding its work in medical equipment, while it began investing most of its funds into the issue of securities in derivatives, which was not made known to investors. Seven class action suits, including the action against Dor Chemicals, were pending at the end of 2007.

Amendment 3 to the Companies Law adopted in 2005 improved the procedures to file derivative suits. These procedures encourage derivative suits as plaintiffs are asked to pay a low initial fee to commence a suit. The Ministry of Justice and the ISA are currently considering the possibility of amending the Companies Law and adding the possibility of providing ISA financing for derivative actions as it does for class action suits. Another proposed change relates to the powers of discovery of plaintiffs. Once a complaint is filed, the litigants may obtain, after establishing *prime facie* evidence, a court order allowing them to subpoena evidence from the company. However, in the absence of prior evidence many potential claimants hesitate to undertake the initial steps. New legislation under consideration would compel companies to release to potential litigants the minutes of board meetings and related documents.[29]

As an alternative to criminal enforcement procedures, the ISA has some administrative powers such as the right to impose monetary sanctions on reporting corporations. In addition, the ISA and the Ministry of Justice are currently working on a proposal to enhance the administrative enforcement power of the ISA, mainly by allowing the ISA to impose enhanced monetary sanctions and limit the occupation of office holders and controlling shareholders who violate the Law. Finally, an amendment to the Companies Law giving the ISA the authority to impose financial sanctions on companies subject to the reporting requirements of the Securities Law is being currently considered. The idea is to allow ISA to take action in cases where it is relatively easy to prove a violation but where there is no incentive for a plaintiff to enforce them in a civil suit since damages are minimal or hard to prove.

1.7. Financial reporting and accountancy

The Israeli Accounting Standards Board (IsASB) and the Institute of Certified Public Accountants (ICPA) are the two professional bodies charged with designing and applying the relevant accounting standards in Israel. The ICPA is an old professional association predating even the state itself. IsASB was established in 1997 as an industry regulatory body charged with the objective of setting and improving accounting standards in Israel both for listed and non-listed entities, following an agreement with the ISA and the ICPA.

1.7.1. The Israeli Accounting Standards board

The Israeli Accounting Standards Board (IsASB) is a self-regulatory body in a sense that the work is done by practitioners from the accounting profession. IsASB consists of three distinct bodies: the Managerial Board, the Supervisory Council and the Board of Directors. The Managerial Board is overseen by two supervisory bodies: the IsASB and the Supervisory Council which consists of members drawn broadly by industry specialists. The work of the IsASB is supervised by the ISA and the ICPA under the delegated responsibility of the Ministry of Justice. Both the ISA and the ICPA retain an effective veto over IsASB's work.

Previously, the IsASB operated as a purely national standard setter, defining accounting standards largely on the basis of IAS, omitting or amending individual sections that were considered ill-suited to Israeli conditions. In 2006, following a decision to adopt IFRS in Israel, the thrust of the work of the IsASB has been on adapting Israeli accounting standards to IFRS. A final set of standards was published in 2006. IFRS became mandatory for financial reporting of all public companies effective January 2008.

1.7.2. The Institute of Certified Public Accountants

The Institute of Certified Public Accountants (ICPA) has various functions such as developing the accounting profession in Israel, developing auditing standards and verifying the quality of their implementation, as well as issuing and enforcing ethical rules. The ICPA is an influential organisation with more than 90% of Israel's certified public accountants among its members. The Law stipulates that the ISA must hear the president of the ICPA prior to publishing directives related to the presentation of items in the reports. The Ministry of Justice also consults with the ICPA prior to issuing the relevant legislation or regulation.

The ICPA partners with the Ministry of Justice in operating the Auditors Council, the function of which is to review audit firms. The Auditors Council has the authority to revoke licenses and take accounting firms to court where necessary. It is independently funded and operates under the delegated authority of the Ministry of Justice. In addition to its function in this body, the ICPA introduced a peer review institute in 2005 to ensure the integrity and high standards of performance of accounting firms.

The peer review approach is partly a consequence of the fact there is no differentiated licensing of auditors in Israel and no restrictions on the size of an accounting firm that could audit large listed companies. The quality control obtained via peer review is thought to be equivalent to internal review mechanisms that are put in place by the global headquarters of the largest international accounting firms, which also conduct reviews of their Israeli subsidiaries. The peer review institute informs the Auditors Council and ISA if serious irregularities are uncovered by reviews. In addition, the ISA is updated on a regular basis of the general findings uncovered during the reviews.[30]

1.8. Capital markets and the financial sector

Israeli capital markets have grown rapidly over the past few years, while the role of the banking sector has been on decline. In parallel, the role of institutional investors in corporate governance is seen to be growing, albeit from a low starting point, as the latter increase their exposure to equity investment. The following section briefly outlines the recent trends in the financial sector in Israel as they may be relevant to corporate governance issues.

1.8.1. The banking sector

The structure of Israeli banks is reminiscent of the "German" model of universal banking where banks act as multi-product firms within the financial sector. The sector has historically been and remains rather concentrated. It is currently dominated by 5 diversified banking groups (Hapoalim, Leumi, Israel Discount, Mizrahi Tefahot, the First International),[31] which together account for 95% of the assets of the banking system. In particular, the size of Bank Hapoalim and Bank Leumi stands out; each group accounts for almost one third of the Israeli banking sectors' assets (BOI, 2006). There are few foreign

banks in Israel.[32] Despite various measures adopted by the government to increase the role of capital markets, and even more directly, to break-up the existing banking groups, the level of bank concentration has been relatively constant over the years.

In recent years, the regulators have taken several measures to separate investment services from the banking groups. In 2005, a government committee (subsequently known as the "Bachar Committee") was established to enhance competition in the management of the public's financial assets and to enhance competition in credit provision through non-bank credit instruments *vis-à-vis* the household sector. The principal recommendation of this Committee was to divest banks of their ownership of institutional investors. The recommendations of the Committee were largely implemented through the enactment of the *Law for Increasing Competition and Reducing Concentration and Conflicts of Interest in the Israeli Capital Market* (2005).

The reform has had a profound effect on the ownership structure of the Israeli financial sector. The immediate impact was that the banks sold the fund management companies and the insurance companies. In the slightly longer term, the reform seems to have brought increased competition between the various segments of the financial sector, as well as a stronger reliance on capital markets as opposed to banks for corporate funding. Illustrating this point, the share of banks in business sector financing fell by 25 percentage points from 2003 to 2007, and currently stands at just above 50%. Institutional investors currently account for approximately 25% of funding to the business sector.

1.8.2. Institutional investors

In keeping with the government's intentions, the role of institutional investors in domestic capital markets has grown. As of the end of 2007, institutional bodies in Israel managed assets of NIS 838 billion (Table 2.2). This compares positively with comparable statistics for OECD member countries. In particular, the long term savings sector (pension, provident and life insurance companies) in Israel has been on the rise, having grown by 11 % in 2006 to account for over 30% of the public's financial assets portfolio. Provident funds are the largest individual category, followed by pension funds, insurance and mutual funds.

Table 2.2. **Holdings by institutional investors**

Institutional investors	Assets (in billion NIS)	Share of TASE-listed securities held by institutional investors (% of listing)		
		Private sector debt	Government debt	Equity
Provident funds	278	26.9	18.9	9.1
Pension funds	224	6.9	11.2	2.1
Insurance companies	216	9.5	8.8	3.7
Mutual funds	120	13.7	14.7	2.9
Total	**838**	**57.0**	**53.6**	**17.8**

Source: Israel's Self Assessment, 2008; Israel Securities Authority Annual Report, 2007. Data provided as of end of 2007.

A number of reforms in the past five years have changed the landscape of institutional investors in Israel. Investment rules have been gradually liberalised and tax provisions favouring domestic investment have been dismantled. In addition, reforms of the governance of the institutional investors themselves have been introduced. In 2006, the

Commissioner for Capital Markets, Insurance and Savings Division, published regulations establishing a framework of principles to ensure the proper operation of the board of directors.

Concomitant with the growing influence of institutional investors, their role in corporate governance has strengthened – albeit from a low starting point. Institutional investors are required by law to participate in shareholder meetings if they deem that the decisions taken there may potentially harm their unit holders in case of mutual funds and customers in case of insurance, pension and provident funds. The *Committee for the Examination of the Necessary Steps for Increasing the Involvement of Institutional Investors in the Israeli Capital Market* (known as the Hamdani Committee), which submitted its recommendations in January 2008, has recommended that all institutional investors be required to also submit an explanation of voting decisions when the vote might raise a suspicion of a conflict of interest. Other recommendations of the Committee deal with voting in meetings of companies connected to institutional investors and encouragement of such investors to receive professional expertise on voting decisions. Progress is being made in this area, including through a legislative proposal ("Joint Investment Trust Law (Amendment 13 to the Law), 2009"). According to the amendment, the Minister of Finance will be authorised to issue regulations regarding the participation of a fund manager in the general meetings of the corporations held by funds under its management.

Institutional investors' ability to play a dominant influence – alone or conjointly – is limited by some factors not directly linked with corporate legislation. For example, they are discouraged by tax laws from holding more than 20% of the stock of a listed company. Should their investment exceed this threshold (individually or by institutional investors deemed to act in collusion), they would lose the tax free status with respect to income tax on dividends or with respect of the capital gains tax on any sales of investments. In addition, the Restrictive Trade Practices Law (1988) includes consultations between institutional investors in its definition of a restrictive arrangement that can harm the competition in the market. This issue is, however, subject to ongoing consideration in Israel; a statement to be published soon by the Antitrust Commissioner is, according to the Israeli authorities, expected to change the current situation.

1.8.3. The Tel-Aviv Stock Exchange

The Tel-Aviv Stock Exchange (TASE) is the only stock exchange in Israel.[33] TASE is a private company owned by its members (domestic and international banking and non-banking corporations) which is overseen by the ISA. It does not act as a self-regulatory organisation in the broad sense of the word.[34] TASE is vertically integrated, providing listing for an array of financial instruments, an automated central book order trading system, a mechanism for clearing and settlement activities, and real-time trading data and announcements. It is responsible for supervising the banks' investment houses, which are members of TASE and the Clearing House.

Its activities are overseen by a 16 member board, including the Bank of Israel, the Treasury, 7 external directors and 7 members. The Chief Executive Officer is a member of the Board, but has no voting rights. The activities of TASE are regulated by the Securities Law, and fall under the direct supervision of the Israel Securities Authority. Decisions by TASE Board of Directors are subject to approval by the ISA should the Board set new directives. An amendment of TASE by-laws requires the approval of the Minister of

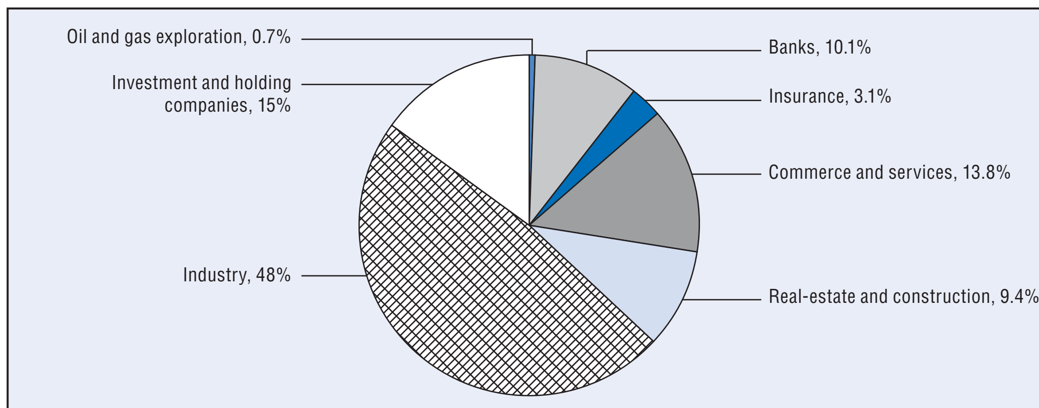
Finance, after consultation with the ISA, and the approval of the Finance Committee of the Knesset.

TASE's capitalisation, at USD 133.6 billion in 2008 (USD 235.2 in 2007),[35] is modest compared with the stock markets in many OECD member countries. Yet, the stock market is large relative to the size of the Israeli economy, with the total market capitalisation reaching 107% of GDP in 2007 (TASE, 2008). This figure is comparable to that of a number of member countries with highly developed stock markets such as Korea and is in fact higher than a number of them.[36] The size of the market has grown rapidly over the last decade, partly because of the growth in stock prices until 2008, but also reflecting the Israeli privatisation programme and a large number of IPOs and secondary share offerings by private sector companies.

The growth of the Israeli capital markets also reflects a shift by Israeli investors and securities issuers, who previously tended to target the deeper pools of liquidity offered by larger overseas exchanges. Foreign investors also contributed, making more than USD 900 million net investment in Israeli listed stocks in 2007 alone. Domestic and foreign investors are attracted not only by the growing number of stocks on offer, but also by the broadening of the market to encompass more instruments in recent years (ETFs, derivatives) as well as by a generally increasing liquidity. With an average daily turnover of USD 547 million in shares and convertibles and USD 1.1 billion in bonds in 2008, the market is much more liquid than it has been historically.[37] In recognition of the growing breadth and depth of TASE's market, in 2007 FTSE reclassified Israel from an "advanced emerging" to a "developed" market status.

TASE features over 640 companies which have listed equity, the largest of which are in finance, chemicals, telecom and technology sectors. In addition, an estimated 160 companies have listed exclusively corporate bonds.[38] Figure 2.2 illustrates the composition of TASE by sector, highlighting the significant contribution by banks to the overall capitalisation. While the role of banks as a financing source has been declining in the past years, their role in the economy remains clearly important. The Figure also demonstrates the importance of holding and investment companies (discussed above) which account for 15% of total capitalisation, but interestingly, for over 25% of the value of the large cap T-25 index.

Figure 2.2. **Ownership of shares listed on the Tel-Aviv Stock Exchange (2007)**



Source: TASE, 2007.

The Israeli stock market features a large number of dual listed companies (approximately 10% of the total number of companies with listed equity). These companies are found in all sectors, but are particularly prevalent in the IT-related industries. Most dual listed companies (71%) are cross listed on NASDAQ[39]), but others are listed on the NYSE, LSE (Main Exchange as well as AIM) and other European exchanges (mainly Euronext).

The high number of Israeli companies on foreign stock markets can mostly be traced back to the dot-com boom, when a number of Israel's high tech companies listed abroad. During the period 1990-1996, 56 Israeli companies, most of them high tech oriented, issued stock in the United States, raising approximately USD 1 billion. This trend reflected to some extent the relative lack of attractiveness of domestic markets, but also the fact that many of these companies were backed by foreign venture capitalists which had a preference for IPOs in their national stock markets. Therefore, and in contrast to what is seen in most countries, the majority of Israeli double listings are companies already listed abroad seeking a secondary listing on TASE.

The number of dual-listed companies over the past 15 years has grown rapidly, following measures by TASE to prevent further flight of domestic companies and to lure back Israeli companies. Recognising the difficulties of bolstering domestic IPOs, particularly in technology related sectors, TASE's interest focused on easing the way for foreign listed companies to obtain a secondary listing in Tel Aviv (Licht, 2001a). Following discussions about the recommendations of the *Brodett Committee*, charged with examining whether exemptions should be granted to foreign listed securities, in 2000 the Knesset enacted a unilateral recognition arrangement that allowed issuers listed on NASDAQ, NYSE, AMEX or LSE Main Market in compliance with reporting requirements abroad to dual-list on TASE without additional reporting.

An interesting explanation has been advanced to explain the apparent success of attracting Israeli companies back to TASE, following the establishment of mutual recognition agreements. This explanation centered on the presence of a regulatory arbitrage following the conclusion of agreements between TASE and foreign exchanges which incentivised Israeli companies to list abroad in order to avoid greater disclosure at home (Licht, 2001a). Certainly, the motivations behind success of the 'double listing' phenomenon may be debatable and are certainly not solely related to the regulatory differences between Israel and other jurisdictions. Indeed, some academics have argued that the regulatory arbitrage has mostly eroded in recent years, with some relatively minor differences remaining.

Other recent measures to establish mutual recognition and simplify reporting by dual listed companies have been adopted. For instance, in January 2008 the ISA concluded an agreement with the French *Autorité de Marchés Financiers (AMF)*, permitting Israeli companies listed on TASE to double list on the French market based on its domestic filings and vice-versa.[40] This mutual recognition agreement is the first of its kind to be signed by the ISA and is seen by it as an important precedent for other members of the EU. In addition to this agreement, MOUs have been established with several exchanges, including the NYSE-Euronext and Shanghai Stock Exchange in 2008. Israel also actively participates in the work of IOSCO and is a signatory of a "Multilateral MOU concerning consultation and co-operation and the exchange of information".

TASE does not have a strong independent role as a standard-setter for corporate governance due to the fact that most governance standards are encompassed in the

Companies Law. Listing requirements bear on corporate governance mostly through their impact on the ownership and control structure. Specifically, the listing requirements established by TASE specify minimum thresholds for free float (in percentage and absolute terms) and minimum value of the public's holdings, which aim to contain the concentrated ownership structure in Israel.

The minimum free float rate ranges from 7% for companies with a listing value exceeding NIS 200 million to 20% for companies with a listing value of up to NIS 20 million. In recent years, TASE has increased the minimal public float for TA-25 and TA-100 indices to 25%, forcing large companies which did not meet this requirement to conduct secondary offerings or de-list. In 2008, in view of the outbreak of the financial crisis, TASE relaxed the free float thresholds for its indices back to 20% as an emergency measure to remain in effect until the end of 2009. It has also reduced the minimum value of the public's holdings applicable to TA-25 and other indices by one-third.

In addition to these temporary measures, less stringent free float requirements normally apply for small companies and research and development-intensive companies.[41] This was done to encourage high-tech IPOs domestically, but so far the measure is not seen as having had a major impact. In fact, smaller research and development and IT companies were historically accommodated in the second tier of the Tel Aviv market – now abolished –and were thereby historically subject to more lenient requirements.

In addition, TASE has introduced maintenance rules which include criteria with respect to public float value (no less than NIS 5 million), public float rate (no less than 15% of share capital) and equity (no less than NIS 2 million). Those companies which are in breach of the rules are placed on a Maintenance List and traded only in a limited format.[42] Companies on the Maintenance List are given 6 months to remedy the breach, and those which do not do so are delisted after at most 2 years. Similar to free float requirements, the rules for transferring companies to the Maintenance list have also been temporarily relaxed in view of the financial crisis.

1.9. Ongoing reforms

A number of important changes have been made over the past several years to the Israeli corporate governance framework. These changes have primarily taken the form of amendments to the Companies and the Securities Laws, listing and maintenance criteria by TASE and secondary regulations initiated by the ISA. Further amendments aiming to enhance Israel's corporate governance framework are currently being considered, following the recommendations coming out of the work of the *Committee for the Examination of Corporate Governance in Israel* led by the ISA Chairman Professor Goshen, the current chairman of the ISA. This Committee provided a number of recommendations on improving the corporate governance framework in Israel in relation to matters concerning the composition and functioning of boards and the audit committee, authorisation of transactions with principal shareholders, directors' declarations, etc.

Key among these recommendations was the establishment of a corporate governance code in Israel, in addition to the provisions already established in the Companies Law. The Ministry of Justice and ISA are currently preparing an appendix to the Companies Law which will introduce a recommended "comply or disclose" corporate governance code. The proposed code focuses on augmenting the board of directors' independence, enhancing the role of the audit committee, and increasing the transparency of and accountability for

internal controls. It is envisioned that the ISA will oversee the quality of the reporting under this code. In the meantime, some of Goshen Committee recommendations have been adopted in the form of amendment 8 to the Companies Law.

A number of other amendments to the Companies Law are being considered, primarily following recommendations by the Goshen and Hamdani committees. These recommendations have already been approved by the former Minister of Justice, but in view of a pending change of government, an approval of the newly appointed Minister will be also required. Box 2.1 outlines the key points of reform.

Box 2.1. **Proposed reforms to the Companies Law**

In light of extensive discussions following the recommendations of the Goshen Committee , the following reforms are currently being considered:

- An extension of the special approval procedure concerning a merger of the roles of the chairman acting also as a general manager. It is proposed that this procedure apply to chairman of the board and general manager who are related through first degree family ties. It is also proposed that anyone who is subordinate to the general manager cannot serve as a chairman of the board.
- A provision that a qualified director must exercise independent judgment when voting at board meetings and its committees, and may not act in accordance with instructions of any other person. This provision would effectively supplement existing provisions regarding directors' duty of care and fiduciary duty.
- A proposal that the relative weight of outside directors on the audit committee be increased through a requirement that most of the members of the committee, including its chairman, be outside directors. Currently, the law provides only that all of the company's outside directors are to serve on the audit committee. In addition, it is proposed that the quorum for adoption of resolutions be a majority of directors and a majority of outside directors present.
- A proposal to extend powers of the audit committee in relation to internal and external audit. According to this proposal, the audit committee will examine the internal audit plan and resources available to auditors as well as the scope of external audit work and fees. An additional proposal is to require the audit committee to hold at least one consultation with internal or external auditor per quarter in the absence of chairman and management.
- A proposal to increase the power of shareholders in nominations for outside directors to majority of shareholders who are neither controlling shareholders nor associated with them (from currently one-third), at the same time as increasing the level of opposing votes to prevent election of directors to 2% of voting rights (from currently 1%). A similar proposal has been made in relation to approval of transactions with a controlling shareholder.
- A proposal that the company and its controlling shareholder should not be able to prevent the appointment of an outside director for a further 3 year term if a majority of minority shareholders approve this appointment.
- A proposal that the terms of remuneration of all corporate officers be also subject of prior approval by the audit committee and the board, whether or not they constitute an exceptional transaction.
- An amendment relating to complete tender offer procedures stipulating that so long as most of the offerees respond positively to the offer, it can be accepted. (Previously only possible if the holdings of the offerees rejecting the offer represented less than 5% of share capital).

1.10. Overview of the state-owned sector

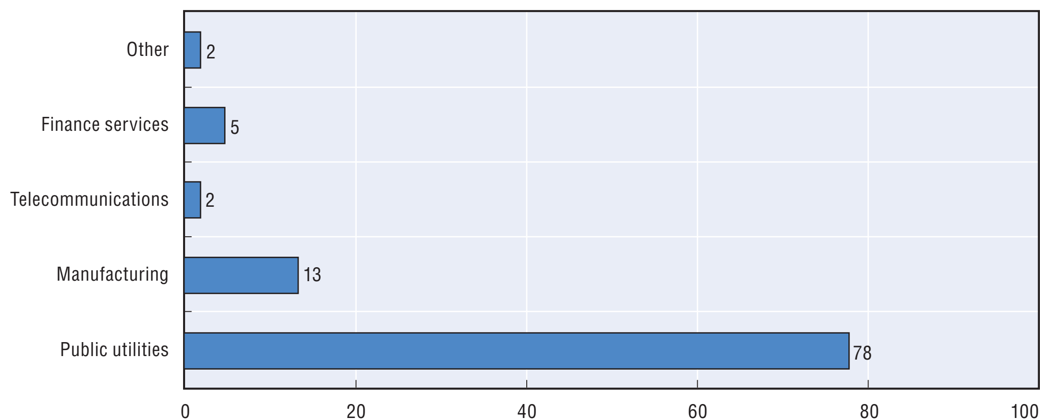
1.10.1. Definitions and sectoral composition

State-owned enterprises in Israel are officially divided into three categories: government companies, government subsidiaries and mixed companies. Government companies are considered to be those where the state possesses over half of the voting power or the right to appoint over half of the board members. Government subsidiaries are separately incorporated entities subordinate to existing government companies where the government company alone or together with the state possesses over half of voting power or the right to appoint over half of the board of directors. Those companies where the state has a degree of ownership or control that do not meet these thresholds are considered to be mixed companies.

According to these definitions, the SOE sector in Israel comprises 68 government companies, 6 government subsidiaries and 18 mixed companies. Of these, a number of companies and subsidiaries are operating with non-commercial objectives – in fact, only 33 SOEs are considered to be operating with commercial motives.[43] Based on the 2007 data, the total assets of the Israeli government companies having a commercial orientation amounted to USD 37.5 billion and the staff employed by them to over 50,511. For the same year, the total assets of the mixed companies amounted to USD 484 million and their employees to just over 500. In addition, a number of enterprises exist at the municipal level, however they fall outside the scope of this review.

Given the economic importance of government companies (vis-à-vis mixed companies) in the Israeli SOE sector, the industrial distribution of the government companies provided below is indicative of the overall sectoral distribution of Israeli SOEs. Figure 2.3 illustrates the importance of Israeli SOEs in public utilities sectors, including water, electricity, railroad and port transport, and energy-related sub-sectors.

Figure 2.3. **Sectoral distribution of commercial government companies (in per cent of asset value)**



Source: The Government Companies Authority, 2008.

SOEs in the public utilities but also those operating in defence-related industries are some of the largest SOEs in Israel (Table 2.3). Some of these SOEs, such as Mekorot (a nation-wide water company) and companies operating in the defence sector (*e.g.* Israel Aircraft Industries), retain monopoly positions. However, this is relatively rare since the

Israeli government has over the years sought to increase competition in sectors where commercially-oriented SOEs operate. For instance, a few years ago the then state monopoly Oil Refinery was split horizontally into two entities, which were corporatized, exposed to competition and subsequently privatised.

Table 2.3. **Details of the largest government companies**[1] **(in declining order by book value)**

Company	Number of employees	Annual revenue[2] (thousands) USD	Book value of assets (thousands) USD	Government ownership
Israel Electric Corporation	12 212	5 008 840	17 933 957	99.8%
Israel Railways	2 107	237 943	3 743 696	100%
Israel Aircraft Industries	12 939	3 516 381	3 375 195	100%
Mekorot Water Group	2 211	756 307	3 082 298	More than 90%
Rafael Armament Development Authority	5 213	1 373 773	1 252 795	100%
Israel Ports Development and Assets Company	105	183 750	1 127 408	100%
Ashdod Port Company	1 275	281 635	740 394	100%
Israel Postal Company	4 707	450 671	704 362	100%
Haifa Port Company	1 064	225 320	618 250	100%
Israel Military Industries	2 966	610 368	481 327	100%
Agrexco Agricultural Export Company	365	927.621	235 487	50%
The Israel National Roads Company	296	647 788	140 072	100%

1. For the purposes of this table, only SOEs which met one the following criteria were included: *1)* market capitalisation or estimated value of more than USD 100 million; *2)* annual revenues exceeding USD 100 million; *3)* over 500 employees.
2. Figures provided are in thousands of US dollars.

Source: Government Companies Authority. Data provided as of December 2007.

In addition to the said SOEs, approximately 50 statutory corporations operate in Israel. These are not officially considered as SOEs because, having been established through specific laws regulating their operations and governance structures, they are not subject to the same ownership framework which applies to other SOEs. Their relatively large number reflects the fact that Israeli legislators have chosen to organise a number of activities as statutory corporations that would in most OECD countries be found in autonomous public bodies, non-profit institutions, foundations, etc.

Some of the most prominent statutory corporations in Israel are the National Insurance Institute, the Bank of Israel, Israel Securities Authority, the Israel Broadcasting Authority and the Magen David Adom (medical) services – all of which would not necessarily fall within the scope of the SOE Guidelines. Only a few commercial operations such as the Israel Airports Authority and the Israel Sports Betting Board would be considered as SOEs. As discussed in below, the framework for supervision of statutory corporations is under review.

1.10.2. Privatisation

In consequence of an ambitious privatisation programme initiated in 1980s (as part of the “Economic Stabilisation Plan”), the role of SOEs in the Israeli economy has been significantly reduced. In total, between 1986 and 2007, 94 companies changed their status from government companies to either mixed companies or completely private enterprises. The privatisation proceeds totalled USD 14.2 billion. The most significant individual privatisation transactions in terms of revenue to date have been Israel Chemicals in 1992,

Zim (a shipping company) in 2003,[44] Bezeq (telecoms operator) in 1997-2005, El Al (the national air carrier) in 2003-2007 and Oil Refineries in 2006-2007. In parallel, the government has divested its share in the major Israeli banks, all of which came into unintended state ownership following the 1983 banking crisis. The State remains a minority shareholder in two banks – Bank Leumi and Bank Discount – from both of which it intends to further divest.

In consequence, the Israeli SOE sector does not represent a major share of the economy. SOEs currently contribute less than 2% of total employment and GDP and represent around 8% of total exports and gross capital formation. Further privatisations are planned starting from 2010 in postal services, ports and, tentatively, the military industrial sector. Today, the government's stated approach is to retain an interest only in those companies which pursue public policy objectives and/or are of national security importance.

One reason why the privatisation programme has not resulted in an even larger decline in the size of the SOE sector is that in recent years a number of SOEs have been established through corporatisation. The Israeli government's strategy has been to separate activities previously performed within Ministries and make them subject to the relevant corporate law, with a view to increasing competition between the state and privately held companies. For instance, the Israel National Roads Company was established in 2003 as an SOE to replace a unit of the Ministry of Transport, assuming responsibility for the inter-urban system, traffic management and control, as well as planning and maintenance of roads. The Israel Postal Company and its subsidiary, the Postal Bank, were established in 2006 to replace the Israel Postal Authority in order to enhance efficiency in the postal services and increase competition in banking and postal sectors.

1.11. The legal and regulatory framework applicable to SOEs

1.11.1. Legal framework

The legislative framework applying to Israeli SOEs (excluding statutory corporations) is two-or three-layered. The general Companies Law applies equally to SOEs and other incorporated companies, subject to the provisions of the Government Companies Law (GCL) of 1975[45] which applies to government companies, government subsidiaries and some of which also apply to mixed companies. Furthermore, listed SOEs have to comply with the Securities Law.

A major part of the GCL is dedicated to corporate governance questions, addressing issues such as the qualifications of directors; restrictions on directorships; the operation and responsibilities of the board; convening and voting at shareholders' meetings; the appointment of the general manager; and appointment and duties of auditors and legal advisers. The Law addresses the rights of private shareholders in SOEs, in particular minority shareholders, including in the context of changes in the government ownership share.[46] Dispute settlement between government utility companies is addressed specifically. The Law also deals with protecting the interest of the state in companies being privatised via mechanism of "vital interest" orders.[47] A golden share mechanism is established through the Securities Law.

The GCL stipulates that, in addition to complying with the Companies Law, a government company must operate in accordance with the same business considerations

as a non-government company.[48] In addition, some elements of the general requirements applicable to listed companies have been extended though GCL to even non-listed SOEs. A number of Sarbanes Oxley based reporting requirements, which have not yet been imposed on listed companies but adopted in SOEs and the Banks, have been recently imposed on SOE boards and management members, discussed in more detail below.

The options for legal recourse against a government company that are available to private investors and non-public stakeholders do not differ from what applies to other companies. Suits against an SOE can be filed as per the procedures stipulated in the Companies and/or the Securities Law (regarding listed SOEs), or when administrative issues are concerned a petition can be filed with the Supreme Court. As for disputes within the general government sector, a complaint with the Attorney-General's Office can be filed if one deems that there is Ministerial intervention in the company, beyond the limits defined in GCL or for whatever other reason that may arise. With respect to disputes between SOEs, the Attorney-General's Office has issued a guideline to facilitate resolution of disputes between SOEs or between an SOE and the State without resorting to legal action.

1.11.2. Regulatory requirements

In addition to the generally applicable legislation mentioned above, certain government and mixed companies are subject to further regulation and reporting requirements. As already mentioned, listed SOEs are subject to the Securities Law, including the additional disclosure requirements arising from this fact. The oversight of financial sector SOEs – currently comprising 8 provident funds (which are co-owned by the government and the various professional trade unions) and 3 insurance companies (for which ownership is entirely vested with the Ministry of Finance) – lies with the Capital Market, Insurance and Savings Division of the Ministry of Finance.

Several regulations implementing various provisions of the GCL have been issued by the Minister of Finance. The Government Companies Authority (the state-ownership agency – described below), which does not have the power to issue regulations pursuant to the GCL, issues regularly circulars, clarifying for instance, the accounting and audit rules. Most of these circulars are non-binding but rather carry an advisory function and some of them are binding and in accordance with specific provisions of the GCL, for instance regarding certain aspects of auditing and accounting rules. The GCA can request that the content of circulars is presented at board meetings of SOEs, therefore ensuring that the recommendations are implemented by SOEs.

The Israeli government sets objectives for individual SOEs at the time of their establishment and lays down these objectives in the company's articles of association. An overall ownership policy cutting across the SOE sector as foreseen by the OECD Guidelines is not formulated. However, several ownership policy issues relevant to all SOEs such as dividend policies are part of a general strategy established by GCA. Another example is arguably the government's recent decision to prescribe proficiency and suitability terms additional to those established by GCL.

1.12. The ownership function for SOEs

The Government Companies Authority (GCA) is the government body charged with exercising the ownership function in SOEs. The GCA was created in 1975 by virtue of the GCL as a unit of the Ministry of Finance responsible for exercising the State's ownership

functions *vis-à-vis* all government, mixed companies and government subsidiaries. The GCA acts on behalf of, and as an advisor to, the Ministers with whom the actual ownership function as holders of the shares of the SOEs is vested. The Ministers responsible for a particular SOE are the Ministry of Finance and the line ministry designated for the SOE by the Government decision regarding the establishment of the SOE. Both enjoy essentially equal powers with respect to the ownership function, having to make decisions by consensus except in specific provisions where the Minister of Finance is the sole authority.

The GCA derives much of its actual powers from provisions in the GCL making it mandatory for Ministers to seek the advice of the Authority before making a wide range of decisions.[49] The political dynamics and Israeli legal system make it difficult for Ministers subsequently to ignore the advice. While most operational decisions are implemented by the GCA on behalf of the Ministers, certain decisions (such as the appointment of directors) remain the direct prerogative of the Ministers. Their discretion in this respect is limited by a number of control mechanisms described in a later section. In a number of other matters such as the appointment of the Chairman of the Board and CEO appointments by SOE boards, Ministerial approval is required.

The GCA is a unit of the Ministry of Finance, employing 50 professional staff, mostly with a background in law, economics, accountancy and business. According to the GCA, it considers itself independent of the Ministry of Finance in several aspects and in accordance with its duties set for the GCA in the GCL. However, its Director is appointed by the government following a proposal by the Minister of Finance. Furthermore, its budget is defined separately, but within the overall budget of the Ministry of Finance. The Authority reports to the government through the Minister of Finance, and to the Knesset Finance Committee at least once a year and at its demand. Given these arrangements, the OECD has not been able to ascertain the degree of GCA's *de facto* functional independence from the Ministry, whereas the explicit powers granted to the Agency under the GCL should to a large extent safeguard its autonomy.

The responsibilities of the Authority are quite varied, including: advising the Ministers on matters concerning SOEs; advising/assisting SOEs in the management of their activities; dealing with matters related to SOEs in accordance with directives of the government; advising and assisting government companies in the conduct of their business; following up the activities of government companies and the implementation of their objectives; examining the reports submitted by government companies; dealing with formation, liquidation, and other reorganisation of government companies, and; advising the Ministerial Committee on matters connected to privatisation. The GCA is also tasked with monitoring the implementation of the State Comptroller's recommendations. In addition, according to the GCL, the GCA is required to perform, in respect to a government company, any function with which it is charged by the Government or the Ministers.

The Authority also possesses a range of powers with respect to the privatisation of SOEs. Namely, the GCA's Privatisation Unit is responsible for advising the "Ministerial Privatisation Committee",[50] formulating the annual privatisation plan, setting out methods of privatisation of specific SOEs, implementing privatisation resolutions, performing the sales on behalf of the State under the supervision of a special tender committee which includes also members of the Accountant General in the Ministry of Finance, and carrying out the privatisation transactions.[51] It possesses the authority to issue directives outlining the actions an SOE ought to take in preparation for the

privatisation resolution. The GCA does not have any decision-making power with respect to the privatisation of SOEs; such decisions are taken by the Ministerial Committee.

In practical terms, the powers and scope of authority of the GCA *vis-à-vis* government and mixed companies are also rather broad. The Authority has the right to convene board meetings,[52] issue reporting instructions, request information on the affairs of the company, and inspect its records.[53] Though the GCA cannot issue regulations to SOEs or otherwise legally oblige them to accept its recommendations, the Authority has the ability to dispute some decisions of SOEs where the interests of the State are seen to be at stake, as for example when it disagrees with the board's decision regarding profit distribution. In addition, certain decisions by government companies, such as the appointment of an external auditor or legal counsel require the Authority's approval. In a recent report, the Comptroller's Office has criticised the GCA for not making sufficient use of its powers *vis-à-vis* SOEs under its purview.

Some specific prerogatives lie outside the scope of authority of the GCA or the line ministries. For example, the responsibility for establishing the rules for the compilation of financial reports of SOEs (limited to those "providing an essential service to the public") are exercised by the Minister of Finance after consultation with the Minister of Justice, and appointing members of the "Committee for Selection of External Auditors for SOEs" are shared between the Ministers of Finance and Justice. Furthermore, certain decisions are considered beyond the ministerial decision making power, instead requiring the approval of the government and/or the Knesset. For instance, the formation of a government company requires a decision by the government, accompanied with an opinion of the GCA.

An additional arrangement applies to financial sector SOEs. These companies are subject to dual supervision by the Division of Capital Markets, Insurance and Savings Division of the Ministry of Finance and the GCA. They are subject to the GCL as well as sectoral legislation applying to provident and insurance funds. The governance arrangements in these SOEs are relatively similar to other SOEs, with some relevant differences such as dual review process of nominations for directors by the MoF and in accordance with the GCL.

1.13. Recent and ongoing reforms of the SOE sector

Recent reforms of the SOE sector have been introduced primarily via the circulars issued by the GCA as well as through government regulations promulgated by the Minister of Finance. The emphasis of recent reforms has been – consistent with the general approach of the Israeli government – on increasing the transparency of the SOEs, both in terms of their activities and their reporting on those activities. A number of reforms have occurred following audits conducted by the Comptroller's Office which have led the latter to make recommendations to the GCA on the necessary procedures to minimise the risks of nepotism, inside interference in staffing decisions, political nominations and other types of intervention by the Ministers. Box 2.2 describes in detail the role of the Comptroller's Office in the reform process of the Israeli SOE sector.

In line with recommendations of the Comptroller's Office, a number of recent reforms have focused on eliminating nepotism, perceived in the past to be an issue in some SOEs. In particular, the "Rules for Employment of Relatives" prepared by the GCA, and issued by the Minister of Finance in 2005 deal precisely with this matter, severely restraining the possibility of relatives to be employed in the same company, in particular when a relative

of the applicant is employed in a senior position or when the position to be filled is a senior one.[54] In addition, the regulations specify that in the report filed by the Chair of the Board to the GCA, the company shall include details regarding employment of relatives such as their number, positions, etc.

The Israeli government has taken steps to improve the transparency of financial and non-financial disclosure and requires management sign-off on the various reports. Since the introduction of the government companies regulations on "*Additional report concerning actions taken and representations given for assuring the propriety of the financial reports and the director's review*" in 2005, the chairman of the board, the CEO and the CFO of government companies and subsidiaries are required to sign a declaration attesting to the propriety of the financial reports. These regulations resemble Section 302 of the Sarbanes-Oxley Act.

Box 2.2. **The office of the State Comptroller**

The State Comptroller's office is an important institution for the oversight of the government sector, including the SOE sector in Israel. According to Israel's State Comptroller Law (1958), the Comptroller is charged with auditing government companies, government subsidiaries, some mixed companies, statutory corporations, as well as the GCA itself. The State Comptroller decides on the subjects to be audited, apart from cases when it is requested by the Knesset, the Knesset Committee for State Audit Affairs, or the Government to submit an opinion. Given its function as the auditor of Israeli government Ministries and any entity where the State has an interest, its institutional independence has been guaranteed in both the Basic Law and in the State Comptroller Law.

The State Comptroller Law provides a basis for the State's audit function and vests the Comptroller's office with a broad range of responsibilities in terms of both the categories of bodies subject to state audit and the comprehensiveness of the audit. The Law includes a number of elements of audit in a traditional meaning of regularity and legality, as well as efficiency and moral integrity considerations. The Comptroller has a wide range of powers to investigate the operations of any SOE and can request that the audited body submit any documents deemed to be relevant to the audit. Audited entities must also put in place a team to address deficiencies; this team is appointed by the board of directors of the company. In instances when its audit findings reveal significant deficiencies, the Comptroller's Office has the option of bringing the matter to the attention of the Minister concerned and to the Prime Minister. While the Comptroller enjoys some powers of inquiry, s/he does not have the administrative authority to enforce laws or apply sanctions.

In addition to audits of individual SOEs, the Comptroller's Office has in recent years issued a number of topical reports on the operation of the SOEs sector, dealing with issues such as political appointments, nepotism, and audit standards. A number of recommendations emanated from these reports, and as a result of their implementation by the GCA and the individual SOEs, the prevalence of these practices within Israeli SOE sector has dramatically declined. For instance, the Comptroller's Office has recommended the implementation of audit principles and director certification requirements, similar to those outlined in ss. 302 and 404 of the Sarbanes-Oxley Act. As a result, additional regulations have been put in place, according to which managers of government companies are to sign a manager's declaration, and large government companies are to issue an additional report on the effectiveness of internal controls of financial reporting.

Further to this measure, another government companies regulation ("*Additional reports regarding effectiveness of internal control over the financial reporting*", 2007) has been adopted, requiring government companies which reach a certain threshold size[55] to attach to their annual reports an additional disclosure dealing with the effectiveness of the internal control over financial reporting. This report is to describe significant weaknesses (if any) and include signed statements from each of the corporate officers mentioned above who have signed the declaration pledging the propriety of the financial statements and the Directors' Report. This additional disclosure is also to indicate all the changes that have taken place in the preceding year which had, or were likely to have, a significant impact on internal auditing. A report from the company's auditor, which is to include the auditor's professional opinion regarding the effectiveness of internal control over financial reporting and any significant weaknesses identified, is to be attached.

Another objective of the reforms recently undertaken by the Israeli government has been to improve the professionalism of SOE boards. In general, board members representing the State in Israeli SOEs are appointed by the Minister of Finance and the Minister responsible for that SOE following a consultation and approval of certain aspects by the "Committee for Examining Appointments". The latter is charged with examining the suitability of the candidates required under the GCL, which outlines specific criteria each candidate must meet in order to be appointed as a director in an SOE.[56] Complementing this legislative framework, a government resolution adopted in 2008, prescribed additional proficiency and suitability terms in order to increase the professionalism of directors serving on SOE boards.

In addition to the proposed reforms of the Companies Law which will apply to SOEs, a number of reforms to the Government Companies Law and the regulations applicable to the SOEs are currently being considered. Box 2.3 elaborates on the main undertakings in this regard.

Box 2.3. **Key ongoing reforms of the SOE sector**

Following the report by the Public Corporation Council (2003) and by the State Comptroller's reports, a *proposal to create a uniform framework for the activity of statutory corporations* is being drafted by the GCA and the Ministry of Justice. There are further discussions about possibly bringing statutory corporations under the oversight of a special unit to be created within the GCA. The difficulty of putting such a framework into place lies in the fact that the nature of statutory corporations is radically different, making it difficult to subject them to a single legislation. Likewise, making GCA responsible for statutory corporations could be complicated by the fact that it would effectively make the Authority responsible for the Bank of Israel and the Israeli Securities Authority which are both statutory corporations. Also, currently the GCA is of the opinion that regulatory statutory corporations such as these should be exempt from this framework. This draft bill is currently being discussed with the relevant government entities.

A draft circular formulated by the GCA upon recommendation of the Comptroller's Office (2006) would compel all government companies to *develop individual ethics codes*. It is meant to reinforce some of the recently adopted measures aiming to improve the transparency and accountability of SOEs and could ultimately lead to a comprehensive framework addressing the appropriateness of all behaviour by a government company and its employees. The circular will potentially deal with a broad range of subjects including restrictions

Box 2.3. **Key ongoing reforms of the SOE sector** *(cont.)*

on employment of relatives, regulations for the selection of senior officials, the restriction on the provision of gifts above a symbolic amount, prohibition of receipt of favours by civil servants who serve as directors of government companies, equality of opportunity for female employees, etc. However, the recent global economic crisis and lessons learned from ethical codes around the world have prompted a rethinking of the circular and ethical codes more generally. The subject is now addressed by the 2009 work plan of GCA.

The GCA has prepared an amendment to the *Rules Regarding Remuneration and Expenses for a Public Director in Government Companies* (1994), proposing that its Director-General be authorized to award directors in government companies remuneration not only in relation to the meetings that they attend (as set out in the schedule encompassed in the current regulation), but also additional annual remuneration and reimbursement of specific expenses.

The GCA is preparing a *draft bill to amend the GCL*, enabling the GCA to publish reports and announcements submitted by government companies, similarly to the Magna system established for listed companies by the Israeli Securities Authority.

An *Amendment to the Tender Duty Regulations* has been published, which is expected to effectively; change the composition of the Tender Committee in government companies to comprise employees of SOEs only (not include members of the board); oblige the Tender Committee to report on any exemptions to the regular tender procedures to the Audit Committee; and add a mechanism to facilitate exemption from duty of tender of the engagement between the government and the SOEs operating on behalf of the government.

The State Comptroller's office has prepared and circulated a *draft bill which effectively enlarges the scope of SOEs which are subject to its audit*. In addition to companies currently subject to the audit of the State Comptroller (Box 2.2), the draft bill proposes that other categories of SOEs be added including for instance, government companies controlled by the State even if the latter does not participate in its management, government subsidiaries controlled by government companies, etc.

2. Ensuring a consistent regulatory framework

The first core corporate governance feature for the review calls for Israel to ensure a consistent regulatory framework that provides for the existence and effective enforcement of shareholder rights and the equitable treatment of shareholders, including minority and foreign shareholders.

2.1. The regulatory framework for corporations

Principle II.E of the OECD Principles of Corporate Governance states that "Markets for corporate control should be allowed to function in an efficient and transparent manner: *1)* The rules and procedures governing the acquisitions of corporate control in the capital markets, and extraordinary transactions such as mergers and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. *2)* Anti-takeover devices should not be used to shield management from accountability."

As mentioned earlier, 79% of Israeli listed companies have controlling shareholders. This obviously stymies the markets for corporate control, and hostile takeovers (and

therefore anti-takeover devices) have been virtually non-existent.[57] In the banking sector, unsolicited bids may not occur due to the 5% ownership caps established by law. Mergers and sales of control blocks (outside the banking sector) are not uncommon. It is not unusual for public companies as a precursor to ownership change to be voluntarily delisted, temporarily releasing the control-holder of the requirements of the Securities Law. In such cases, a formal settlement between the company and its shareholders must be established, and approved by courts and by 75% of the votes in a shareholders meeting.

Israel does not have a take-over law. The Companies and the Securities Laws set out the framework for mergers, sales of control blocks and other means of transfer of control. The Companies Law establishes two thresholds which necessitate the issuance of a tender offer (25% and 45%, respectively).[58] The tender is accepted on the condition that it is approved by a majority of shareholders who are not affiliated with either principal or controlling shareholders of the offeror. The Law further requires shareholders acquiring 90% or more of the equity in a company, to issue a full tender offer. If the tender is accepted and less than 5% remains in the hands of minority shareholders, the Law mandates a squeeze-out.[59] As mentioned in the landscape section, an amendment relating to tender offer procedures is pending.

Tender Offer Regulations (2000) include additional provisions primarily relating to the procedures for making a tender offer. According to these regulations, the offeror must make available to the tendered company, the TASE and the ISA all the relevant details regarding the proposed transaction. The ISA has the powers to declare the submitted documents as insufficient and require the offeror to amend them or postpone the transaction date. Should the transfer of control be conducted in breach of these regulations or applicable laws, excess voting rights are considered void so long as they remain in the hands of the violating party, and can constitute a basis for a civil suit by the other shareholders. Israeli case law provides evidence of the application of these laws of regulations, as well as reliance by the judiciary of the shareholders' duty to act fairly to the company.

Principle II.F states that "The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated: 1) Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. 2) Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments."

Though institutional investors are not explicitly required to have a voting policy, some investors have done so voluntarily. A recommendation requiring institutional investors to establish a voting policy is being currently considered. In any event, institutional investors are required to participate in shareholder meetings of public companies on matters involving related parties and those which in their opinion may be of consequence to their ultimate clients. In addition, they are required, by the respective laws and regulations applicable to them, to disclose their voting decisions in such meetings.

The Committee for the Examination of the Necessary Steps for Increasing the Involvement of Institutional Investors in the Israeli Capital Market (known as the Hamdani Committee) released its recommendations in 2007. Among key proposals were the following: 1) establishing a list of matters on which institutional investors would be

required to vote, instead of giving them discretion over participation in certain meetings, *2)* increasing the involvement of institutional actors in appointments of external directors, *3)* requiring institutional investors to establish a voting policy, and 4. encouraging them to receive advice on voting recommendations from professional entities. The respective regulators of institutional investors are now considering these recommendations, especially extending/specifying the matters on which institutional investors be required to vote.[60]

In terms of managing conflicts of interest by institutional investors, the Bachar reform (forcing banks to divest their investment services in institutional investors) significantly reduced the risk of conflicts of interest of fund management companies. Other regulations have been introduced to assure that the conflicts of interests by institutional investors are managed.[61] However, there is no explicit requirement for institutional investors to disclose how they manage material conflicts of interest. The ISA is currently working on an update to the *Joint Investment Trust Regulations* which would require the fund managers to also disclose how their voting decisions were reached, as well as the methods used to ensure that there was no conflict of interest. This is an important point since: *1)* a number of institutional investors still belong to corporate groups, and *2)* institutional investors continue to provide services to companies whose shares they are required to vote. However, this issue is expected to be resolved in consequence of the pending legislation (mentioned earlier) authorising the Minister of Finance to issue regulations regarding the participation of fund managers in general meetings.

Principle II.G states that "Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse."

The Israeli legal framework does not specify any mechanisms or procedures which would prevent shareholders from consulting each other. Shareholder consultations must respect the requirement in the Companies Law that shareholders avoid discriminating against other shareholders, that they must act in good faith and in customary manner in exercising their duties towards the company and other shareholders, and that a controlling shareholder must act fairly towards the company.

In the case of institutional investors, the situation is more complex. On one hand, corporate legislation has no specific provisions that deal with the rights of institutional shareholders to consult one another. One the other hand, the existing anti-trust legislation may effectively prevent consultations. The Hamdani Committee recommended that the Anti-trust Authority consider the possibility to issue exemptions covering this type of collaboration, a proposal which as mentioned above is currently being reviewed by the Authority. In addition, as mentioned in the assessment under the *Principle II.D.,* certain fiscal advantages maybe unavailable to institutional shareholders if they are considered to constitute a controlling block. Discussions with institutional investors revealed informal consultations between institutional investors do occur, particularly on issues such as confronting majority owners at shareholder meetings.

As a part of ISA's programme to address the financial crisis, it has examined matters that may inhibit or constrain various parties from reaching agreement on the refinancing of payment obligations to bondholders. The ISA together with the Anti-trust Authority agreed that in such cases a Representative Forum shall be set, where three of the largest

bond holders of a given bond issue (usually institutional investors) can co-operate and can appoint an Officer who will negotiate/ restructure the debt on their behalf.

Principle III.A (1) states that "All shareholders of the same class should be treated equally. Within any series of class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected."

Companies offering their securities to the public cannot issue shares of different classes (with the exception of preferred shares and golden shares). However, as mentioned earlier, a total of 8 listed companies still had dual-class shares issued prior to the enactment of this rule which have not been subsequently unified. The Companies Law provides that the by-laws may not be amended in a manner that adversely affects the rights of shareholders of a class of shares without the approval of a meeting of that class of the shareholders. Shareholders of any company have access to companies' by-laws through the Companies Registrar. In addition, investors in public companies have information on all company filings, including changes to the by-laws, through the MAGNA database.

Principle III.A (2) states that "Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress."

The Israeli corporate governance framework puts significant emphasis on the protection of minority shareholders. First, the duties of ordinary shareholders under Israeli law (to act in good faith and customary manner, not to discriminate against other shareholders) and of controlling shareholders (the duty to act fairly) are defined not only towards the company, but also towards other shareholders. Second, a number of shareholder approval mechanisms have been incorporated in the Companies Law. As a first measure, extraordinary transactions[62] involving controlling shareholders (or parties connected to them) must be approved by the audit committee, the board of directors and the shareholders. The approval of the shareholders meeting is valid only if less than one third of the "disinterested" shareholders vote against, or if the opposing votes account for less than 1% of the voting rights.[63] Shareholders who participate in a vote on an extraordinary transaction are required to notify the company whether or not they have a personal interest in its approval.

In addition, the Companies Law outlines a set of specific transactions, including significant private placements and transactions with company office holders which also require the approval of the board of directors, followed by the approval by the general meeting and the audit committee. Transactions involving company directors and officers such as those concerning employment terms must be approved by the board of directors and the audit committee. Transactions between public companies and controlling entities (or parties connected to them) must be approved by the board of directors, the audit committee, and must be ratified by a majority of shareholders which includes at least ⅓ of its minority shareholders.

The *ex-post* legal protection of shareholders relies mainly – since the relevant provisions are set down in the Companies Law – on civil enforcement. Shareholders' access to individual redress in case of a director's perceived breach of duty is limited to complaints about disclosure or attempt to defraud, which are both also criminal violations under the

Securities Law. In most other cases action must be taken through derivative suits or class action suits, due to the fact that office holders' fiduciary duty and duty of care are defined toward the company rather than the shareholders. The Companies Law may be said to encourage derivative action by limiting the financial liability of plaintiffs. The ISA has suggested an amendment to the legislation which would allow it to financially support derivative actions in addition to existing similar provisions regarding class action suits.

As explained above, the filing of both derivative and class action suits requires court approval. This approval process is not a trivial point: some of the practitioners and academics consulted suggested that one of the weakest points in the protection of minority shareholders is the difficulties associated with filing of derivative suits (from a cost and timing point of view).[64] To remedy this situation, the Goshen Committee has proposed that a court of Securities and Companies Law litigation be introduced. While this proposal has not been implemented, the establishment of a division to deal with matters of commercial adjudication within the Tel Aviv District Court has been more amenable to all involved and, as mentioned above, is expected to be legislated in the near future.

Principle III.A (3) states that "Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares."

The shares in Israeli listed companies are mostly held via nominee companies, owned by the country's four largest banks. Any member of TASE Clearing House (including the four nominees) may act as a custodian to share holders. Under the Companies Law the person in whose favour shares are recorded in the TASE member's books is the true beneficial owner of the shares and therefore entitled to all the rights attached to the security – including voting rights.

In public companies, all shareholders whose ownership passes the threshold of 5% must be noted in the register of principal shareholders in the company's books and in the MAGNA (including shareholders whose shares are held by custodians or trustees). Both the beneficiary owner and trustee are considered to be shareholders for the purposes of dissemination of relevant data and disclosure requirements.

Beneficial owners can choose whether to delegate voting rights to the custodian/nominee or give instructions on a case by case basis regarding how to vote. In the latter case, according to *Proxy Voting and Position Statement Regulations* (2005), TASE members are required to supply proxy materials to shareholders of publicly traded companies for no consideration. Shares may be held in trust, in which case the right to vote is transferred to the trustee.

Principle III.A (4) states that "*Impediments to cross border voting should be eliminated.*"

According to the Companies Law, public companies whose shares are offered to the public in Israel only or which are traded only on an Israeli stock exchange must hold its general meetings in Israel. In order to facilitate cross-border voting, both private and public companies are required to allow shareholders to vote by proxy ballot in meetings which address the appointment and dismissal of directors, approval of transactions with controlling shareholders or officers, mergers, or in matters regarding the settlement between the company and its shareholders. Stock exchange members must distribute proxy materials to their clients prior to the shareholder meeting. In addition, companies can, but they are not required to, let shareholders vote via the Internet (provided that measures have been taken to secure the information). The Companies Law outlines

adequate periods for notification of general meetings, for issuing position statements and for the submission of proxy ballots (see assessment under *Principle II.G.*)

Principle III.A (5) states that "Processes and procedures for general shareholders meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes."

All owners of common stock in public companies are entitled to participate and exercise their voting rights in shareholder meetings. The legal framework seeks to ensure, to the extent possible, that such participation is not unduly costly. For instance, the confirmation of ownership necessary for voting is to be issued for no consideration. All registered shareholders must receive the voting paper and any statements of position that have been made. The Minister of Justice, in consultation with the Minister of Finance and the Securities Authority, may prescribe additional provisions regarding, *inter alia,* the maximum payment to be made for sending voting papers or statements of position. Given Israel's size, physical access is not considered to be an issue. The OECD heard anecdotal evidence of listed companies in the past trying to discourage the participation in shareholder meetings by choosing inconvenient timing and location, but this is neither seen as widespread nor as a serious concern.

Principle III.B states that "*Insider trading and abusive self-dealing should be prohibited*".

In the Israeli corporate governance framework, abusive self dealing is primarily dealt with by the Companies Law, which as described in the assessment under *Principle III.A. (2)*, establishes numerous approval mechanisms for transactions in which interested parties are involved. In abusive self-dealing transactions, shareholders would have *ex-post* recourse to civil remedies as specified in the assessment under the same Principle, either by suing directors or by engaging in a class action or derivative suit, as appropriate. In practice, the presence of private companies in pyramids, which are subject to much more limited disclosure requirements, could make it harder to detect and prosecute abusive self-dealing. As mentioned above though, the Israeli authorities have implemented provisions to ensure that private companies in publicly listed groups cannot be used as a shield for related party transactions.

With respect to insider trading, the prohibition on the use of inside information is a key provision of the Securities Law, which outlines criminal penalties for the use of inside information. These rules are stricter for insiders, in particular senior executives, who under certain circumstances may have the burden of proof to avoid conviction. The Law defines inside information broadly[65] and does not restrict its use to "insiders" strictly speaking. An amendment which came into effect in 2007 extends the use of "insider information" to derivative financial instruments. Moreover, the Law establishes the definition of an "insider" rather expansively, covering not only corporate officers, but also any party who has relations to the company such as consultants and accountants or their family members.

ISA's Department of Supervision of the Secondary Market monitors the trading on TASE, which is facilitated by the automatic control systems developed by the securities supervisor. A review of the annual reports of the ISA demonstrates an enforcement record, including successful prosecutions. In 2007 alone, 4 criminal indictments were filed by the Tel-Aviv District Attorney's Office following the investigations carried out by the ISA, and over 30 cases were awaiting trial at various stages.[66] The ISA has been involved in a number of important cases in which governance related matters were at the heart of the

dispute. A particularly important case which was adjudicated with the involvement of the ISA is the *State vs. Shlomo Eisenberg case* (1995) where the defendant was convicted on 3 counts of aggravated fraudulent acquisition for obtaining the required special approval of a related party transaction under false pretences. This is considered to be an important precedent setting case in Israel.

Principle III.C states that "Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation."

According to the Companies Law office holders must refrain from any act involving a conflict of interest between their position and any personal affairs or any act involving competition with the business of the company. Additionally, they must refrain from taking advantage of an opportunity presented through the company's business with the aim of obtaining a personal benefit. An office holder or a controlling shareholder in a company who is aware that he has a personal interest in a given transaction is required to disclose this fact and any relevant substantial facts or documents without delay and no later than the meeting of the board of directors during which this transaction is discussed.[67] In addition, the Law requires that a director who has a personal interest in the approval of an extraordinary transaction brought to the audit committee and the board of directors for approval, may not be present at the discussion or participate in the vote, unless if most members in these organs have a personal interest in the approval of the transaction.[68]

2.2. Equitable treatment of shareholders in SOEs

While all elements of Chapter III of the SOE Guidelines on equitable treatment of shareholders are relevant, Annex A. suggests the particular relevance of **Guideline III.A:** "*The co-ordinating or ownership entity and SOEs should ensure that all shareholders are treated equitably.*"

The SOE sector in Israel is subject to general corporate legislation and the GCL which, *inter alia,* outlines the rights and duties of shareholders. The Ministers with whom the ownership function for a given SOE is vested have virtually identical rights to private shareholders. The Israeli law does not, except for specific circumstances, grant the state any special rights. These specific circumstances include instances where the State has a golden share or when it has issued a vital interest order in an SOE being privatised. According to Israeli officials both mechanism are very rarely used. No other control mechanisms are used by the state to affect the proportionality between its ownership and voting rights in SOEs.

Although the GCA has not developed explicit guidance for equitable treatment of shareholders, minority shareholder abuse in government companies does not appear to be of great concern. First, of the 69 government companies in Israel, only 11 have minority shareholders[69] and only one of these (the Mekorot Water Company) is designated as having a commercial orientation. Second, such concerns are addressed by the general legislative framework. On the specific issue of protection of minority shareholders against related party transactions, there are no special rules or procedures restricting transactions among SOEs, or between SOEs and other public entities. However, the relevant transparency requirements oblige companies to disclose such transactions, which are subject to review by GCA and the State Comptroller.

Provisions in the GCL require the state to offer to acquire the interest of minority shareholders[70] if a company is converted to a government company; if the state instructs the government company to act on the basis of considerations other than business considerations; or if government companies merge. In addition, aggrieved shareholders have recourse to the same legal redress mechanisms provided to shareholders in privately owned companies.

2.3. Conclusions regarding the rights and equitable treatment of shareholders

The assessment criteria related to the functioning of the market for corporate control are not of major importance since, due to the prevalence of company groups, there is not in reality much of a "market" in Israel. Should such a market develop over the years, the legal framework would seem – in principle – adequate to accommodate it. Provisions such as mandatory bid thresholds and squeeze-out rules do not appear inconsistent with those found in OECD countries. Moreover, information on block-holdings in individual public companies is made publicly available in real time.

The Israeli authorities clearly wish to encourage an "activist role" by the institutional investors, who have been repeatedly been called upon to act as informed minority shareholders *vis-à-vis* the controlling owners. One remaining obstacle is the conflicts of interest that inevitably arise in a small economy where the same fund managers depend for business on large corporations and the investing public. Industry representatives admitted to the OECD that this sometimes puts them in an uncomfortable position. To counter this, the Israeli authorities should continue their reform efforts aiming to impose voting and disclosure requirements for institutional investors – or at least, consistent with the OECD Principles, institutional investors that are subject to fiduciary duties. The authorities are moreover encouraged to address some current, apparently unintended, impediments to institutional investors consulting with each other concerning the exercise of their basic shareholder rights.

The key concern for the Israeli corporate governance framework is, and should be, the protection of minority shareholders. Considerable headway has been made in establishing *ex ante* mechanisms to prevent abuse, including a relatively broad definition of "interested parties", compulsory board and audit committee approvals of extraordinary transactions, and the approval of such transactions by a qualified majority of the shareholders. The Israeli authorities are encouraged to give continued consideration to a current proposal to tighten the latter provision to a majority-of-the-minority requirement, subject to adequate safeguards to prevent abuse. The practical implementation of these safeguards is a bit less certain. The widely held view in Israel appears to be that the extraction of private benefits within the corporate groups has not entirely receded, but that the practice has been rolled back significantly relative to practices a few decades ago.

Enhancing the *ex post* protection of minority shareholders is still work in progress. Difficulties in pressing derivative suits are noted by Israeli practitioners and the legal framework provides limited scope for individual suits and class action. The Israeli authorities are encouraged to proceed with the implementation of the draft law on the establishment of a specialised court instance as part of the Tel Aviv District Court.

3. Disclosure of corporate information

The second core corporate governance feature for the review calls for requiring timely and reliable disclosure of corporate information in accordance with internationally recognised standards of accounting, auditing and non-financial reporting.

3.1. The regulatory framework covering disclosure

Principle V.B calls for information to "be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure."

As of January 2008, all public companies in Israel are required to prepare their financial statements in accordance with IFRS standards, which have been adopted without any carve-outs. The application of IFRS is not enshrined in law but is based on ISA regulation. The big four accounting firms active in Israel have fully embraced IFRS based on IsASB's translation, as have smaller accounting and audit firms. In addition, the ISA periodically updates disclosure requirements.

The only exception to the application of IFRS standards is in the banking sector, reflecting a decision by the Bank of Israel to delay their application. In addition, certain exceptions to the application of the IFRS standards in state-owned listed companies exist.[71] Discussions are ongoing between the Israeli Accounting Standards Board (IsASB), the body responsible for establishing accounting standards in Israel, and the Bank of Israel regarding to adoption by banks of IFRS in 2010. For the moment, the US GAAP remains the relevant standard for banks. The Capital Markets, Insurance and Savings Division of the Ministry of Finance has delayed the adoption of IFRS in the insurance sector due to concerns related to sectoral reporting, but has recently accepted the standard. For private companies, Israeli accounting standards apply, which according to the IsASB is not substantially different from IFRS.[72]

Monitoring of the application of the relevant financial disclosure standards for public companies is conducted by the ISA.[73] The governing council of the Israeli Institute of Certified Public Accountants (ICPAS) may be involved by the ISA on any specific issue that may arise. The ISA monitors financial and non-financial disclosures of companies and may request that a company revise its financial statements. A review of ISA's annual reports over the last several years indicates its active involvement in pursuing cases of fraudulent or inadequate disclosure. In addition, remedial mechanisms for those who are harmed by inadequate or misleading disclosure are outlined in discussion of the application of the *Principle III.A.(2)*. These may take the form of either civil or criminal damages, depending on whether the matter deals with an attempt to defraud as opposed to a matter of insufficient disclosure.

Principle V.C focuses on the need for an annual audit to "be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects."

As discussed in the landscape section, every company in Israel is required to have an annual audit; auditors are to be independent of the company. In public companies, all the outside directors are required to be members of the audit committee; a holder of control or a relative of such person shall not be a member of the audit committee; and neither the chairman nor any director shall be its members.[74] Where an act of audit is deemed to be performed at a time when there were relations of dependence, an additional audit shall be

performed by another auditor. In addition to appointment of external auditors, the board of directors of a public company shall appoint an internal auditor at the proposal of the audit committee.

All auditors are required to obtain a CPA licence, for which specific criteria have been established. Professional guidelines regarding the conduct of accounting firms are set out in the Accountancy Law. Every new member of the CPA has to sign a contract committing to observe these guidelines. Israeli accounting firms are required to develop ethics rules; in addition, courses on integrity are offered through the CPA. The CPA is charged with regulating industry issues in terms of professional conduct and auditor independence.[75]

A body of ICPAS (the Members Review Board) carries out peer reviews, participation in which is compulsory for firms of certified public accountants that audit financial statements of public companies. ICPAS has discretion over the frequency of such reviews (no less than once every 3 years), with the reviews of the five largest firms being annual. Submitting to a peer review is compulsory to CPAs involved in auditing financial statements of public companies. Each auditing firm which does not consent to such a review has to make a public disclosure of this fact.

The work of this peer review process is recognised by ISA and the requirement that a public company rotate its auditors does not apply if the company agrees to open its books to peer review. ICPAS has a duty to notify the ISA of any violations uncovered during the review, while the ISA retains the right to advise ICPAS on any matters it wishes to have included in the review framework. The ISA is currently contemplating the formation of a public oversight accounting board, similar to the PCAOB in the United States, to further enhance the confidence of the public that audit of public companies regarding the quality of audit standards and their application.

3.2. SOE disclosure and transparency

Guideline V.D states that "SOEs should be subject to the same high quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose financial and non-financial information according to high quality internationally recognised standards."

The majority of Israeli government companies and subsidiaries are currently applying the generally accepted Israeli accounting standards that constituted the relevant standard for the Israeli corporate sector until a year ago.[76] Only those SOEs subject to the Securities Law and financial sector SOEs reporting to the Capital Markets, Insurance and Savings Division of the Ministry of Finance are subject to application of IFRS standards as of January 2008.[77] For non-listed and non-financial sector SOEs, the GCA has published a circular in which it requires government companies to prepare for the implementation of IFRS standards, but not yet to apply them in practice. The exact date of transition of IFRS standards has not yet been determined.

The GCA publishes, on an annual basis, a detailed circular specifying the types of reports required from a government company or a government subsidiary, along with the dates when such reports are to be submitted. Government companies and subsidiaries are required to submit audited financial reports including declarations of the managers and a directors' report,[78] report on the work of the Board of Directors, internal audit and internal controls, and a detailed budget performance report, all on an annual basis. A Comptroller's report in 2004 found that 22% of government companies had not submitted their annual

financial reports to the Authority on a timely basis and that some reports submitted were not in accordance with the GCA circulars and the accounting standards in force.

In addition, unaudited financial reports that include managers' declarations and a director's report approved by the board of directors, reports by the company's external auditor and detailed budget performance report must be supplied on a quarterly basis. If the GCA disputes the disclosure of details in financial reports or any other report, it can order the company to disclose the dispute and the Authority's position in it. A report of the Comptroller's Office issued in 2007 noted that the Authority does not make active use of this power and in general has been found to conduct its review of financial statements in an untimely manner.

The auditing standards applicable to government companies are similar to those applying to non-state companies. Moreover, the Authority's circulars contain additional requirements aimed at creating a higher standard among auditors of government companies. OECD discussions with external auditors of government companies indicated that both the external and internal audit systems were well functioning. The GCA selects external auditors for SOEs through a committee selection process, and auditors are subject to a mandatory rotation procedure. Assessment under Guideline I.C. provides a further discussion of the audit standards and independence of auditors.

Guideline V.C states that "SOEs, especially large ones, should be subject to an annual independent audit based on international standards."

All government companies are subject to external audits. They also have to establish internal audit functions, except for cases where GCA is of the opinion that not doing so will not harm the company's activity, which in practice is rare and applies only to small or non-commercial entities. All government companies and some mixed companies are subject to the audit by the State Comptroller.[79] In addition, the GCL and the government companies' regulations "*Rules Concerning the Commissioning of an Inspector by Authority*" (2005), enable the GCA to nominate an inspector to investigate the affairs of an SOE.

While the audit standards used for government companies and for private companies are largely similar, the procedure used for selecting auditors varies in some important respects. First, the rules for selection of external auditors are established jointly by the Ministers of Justice and Finance, with the approval of the Knesset Finance Committee. As per the GCL, the appointment of an auditor for a government company requires GCA approval. The OECD was informed that the "Committee for the Appointment of Accountants" was not appointed in certain periods in the past and as a consequence, some companies were employing accountants without the recommendation of the Committee and without approval of the Authority. Recently, the Committee was appointed and has resumed its work.

Over the past years, a number of government companies' regulations and GCA circulars have aimed to increase the professionalism and independence of auditors. For instance, government companies regulations "*Appointment of Auditors and their Remuneration*" (1994) complement the GCL, establishing additional provisions regarding the auditor's appointment procedure. The GCL and its regulations prescribe specific arrangements which are meant to assure the independence of internal auditors with a view to avoid potential conflicts of interest. The GCA has also issued a circular on "*Conflicts of Interest and Damage to the Independence of the Auditor as a Result of Another Occupation*" to complement existing regulations in the area of auditor independence.

Consistent with the overall supervisory approach over the SOE sector, the GCA and the state have strong powers of inquiry over the auditors. Under the GCL, the auditor is required to submit information on the company's affairs to the board of directors of a government company, but also to the Ministers and to the GCA. In addition, following recommendations contained in a 2008 GCA circular, the auditor is required to submit to the board of directors and to the Authority a discussion of the audited financial reports, which is to include findings of deficiencies, as well as comments on the internal auditing. Finally, the auditor can be required perform a special audit and submit a report on its results at the request of the Ministers or the GCA.

3.3. Conclusions regarding transparency and disclosure

Following the shift to IFRS standards in 2008 the accounting standards demanded of Israeli public companies are generally comparable to those in force in OECD countries. The non-application of IFRS in banking, while not a major concern, is nevertheless a potential source of confusion which should be addressed as soon as this can be reconciled with the concerns of financial supervisors.

The safeguards concerning the auditing of public companies, with quality controls largely reliant on peer reviews, are reminiscent of the arrangements in place in many OECD countries a decade ago. It should be noted that the direct oversight and participation in the process by the Ministry of Justice probably lends it "more teeth" than has been seen in many other jurisdictions. Nevertheless, the Israeli authorities are encouraged to continue their efforts to establish a public oversight accounting board with supervisory powers over the auditing profession.

As far as SOEs are concerned, the Guidelines recommendation that "large or listed SOEs should disclose… according to high quality internationally recognised standards" is only half-implemented, in that this applies to listed SOEs but not to others regardless of their size. However, it bears mentioning that the pre-existent national accounting standards (which most SOEs still follow) already incorporated most elements of the International Accounting Standards. An impression shared with the OECD by several Israeli accounting professionals is that the additional requirements established by GCA circulars provide for generally high statutory standards of financial disclosure in government companies.

A remaining problem has been that until recently the disclosure requirements for SOEs were not uniformly enforced; the Authority had not taken adequate steps to ensure that all companies prepare their reports on a timely basis and in accordance with the accounting rules. Following criticism by the Comptroller's Office, this problem has been largely addressed.

4. Separation of ownership and regulation

The third core corporate governance feature to be reviewed concerns establishing effective separation of the government's role as an owner of state-owned companies and the government's role as regulator, particularly with regard to market regulation.

4.1. Exercising ownership rights over SOEs

Guideline I.A calls for "a clear separation between the state's ownership function and other state functions that may influence the conditions for state-owned enterprises, particularly with regard to market regulation."

As mentioned earlier, the State's ownership function is vested with two Ministers and in most respects exercised by the GCA or subject to consultation with the GCA. The Israeli authorities suggest that this provides for an adequate separation of ownership and regulation: the regulatory function is entrusted to specialised units whose role *vis-à-vis* the SOEs is limited to issuing sectoral regulations. Regulation of SOEs is in an ideal situation contingent upon them operating in a regulated sector rather than being linked *per se* to government ownership. However, the reality could be more complicated, for instance since some SOEs often enjoy sectoral monopolies whereby the "sectoral" regulation remains a one-company issue. For this construction to be credible it calls for strong Chinese walls to be erected within the relevant ministries.

Reflecting this – and perhaps also in preparation for more competition in the network industries – an important recent trend has been the creation of autonomous sectoral regulators. As an illustration, following the creation of the Water Authority, all the regulatory powers over the water sector and over the national water company, Mekorot, have been transferred out of the Ministry of Infrastructure. The Water Authority is independent of the Ministry, however its Council comprises Ministerial representatives (including from the Ministry of Finance). Arguably, this has weakened the risk of a politicised regulatory process but has not totally eliminated it. The reforms went hand-in-hand with a shift toward cost-recovery pricing in the water sector and the opening of the first steps of the sector's value chain to private providers through public-private partnerships.

A similar approach may be taken in the future by other government Ministries in order to place the ownership and the regulatory functions one step further away from each other. The Ministry of Transport has prepared a bill to establish a national transportation authority which would operate alongside, but not as a part of, the Ministry. Similarly to the Water Authority, one idea behind the change is to obtain a greater separation between the regulation and ownership functions of SOEs under the purview of the Ministry of Transport. The bill proposing this change has not yet been presented to the Knesset and government representatives estimate it could take over a year to make such an Authority operational.

With respect to the separation of the ownership function from entities which may be clients or suppliers of SOEs, standard procurement rules are thought to be largely adequate. SOEs seeking to procure supplies are subject to the Tender Requirement Law (1992) and the relevant regulations. As mentioned, certain exemptions from tender obligations exist regarding the engagements between the government and SOEs. The regulations include several other provisions regarding exemptions from tender duty obligations applying to SOE operating on behalf of the State, which need to be approved by the Tender Committee. The state's ownership of a government company does not confer it with special rights in its capacity as a consumer of this company's products or services.

Guideline I.B calls for governments to "strive to simplify and streamline the operational practices and the legal form under which SOEs operate. Their legal form should allow creditors to press their claims and to initiate insolvency procedures."

In Israel, SOEs (other than statutory corporations) can be established either as private companies or as listed entities. As noted, statutory corporations are formed by individual laws, a fact reflected in their governance arrangements as well as their legal form. The governance arrangements of statutory corporations vary significantly depending on the

laws establishing them – some of which having been implemented before the more recent reforms to improve the governance of SOEs. As also mentioned, a reform of the framework governing statutory corporations has been under consideration since 1992; the Israeli authorities are encouraged to continue their current efforts in this realm so that a consistent framework for their supervision can be established.

While in all other respects, including insolvency, the structure of government companies is not substantially different than private companies. However, the treatment of employees in government companies is subject to regulations which are naturally not applicable to private sector entities. Generally, the terms of employment of government companies' employees are determined in personal contracts and collective agreements. In addition, the GCL imposes an obligation on directors of government companies to determine the salary, social conditions, benefits and bonuses of government companies in accordance with existing government regulations, following a consultation with the GCA. Under the Budget Basic Law (1985), an SOE cannot agree to changes in the monetary benefits associated with employment unless this is in line with the regulations approved by the Minister of Finance.

Guideline I.C states that "Any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws and regulations ... and … should also be disclosed to the general public and related costs should be covered in a transparent manner."

Obligations for individual SOEs are mandated by legislation, government resolutions, or by formal agreements between government companies and the state. Additional performance requirements or public service obligations may derive from the actions of sectoral regulators, particularly in essential services and utilities sectors. Benchmarks for financial performance of individual SOEs are established by the relevant regulators, though discussions revealed that the GCA has not always followed up with individual companies on their realisation.

The regulations and legislation imposing public service obligations and other requirements to SOEs are publicly available. In addition, agreements between the state and government companies considered to the operating on its behalf (*e.g.* Dead Sea Sustainable Preservation Company or the Cross Israel Highway), are also publicly available. The OECD estimates transparency in this area to be generally high, particularly with regards to companies designated as operating for commercial purposes.

The Freedom of Information Law allows citizens to request information relating to the operation of SOEs, with exceptions for provident funds and a few companies which have been excluded for reasons of commercial confidentiality or national security.[80] The public has access to parts of the relevant information through the published annual and quarterly reports of listed government companies. A reform proposal recently put forth by the GCA suggests the publication of annual reports of all SOEs on its website. When adopted, this measure will further increase the transparency regarding the obligations and responsibilities of SOEs and their ability to fulfill these said obligations.

On the issue of covering costs in a transparent manner, Israel has apparently not progressed very far. The change of regulatory structures over the last 15 years has meant that the costs in connection with obligations imposed by the regulatory or other requirements on SOEs are mandated through transparent decision processes. However, the

OECD is aware of no efforts to identify actual costs incurred or cover them via public budgets.[81]

Guideline I.D states that "SOEs should not be exempt from the application of general laws and regulations. Stakeholders, including competitors, should have access to efficient redress and an even-handed ruling when they consider that their rights have been violated."

Israeli SOEs are not exempt from the application of any general laws and regulations that the OECD is aware of. The Companies Law applies to SOEs except when alternative provisions have been specified in the GCL, and listed SOEs are subject to the Securities Law. As mentioned in assessment in relation to Guideline I.A., sectoral regulation applies equally to SOEs as it does to private enterprises operating in regulated sectors. SOEs have no protection, either partial or complete, against bankruptcy or insolvency because of their status as government companies. Furthermore, other legislation applicable to the government sector such as the State Audit Law equally applies to SOEs.

The options for legal recourse against a government company that are available to private investors, stakeholders and competitors do not differ from what applies to other companies. Equally, government companies and their board members do not have special legal privileges such as immunity to lawsuits. Suits against SOEs can be filed as per the procedures stipulated in the Companies and/or the Securities Law. Complaints by aggrieved parties can be addressed through the court system; they also can be filed with the GCA and the State Comptroller's Office.

With regard to alleged grievances relating to the presence of a competitive level playing field between SOEs and private sector enterprises, the Anti-Trust Authority can be involved. That being the case, very few recent cases of anti-competitive behaviour by SOEs have been registered in recent years, in part possibly due to the fact there are only 34 government companies that operate with a commercial motive. Furthermore, competition in sectors where SOEs operate has been encouraged by the strategy of horizontal splitting of SOEs prior to privatisation.

Guideline I.F stipulates that "SOEs should face competitive conditions regarding access to finance. Their regulations with state owned banks, state-owned financial institutions and other state-owned companies should be based on purely commercial grounds."

One part of the Guideline is easily dealt with since Israel has no remaining state owned banks. The state is still a major share owner in Bank Leumi and would be in a position to influence decision making, but the OECD is aware of no indication of a "special relationship" between this bank and SOEs. Non-financial SOEs generally do not lend to each other. Trade credits between SOEs do occur but, do not seem to be a main source of finance.

As in several other aspects of SOE governance there is a difference between "normal" government companies, which pursuant to the GCL are required to act in accordance with the same business principles employed by other companies, and the ones designated by government and parliament as non-commercial. Generally government companies obtain loans on market conditions, the most common source being commercial banks. A limited number of companies have raised capital by issuing marketable and non-marketable bonds, likewise with interest rates and repayment terms according to market conditions. In rare cases, SOEs' ability to do this is has been circumscribed by law.[82]

SOEs whose principal objective is to supply the public with goods or services for non-profit purposes and in the interest of the State may benefit from state loans on

concessionary terms. In like circumstances companies may benefit from state loan guarantees. An example is the Israel Export Insurance Corporation (Ashra) which offers insurance to exporters against foreign commercial and political risk with the backing of the state. Government companies are required to disclose in their financial reports details of loans provided by the State or other SOEs.

4.2. Conclusions regarding separation of ownership and regulation

The separation of ownership and regulation in Israeli government companies is the subject of ongoing reform. The growing prominence of GCA has deprived the sectoral ministers of most of their direct influence on SOEs, but residual powers do reside with Ministries that in many cases also have regulatory roles to play. The recent trend to establish autonomous sectoral regulators – which while not totally independent are nevertheless an arm's length further from the political process – must be considered as an encouraging development.

The legal form and operational practices under which Israeli government companies generally operate is close to that of private companies – by virtue of the fact that both are subject to the general Companies Law. The fact that a number of government companies are designated as "non-commercial" is not seen as problematic as these companies fulfil tasks that would have been pursued by unincorporated entities in most other countries. A small number of statutory corporations pursue commercial tasks and the Israeli authorities should arguably consider their incorporation subject to the GCL. More generally, the authorities might want to consider simplifying the current structure of commercial and non-commercial government companies, and commercial and non-commercial statutory corporations, into just two groups of SOEs divided according to their degree of commercial orientation.

There appears to be a reasonably high degree of transparency around any non-commercial objectives placed on Israeli SOEs. Most of the largest remaining (commercial) government companies are subject to sectoral regulations, through which public service requirements, etc. are established. Moreover, the consolidated annual reporting by GCA covers the objectives of individual SOEs, and the Israeli Freedom of Information Act secures the public a generally high degree of insight. However, the cost of such "non-commercial objectives" is apparently not assessed or disclosed, nor are they subject to specific coverage in public budgets.

There is no indication of commercially operating government companies obtaining concessional financing. In the absence of state-owned banks and with SOEs rarely extending trade credits to each other such finance would have to be extended directly by the government. The government normally only does this to provide operating funds to SOEs whose principal objective is to pursue non-profit purposes or otherwise operate in the interest of the state.

5. Ensuring a level playing field

The fourth core corporate governance feature concerns ensuring a level playing field in markets where state-owned enterprises and private sector companies compete in order to avoid market distortions.

5.1. The role of the regulatory framework

Except for some relatively rare exceptions, commercially-oriented SOEs are subject to a legal and regulatory framework that encourages competition. They are subject to Israeli

competition legislation to the same extent as privately owned companies. There have been no recent major investigations or action by the Anti-trust Authority pertaining to the question of a level playing field between SOEs and private enterprises, except for an instance where Bezeq, in which the state still has a minority stake, was concluded to have abused its dominant position *vis-à-vis* a new market entrant.

As mentioned in the assessment in relation to Guideline I.F., SOEs face competitive conditions regarding access to finance. And, as mentioned in the assessment relative to Guideline I.D they are not exempt from the application of general laws. Listed SOEs are subject to compliance with the Securities Law.[83] Any obligations that an SOE is required to make beyond the generally accepted norm have to be approved by the Knesset.

That being said, many SOEs, especially in the utilities and network industries, operate as monopolies or oligopolies and effectively do not face competition. This issue has in particular been recently raised by the Anti-Trust Authority in the case of Mekorot (the national water company), where it felt that the Ministries of Infrastructure and Finance did not attempt to maximise competition in certain sectors such as re-use of treated water. As mentioned, the Israeli government is taking steps to introduce greater competition in some sectors by means of privatisation. The process usually involves restructuring the companies while they are still SOEs and breaking them up (as the case may be, vertically or horizontally) prior to privatisation.

In other instances where monopolies are likely to persist, the responsible Authorities have taken steps to vertically separate activities and encourage competition in certain segments. In the case of the Mekorot water company, it retains a nation-wide monopoly on the transport and distribution of water, but new desalinisation plans are built as public-private partnerships following competitive bidding processes among interested private parties.[84]

Deficiencies in implementation of this core feature might arise in relation to statutory corporations that operate with a commercial orientation since they are not subject to the provisions of the Companies Law – including its stipulation that companies are to operate for a profit motive. Statutory corporations have been established by virtue of specific laws, which do not necessarily encourage them to be competitive in the sectors in which they operate. In addition, the fact that the framework of supervision of government companies still raises some concerns regarding the separation of the state's ownership and other functions, could give rise to among other things concerns about a level playing field.

5.2. Conclusions regarding level playing field

Concerns about lack of a "level playing field" do not appear to be very common. Compared with a not-too-distant past of subsidised SOEs operating in competition with other enterprises, Israel has come a long way in privatising operations suited for a competitive environment, and subjecting the rest to the rigours of the general company and competition legislation. The Israeli authorities are encouraged to continue their efforts to introduce competition to the relevant segments of the utilities and network industries.

Some lingering doubts relate to the designation of certain SOEs as being non-competitive although the commission-based procedures involved in this appear reasonably transparent. Also, as mentioned above the actual "non-competitive" companies are mostly involved in that would in many countries not even be considered as corporate activities. Statutory corporations with commercial orientation, though not numerous,

remain a concern and – as concluded elsewhere – the Israeli authorities are invited to continue their efforts to subject these entities to a more competition-encouraging regime.

6. Stakeholder rights and boards of directors

The fifth core corporate governance feature to be reviewed calls for recognising stakeholder rights as established by law or through mutual agreements, and the duties, rights and responsibilities of corporate boards of directors.

6.1. Stakeholder rights

Principle IV.A states that "The rights of stakeholders that are established by law or through mutual agreements are to be respected."

The Israeli Companies Law defines the objectives of a company quite broadly: "The purpose of a company shall be to operate in accordance with business considerations in maximising its profits, and within the scope of such considerations, the interests of its creditors, its employees and the public may *inter alia* be taken into account…". This is a key provision referring to the stakeholders within the body of corporate legislation in Israel.

Other provisions in the Companies Law dealing with the rights of stakeholders focus entirely on creditors. The latter enjoy specific safeguards in the case of dividend distribution and corporate mergers. Other provisions bear on lifting the corporate veil in case of doubts about dishonest or discriminatory treatment of creditors. In addition, Securities Law regulations require disclosure of certain matters concerning environmental protection in prospectuses and companies' annual reports. The ISA is currently considering including additional disclosure requirements in this area in the securities legislation.

Issues of company treatment of other stakeholders are addressed in separate legislation (*e.g.* employee relations are address as part of the Labour Law). Employee rights are enforced through a specific Labour Court, which appears to provide a high degree of protection to employees, insofar as a number of corporate governance practitioners told the OECD of concerns about a perceived pro-employee bias. The direct involvement of employees in corporate governance (such as employee board representation) or environmental clauses (such as regular "green reporting") as seen in some OECD countries are not mandated by Israeli law.

Non-governmental initiatives complement the existing legal framework. Maala, an NGO established to promote corporate social responsibility practices in Israel, has developed a "social management" code which makes reference, among other issues, to community relations, environmental issues, workplace and social accountability. The Tel Aviv Stock Exchange has created a Maala Index which selects the top 20 large public companies based not only on their financial performance but also on their employee relations, contribution to the community, etc. Maala enables companies that participate in the ranking (public companies and approximately 50 private companies in 2006) to review their performance relative to the industry standard and features tools and processes to enable them to improve their performance.

Principle IV.B states that "*Where stakeholders' interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.*"

It follows from the assessment of Principle IV.A that the Companies Law, while acknowledging the broader interest of stakeholders, generally provides legal recourse only

to creditors. The Class Action Law permits stakeholders to bring a class action for any cause of action stemming from a connection to a security, as well as any suit involving environmental damage, as well as in relation to employee or customer protection issues. Stakeholder suits are adjudicated through the normal court system. Stakeholders whose claims do not exceed NIS 8,000 can apply to the small claims court to hear their claims heard.[85]

Principle IV.E states that "stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this."

Draft legislation and regulations currently being considered by the ISA and the Ministry of Justice generally seek to enlarge the scope of work of the audit committee, as well as to strengthen its mandate and independence. Among the proposed additional responsibilities of the audit committee is the responsibility for setting procedures for handling employee grievances about deficiencies in the management of the company. The amendment also seeks to establish protection for employees.

Regulations applicable to companies in the financial services sector already provide that the audit committee shall establish procedures for protection of anonymity for employee whistleblowers who file complaints in relation to the financial statements, internal control and illegal acts. In general, the *Employee Protection Act (1997)* prohibits employers from dismissing or adversely affecting the conditions of employees who have submitted or helped others to submit complaints against the employer or a fellow employee. In such cases, the burden of proof is placed on the employer.

When implemented, the proposed provisions will ensure that employees acting as whistleblowers will have their rights protected. In this respect, it must be noted however, that the current proposal does not refer to stakeholders other than employees. Secondly, the proposed mechanism does not establish a mechanism for filing such complaints with an independent member of the board. This area is a work in progress for Israel.

Guideline IV.A states that "*Governments, the coordinating or ownership entity and the SOEs themselves should recognise and respect stakeholders' rights established by law or through mutual agreements, and refer to the OECD Principles of Corporate Governance in this regard*."

Stakeholders' rights in Israeli SOEs are embedded in legislation, supplemented with private agreements. Civil remedies are available to stakeholders who consider that their legal rights have been violated, including private lawsuits and class action. The protection of government companies' customers and creditors is established by the general Companies Law and does not differ from the rules applying to privately owned companies.

Specific rules relate to employee representation on boards, women and minority groups in government companies. Two employee directors are appointed by ministers from among six candidates elected by majority vote among the SOE staff.[86] The employee directors are subject to the same duties and rights as any other director and the requirements that the GCL places on nomination of directors of directors does not apply to them. Legislation aimed at securing women a suitable representation at all positions in the public sector (Equal Rights for Women Law, 1951) applies to SOEs as well. Furthermore, GCL establishes a legal requirement concerning "suitable representation given to the Arab population on SOE boards". Until this is achieved ministers shall appoint, as far as possible, directors from the Arab, Druze and Circassian population.

The public has access to information about SOEs' stakeholder relationships through the mandatory directors' reviews that companies submit annually to GCA, which must be available to the public under the Freedom of Information Law. The reviews must, pursuant to circulars issued by the Authority, include details of companies' environmental impact as well as their "material environmental investments."

Guideline IV.C states that "The boards of SOEs should be required to develop, implement and communicate compliance programmes for internal codes and ethics. These codes of ethics should be based on country norms, in conformity with international commitments and apply to the company and its subsidiaries."

For the Israeli authorities this area is work in progress. As alluded to in the landscape section, one of the main remaining concerns about SOEs relates to the risk of nepotism and employee insider power in individual companies.[87] As also mentioned, several steps have been taken to remedy this, but what still remains to be done is consolidating GCA's thinking into a circular mandating the preparation of an ethical code by individual SOEs. It should, however, be noted that a number of large SOEs have already on their own elaborated such codes.

A draft circular concerning the ethical code has been drawn up based on the principles of Section 406 of the Sarbanes Oxley Act (SOX) and on the directives of the US Government Accountability Office for similar enterprises in the United States. The draft ethical code will include the following subjects which are currently covered by a number of circulars: regulations for the employment of relatives; regulations for the selection of senior officials; SOX 302; the encouragement of ethical standards in public service; a restriction on the provision of gifts above an amount threshold; regulations and procedures concerning conflicts of interest; prohibition on the receipt of favours by civil servants acting as directors, etc. Under the draft circular, once government companies adopt the ethical code they will be required to display the text of the code on the company's website and make reference hereto in future directors' reviews.

6.2. The rights, duties and responsibilities of boards of directors

Principle VI.A states that "Board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interests of the company and its shareholders".

As mentioned, the Companies Law stipulates that directors owe a duty of care and fiduciary duty to the company. In addition, board members are required to act in good faith and for the benefit of the company, including refraining from: any act that involves a conflict of interest, acts involving competition with the company's business, taking advantage of a business opportunity of the company with the aim of obtaining a benefit. Directors are required to disclose to the company all information relating to any interests which reaches him/her by virtue of his position in the company.

Since directors' fiduciary duty is defined towards the company, it can be redressed by shareholders mostly through a derivative action, though civil suits are technically also possible. Only if the breach of duty relates to disclosure or an attempt to defraud, which are both violations of the Securities Law, is it possible to file individual or class action suits against directors. However, the filing of derivative and class actions requires court approval and is currently seen as cumbersome. Reflecting this observation, the number of derivative suits in Israel has been limited. The proposal to allow the ISA to finance derivative actions

and the establishment of a division for commercial matters within the Tel Aviv District Court are intended to further encourage investors to resort to this redress mechanism. Already, shareholders can apply to the ISA to assist them with derivative actions through the discovery process.

The area of board responsibility, especially with regards to the nature of directors' fiduciary obligations, is covered by an extensive case-law. An often cited case is *Geldaliah Buchbinder v. the Official Asset Receiver, Civil Appeal 610/94*. In this case, Bank North America was seized by the banking supervisor following which evidence of fraud and deception by management surfaced. The official receiver filed a civil complaint against, among others, the Bank's directors claiming that they had failed in their fiduciary duties by not sufficiently monitoring the process of giving credit, failing to act and displaying negligence with regards to arrangements to regulate the Bank's share prices. The Supreme Court upheld a lower court award that the directors personally must bear the Bank's damages, noting "the duty of care… imposes on the director the duty to take all reasonable precautions in order to prevent damage to the company. The director's duty is not absolute. He is not the company's insurer. The duty imposed on him is to take reasonable precautions".

6.3. SOE boards and management

The issue of board independence and managerial autonomy is one of the more intriguing questions in the Israeli SOE landscape. It appears that as a result of the reforms of the last decades, SOE boards have acquired a large degree of statutory autonomy. However, SOE boards remain subject to a degree of monitoring and oversight that goes beyond what is found in many other countries. To some extent the reason for this appears to be historical. Less than a generation ago the Israeli SOE sector was perceived as a source of political patronage, as well as capture by entrenched interest groups within the SOEs that were often affiliated with parts of the political spectrum. Reflecting this, the Law continues to provide GCA with an array of concrete tools for monitoring performance and preventing abuse. Some additional safeguards were also introduced to prevent board and managerial resistance from interfering with the privatisation process.

Mechanisms enshrined in the GCL attempt to discourage Ministerial intervention in the board and management of SOEs. A fundamental principle of the GCL which aims to prevent Ministerial interference dictates that a government company shall act in accordance with the business considerations by which any other private company is guided.[88] A decision that a government company is to deviate from these considerations must be approved by the Knesset.[89] This provision has been introduced, *inter alia,* to ensure that SOEs cannot be used for industrial policy ends. Discussions held with management of selected SOEs revealed that they do not perceive government interference as an issue. That being said, the Attorney-General's office has received 4 complaints in the past 2 years concerning Ministerial nomination of officers and employees in several government companies.

Guideline II.C states that "*The state should let SOE boards exercise their responsibilities and respect their independence*". A related, specific point is raised by the last sentence in Guideline VI.C, which posits that "*[boards] should have the power to appoint and remove the CEO*".

The OECD noted a widespread assessment throughout the Israeli public and corporate establishment that the main remaining discretionary power with the Ministers *vis-à-vis*

SOEs (as opposed to aspects of the ownership function under the *de facto* daily control of GCA) is board nominations. However, the power of individuals is circumscribed by the fact that the branch Minister and the Minister of Finance have to decide by consensus. This arrangement has its value, however, it has resulted in situations where no director is appointed because the relevant Ministers disagree on the nomination.

A further control mechanism has been established in the form of a public *Appointments Examination Committee*, which must agree on the appropriateness of appointees (board members, chairmen of the board and CEOs), subject to a set of required qualifications established by law. The Committee needs to assure itself of the political independence of the proposed candidate. Persons with personal, business or political connection to one of the Ministers are not barred from becoming directors in SOEs, but a significantly more demanding set of qualifications is applied in this case. It ought to be noted that, according to recent reports by the State Comptroller, the Committee has not always fulfilled its role, in some cases relying on declarations by candidates and not verifying the accuracy of the information provided.

As already alluded to, the independence of directors in SOEs is enshrined mainly in fiduciary duties toward the company in the Companies Law. In other words, it would be unlawful for directors to make decisions that are not motivated by profit maximisation subject to applicable laws and regulations. In consequence, control mechanisms that have been seen in some countries such as written instructions on how to vote in board meetings cannot be employed. Similarly, SOE directors who are employees of government ministries cannot be requested to violate corporate confidentiality in the interest of informing their Ministers. If the ownership function wants immediate influence on a SOE board then the main formal mechanism is to convene an extraordinary shareholders meeting and put the matter to the vote. In this case the Law establishes that the Ministers assume the board's duties. This mechanism has been used once in recent years in the context of a privatisation case.

Departing from the statutory independence conferred on SOE boards by laws, it must be noted that board members are subject to relatively wide-ranging disclosure requirements *vis-à-vis* the ownership function. Both board members and the CEO can be required to supply information and material relating to the company's affairs individually to GCA – including, in the case of board members, details of their voting record. When combined with the fact that GCA is entitled to add a topic to the agenda of the board of directors meeting in a government company, this mechanism allows the ownership function at the same time to direct the discussions and to monitor directors' response.[90] The Ministers, after consultation with GCA, or the Authority itself are entitled to dismiss a director who does not fulfil his function properly, including in the context of carrying out the government's privatisation decisions.

Hence, the usefulness of directors' fiduciary duties in preventing undue government influence could in practice hinge on the parties' respective views of the good of the company. It should, however, be remembered that the government powers mentioned in the previous paragraph relates to directors on behalf of the state, not external directors and employee representatives. As for the former, it bears noting that GCL regulations provide that directors who are also public officials, are not entitled to receive remuneration from the company. While formally motivated by a need to avoid self-serving behaviour by public sector insiders, such provisions would seem to make sense mostly in a context where

public officials are considered as performing their SOE board duties in the line of their ordinary ministerial responsibilities.

Guideline II.B states that "The government should not be involved in the day to day management of the SOEs and allow them full operational autonomy to achieve their defined objectives."

It is difficult to assess exactly how strong the Israeli government's *de facto* involvement in the day to day management of SOEs is or could potentially be. Purely *de jure,* the scope for interference is very limited. However, since the Israeli framework for SOEs includes a relatively close monitoring of state directors on SOE boards, as well as GCA non-voting observers in board meetings, the potential scope for tacit operational influence – if not directly then via board members – could be non-trivial. This observation is apparently corroborated by a recent finding by the State Comptroller that "in 2005-2006 the Minister of National Infrastructure submitted about 100 requests – directly or indirectly – to the Israel Electric Corporation to promote matters concerning the employment of certain workers in the company".[91]

Under the GCL, the government is not entitled to issue directives to a company's management and to intervene in its day to day operations – just as a controlling shareholder in a private company is not entitled to do so. However, GCA issues directives covering all matters concerning the propriety, transparency and reporting of companies' procedures, including the compilation of financial reports. Audit procedures and transparency standards are also the subject of directives.

Government company managers are required by law to employ independent discretion and act in the interest of the company. The law also imposes a requirement to show loyalty and an absence of conflicts of interest on directors and office-holders in government companies. These general stipulations are underpinned by a number of guidelines issued by the Attorney-General to Ministers concerning restrictions on their intervention in the management of government companies. Government companies and their office-holders are entitled to complain to the Attorney-General if they consider that there is an attempt to intervene. Further progress in this respect could be on the way due to a proposed amendment of the general Companies Law. According to information provided by the Israeli authorities the amendment will state that "a director will execute his voting powers in the board of directors and its committees independently and will not submit his discretion to others".

6.4. Conclusions regarding stakeholders and boards

Stakeholder interests that are established by law and mutual agreements are generally well protected under Israeli corporate and other law. The Companies Law, in particular, provides what appears to be an adequate protection for creditors, and employee rights are protected through specific legislation. The enforcement of these rights through the general court system and special Labour Courts has not given rise to any particular controversy. It bears mentioning that the extent of mandatory stakeholder involvement in the corporate governance of privately owned companies is not high by the standards of some OECD countries.

Whistleblower protection is still being developed in Israel. The Israeli authorities will need to continue their efforts to strengthen the role and procedures of audit committees to consider employee complains and protect the anonymity of employee whistleblowers.

They might consider broadening some of these mechanisms to include stakeholders other than employees.

The obligation of board members to act on a fully informed basis and in the interest of the company and its shareholders appears well established in the Israeli corporate governance framework. The corporate legislation addresses these issues directly and a wealth of legal precedents speaks of an active enforcement of the legislation and regulation through the courts. The legal precedent for making board members liable for corporate losses apparently goes beyond the practices of many OECD countries.

The independence of SOE boards and management is an area that raises a number of questions. On the one hand, the application of general Companies Law to SOEs leans toward practices not unlike what is seen in the private sector. Proposed amendments to the Law could lend further support to board independence. On the other hand, the not-so-distant tradition of using SOEs as an extension of the general government sector – and often, as a source of political patronage – appears to have contributed to an ownership function geared toward oversight and control rather than autonomy. Extensive monitoring mechanisms *vis-à-vis* SOE boards, including holding directors individually accountable for the voting records, would other things equal seem to detract from the objective of board independence. The Israeli authorities might consider further curtailing Ministers' ability to appoint their preferred candidates to SOE boards, rather than relying on direct oversight to prevent abuse.

The government is not systematically or regularly involved in day-to-day management of SOEs and there are generally adequate safeguards to discourage such practices. However, remaining evidence of ministerial intervention in staffing decisions is one area for concern; evidence of nepotism in individual SOEs is another. While recognising a significant recent progress in this area, the Israeli authorities should arguably further strengthen their efforts to stamp out such practices.

7. Conclusions

This report has reviewed Israel's corporate governance landscape and formulated conclusions regarding each of the five core corporate governance features. While reaching positive conclusions in relation to many aspects of these core features and of the recommendations in both the *Principles* and *Guidelines,* the report has also identified a number of weaknesses in the Israeli corporate governance framework:

Israel's corporate governance landscape: Israel has made considerable progress over the last decade in improving its corporate governance framework, notably through adaptation of its 2000 Companies Law and the implementation of a succession of subsequent upgrades of various parts of its legal architecture. Economic efficiency and a level playing field have been further promoted through a process of privatisations that has left few large companies other than public utilities and military-related enterprises in state ownership. A key issue for consideration is whether the risks associated with the predominance of pyramidal company groups and high ownership concentration have been sufficiently addressed, or will be sufficiently addressed by pending legislation. The Israeli approach has so far been to accept the concentrated ownership and take steps, mainly through *ex-ante* regulatory means, to avoid abuse. Legislative initiatives toward

empowering activist shareholders, especially institutional investors, and opening improved access for shareholders to file suits are currently in progress.

- **Enforcement of shareholder rights and equitable treatment:** Israel's framework to ensure equitable treatment of shareholders and recognition of their rights is broadly responsive to recommendations of Chapters II and III of the Principles. Safeguards built into the Companies Law including a fiduciary obligation to maximise profits, audit committees with a majority of outside directors and approval of extraordinary or related party transactions through qualified majority, go a long way toward ensuring minority shareholder rights. The enforcement of these provisions, whilst formally reliant mostly on civil suits, depends in practice to a non-trivial degree on regulatory interventions by Israel Securities Authority. The Authority has, in particular, made extensive use of its prerogative to mandate corporate disclosure and encourage civil suits by shareholders. Further steps could be taken, including measures already under consideration, including through pending legislation, such as the creation of a majority-of-the-minority safeguard in the case of related party transactions; enhanced fining capabilities for ISA and a right to co-finance derivatives suits; and the creation of a specialised court to hear both civil and criminal cases under the Companies and Securities Laws.
- **Requiring timely and reliable disclosure in accordance with internationally recognised standards:** Israel has taken significant steps to strengthen the quality of financial and non-financial disclosure in most of its listed companies, notably through its transition to IFRS at the beginning of 2008. Pending issues such as the implementation of IFRS in banks need to be addressed as soon as possible given remaining supervisory concerns. The non-implementation so far of IFRS in state-owned enterprises to some extent runs contrary to the intentions of the Guidelines, although it must be recognised that the pre-existent Israeli Accounting Standards to which they adhere already encompass most of the main elements of IAS. The safeguards for auditing of listed companies could also be raised. The audit companies are largely reliant on peer reviews, and although the Ministry of Justice plays an unusually prominent role in the reviews, Israeli authorities should continue their efforts to establish a public oversight accounting board with supervisory powers over the auditing profession.
- **Establishing effective separation of the government's role as owner and its regulatory role, and ensuring a level playing field:** The Israeli approach to SOEs is linked with the country's relatively recent history of a large and sometimes inefficient SOE sector. Today SOEs tend to be seen either as an extension of the general government sector, or as a candidate for immediate privatisation. SOEs that have not – or not yet – been privatised operate mostly in sectors where there is little competition with private companies. Recent attempts at introducing competition into parts of the value chains of Israeli public utilities are welcome and should be pursued further. The ownership function and corporate governance of SOEs is geared toward securing a sufficient degree of government oversight and control, while at the same time establishing safeguards against the abuse of these powers by individual public officials. This may run counter to some of the Guidelines' recommendations concerning the autonomy of boards and management, but it can be justified by a recent history of ministerial interference and nepotism in individual SOEs. There is little or no evidence of such interference (most of which concerned staffing decisions) transgressing the boundary between the ownership and regulatory domains. Recent progress in establishing autonomous regulatory bodies in the utilities sectors further lowers the risk of such outcomes. The Israeli authorities

should continue ongoing reforms in the area of SOE governance, including by unifying the legal frameworks in which SOEs operate, enhancing financial disclosure and requiring SOEs to develop individual ethics codes to guide the conduct of staff and management.

- **Recognising stakeholder rights and the duties, rights and responsibilities of boards:** The only type of stakeholders dealt with explicitly by the corporate governance framework for privately owned companies is creditors. A number of provisions in the Companies Law directly addressing the rights of creditors, including in the context of extraordinary or related party transactions, are enforceable through the normal court system. Other stakeholders such as staff and affected communities enjoy legal protection through labour, environmental and zoning legislation, but they are not subject to such specific corporate responsibility or co-determination clauses (the exception being SOEs) as are seen in some OECD countries. The protection of corporate whistleblowers is currently under consideration; the Israeli authorities are encouraged to continue their efforts to strengthen the role and procedures of audit committees in this respect. As for board responsibilities, an obligation of board members to act on a fully informed basis and in the interest of the company and its shareholders is well established by law and has been actively enforced by courts. Israeli jurisprudence provides a relatively broad scope for holding directors individually liable for corporate losses. Conversely, the independence and individual responsibility of SOE boards have sometimes been called in doubt, and the Israeli authorities need to consider further steps to safeguard board autonomy in this sector.

Notes

1. It should be noted that the banks, themselves minor contributors to GDP, were also in state ownership and that a fair share of the 60% per cent outside SOEs and Histadrut companies consisted of general government economic activities.
2. Purchases of shares in a listed company over 5% are also subject to a reporting requirement to the ISA.
3. In this study, controlling shareholder was defined as owning at least 25% of shares and whose holding is higher than the combined holdings or the second and third largest shareholders.
4. *www.bankisrael.gov.il/press/eng/080416/080416q.htm*.
5. For example, the acquisition of an additional NIS100 million holding in Israel Chemicals, by the Ofer group which already held an over 50% interest in the company (Globes, April 2, 2008).
6. This was also reflected in the centrality of banks in the company groups in early Israeli history.
7. Today, 8 listed companies still feature voting right differentiation.
8. In public companies, preference shares can be issued only after a one year waiting period after the company's initial listing on TASE.
9. Shareholders are required to disclose such agreements to the company and to the ISA.
10. There are no limits on cross-shareholdings in Israel.
11. For instance, in *Baranowitz Assets and Leasing v. Israel Securities Authority*, a public company acted as a guarantor of the liabilities of an affiliated private company, providing its income and assets as a guarantee. The public company refused to comply with the ISA's request for the public company to publish the financial statements of the aforesaid subsidiary. The Court rejected this claim and instructed the public company to do so, stating that fair disclosure requirements are the "prime requirements" of the Israeli law, particularly in view of the fact that both the private and the public company were controlled by the same principal shareholder.
12. That being said, the demarcation between corporate and securities legislation in Israel is not in line with the American corporate regulation.

13. The Knesset is Israel's parliament.
14. According to the Companies Law, a company that issues listed bonds only is not considered to be a public company; however it is under the supervision of the ISA with respect to its traded bonds.
15. The latter is phrased as follows: "The purpose of the company shall be to operate in accordance with business consideration in maximising its profits, and within the scope of such consideration, the interests of its creditors, its employees and the public, may, *inter alia* , be taken into account."
16. Fiduciary duty in Israel is defined in comparable ways as the duty of loyalty might be in other jurisdictions. Note that a recent court ruling (*Kot vs. the Estate of Isaiah Eitan of Blessed Memory*, Civil Appeal 741/01) establishes that there "may be circumstances in which managers will be obliged by a fiduciary duty also to the shareholders" – including where a special dependence is established between managers and controlling shareholders.
17. A company may not exempt an office holder from liability for breach of fiduciary duty towards it, but it can exempt them from liability for breach of duty of care if a provision to that affect is laid down in the articles of association.
18. "Outside directors" are essentially non-executive, independent directors. According to the Companies Law, "a person – including the person himself, his relative, partner, employer or corporation of which he is a controlling shareholder – who has a connection to the company or to a controlling shareholder in the company or to a different corporation at the time of the appointment or in the two years preceding the appointment may not be appointed as an outside director." The term "independent directors" is not defined by the Companies Law. It is, however, used widely to denote any directors unrelated to the controlling owner.
19. To compensate for this lack of domestic jurisprudence, Israeli judges also extensively cite the legal precedents of English and American courts, which enables them to effectively "import" relevant case law from other jurisdictions.
20. An extraordinary transaction is defined as one: not in the company's ordinary course of business, not undertaken in market conditions, or one that is likely to substantially influence the profitability of a company, its assets or liabilities.
21. This does open the possibility of staggered boards, but as takeover battles are virtually unheard of in Israel, it has not been much debated.
22. Extraordinary transactions with a holder of control require the approval of the Audit Committee, the Board of Directors and the general meeting (under specific circumstances). Transactions of a company with an office holder or an extraordinary transaction is considered void if it fails to comply with requirements.
23. For a detailed account of the judicial proceedings involving the ISA, refer to its Annual Report (2006).
24. The listing requirements for the Tel Aviv Stock Exchange, on the other hand refer strictly to companies, with the exception of certain types of limited partnerships.
25. Failure to adhere to these requirements leads to a cause for legal action, which results in penalties, which are mostly criminal. TASE can suspend trading of securities of companies which are delinquent in filing for over a month.
26. In view of the financial crisis, the Knesset has recently authorised employment of additional staff by the ISA.
27. The Chair of the Committee, Professor Goshen of University of Columbia, was subsequently appointed Director General of ISA.
28. In the case of derivative suits, this approval is conditional on the conclusion by the Court that the suit is in the best interests of the company and that the plaintiff is acting in good faith. The approval procedure for class actions is subject to a more explicit set of criteria. A court will approve the action if all of the following conditions are fulfilled: the basis of an action is substantiated, substantive questions of fact and law are to be settled, the action is the most appropriate method of settling a dispute, the interests of the members of the group will be represented by the plaintiff, the action is submitted in good faith.
29. This was to some extent inspired by the outcome of the court case LeHava Hatamim Ltd. Vs. Schlomo Borochov and others, 1267/03, where a judge refused hearing a derivative suit alleging director negligence on the grounds that the claimant had failed to prove *prima facie* cause of action. The court stated that had it had *prima facie* evidence to prove the negligence claim ascribed to directors it would have been right to approve the claim.

30. ISA recently proposed a comprehensive model of accounting oversight for listed companies, which as of October 2009 was under discussion between ISA and the Ministry of Justice.
31. Refer to Annex IV for a schematic of the structure of the banking sector and the groups comprising it.
32. Only one subsidiary of a foreign bank (Dexia) has been established to date, and one domestic bank (Discount) is owned by foreign owners. Four branches of foreign banks (Citibank, HSBC, the State Bank of India and BNP-Paribas) have obtained the right to conduct the business of banking in Israel.
33. In parallel to TASE, a number of alternative trading platforms operate in Israel. The ISA is currently working on legislative amendments in order to create a regulatory framework for such trading venues.
34. TASE and the ISA hold the view that the exchange acts as an SRO, *inter alia*, due to its powers to impose fines on its members for breach of TASE's by-laws, etc.
35. This decline in the capitalisation of TASE has been attributed to the general macro-economic conditions (*e.g.* export orientation of the Israeli economy, etc.), but also to liquidation of investments by foreign investors, a sharp fall in prices of corporate bonds, in particular of international real estate companies.
36. It ought to be mentioned that comparisons of stock market size in relation to the national economy is imperfect, not least from the point of view that many countries have more than one stock exchange.
37. Improvements in liquidity figures reflect growing trading of large cap companies, either directly, or through index trading, while liquidity is lacking for small cap companies. The largest 5% of the listed companies accounted for 69% of trading value in 2006 (WEF, 2006).
38. Companies that have issued publicly traded bonds are commonly referred to as "listed". Moreover, the Securities Law places a number of disclosure requirements on bond issuers.
39. Israeli companies are actually the second largest group of foreign issuers on NASDAQ, second only to Canada.
40. This agreement also includes provisions which would permit simultaneous IPOs based on the same prospectus.
41. For these purposes, an R&D company is defined as one that has invested at least NIS 3 mil in research and development over the last 3 years. Research and development companies with a value exceeding NIS 16 million must have a public float rate of 10% and companies with a value exceeding NIS 50 mil – 7.5%.
42. As of beginning 2008, 18 companies did not meet the public float requirement and were therefore put on the Maintenance List.
43. In these figures are included companies with a state ownership of at least 10%, except for banks.
44. The privatisation of Zim commenced in 1970s with the sale of Zim to Israel Corporation, controlled by the Ofer Group. The privatization process ended in a transaction which took place in 2003 transferring the remaining state holdings to the Israel Corporation.
45. The law has since been amended on a number of occasions.
46. For example, if a company is converted to a government company, the State is required to purchase the shares, other than redeemable preferable shares, of the other shareholders who so desire.
47. A vital interest order is a mechanism which allows the Prime Minister together with the Minister of Finance (and in the case where the Defence Minister is the line minister of the company, together with the latter) – after consultation with the Minister responsible for the affairs of company and the GCA – to publish an Order (subject to a number of conditions established by the GCL) that the State has one or more vital interests in a company under privatisation. The provisions of the vital interests order must receive the approval of the Ministerial Privatisation Committee. The GCA has confirmed that both vital interest orders and golden shares remain in place in very few privatised Israeli SOEs and that their use has in practice been rare.
48. An explicit government directive and details of considerations behind the exception are required for any deviation from this principle. The Knesset Finance Committee also has to approve any such deviation.
49. For instance according to the GCL, the Ministers must receive the GCA's opinion prior to giving instructions regarding voting in the general meeting of the SOEs. In practice, the Ministers

empower the GCA to vote in general meetings according to a letter of proxy based on the GCA's advice.

50. The Ministerial Privatisation Committee currently comprises the Ministers of Finance, Justice and 1-2 other members. It has the power to initiate the privatisation of any company, even without the consent of the relevant line Ministry, subject to a hearing process of the relevant Minster and the relevant SOE.

51. With the exception of banks, the privatisation of which is overseen by the Ministry of Finance through M.I. Holdings, a wholly owned government company.

52. The Ministers acting as the shareholders of the SOE's have the right, *inter alia,* to convene a general meeting that appropriates the responsibility for running the company from its board of directors while imposing directors' responsibility on the State. This right is part of the Companies Law applicable to any company's meeting. This right has been exercised on extremely rare occasions.

53. This provision applies to all government companies and to mixed companies on the condition that the State holds more than ¼ of the voting power at the general meeting or the right to appoint more than ¼ of the directors.

54. The regulations set out circumstances in which relatives may be employed despite the said restrictions, namely when the selection process was made in a competitive process, disclosures by the applicant have been made, and the general manager and legal advisor of the company have approved the propriety of the public process and the reasons for the selection.

55. One of the following conditions must apply: total income exceeding NIS 400 mil, size of total assets exceed NIS 400 mil, value of assets or projects operated or managed by the company exceeds NIS 400 mil.

56. The work of the committee is being performed under the guidelines issued by the Attorney General. In specific cases, the committee may decide to consult with the Ministry of Justice and the Attorney General. The criteria required of directors, CEOs and chairmen of the board is specified in the GCL and includes requirements regarding education and experience.

57. There have been very few cases of a hostile takeover in Israel, where the approval of the sale is still awaiting the court's decision. In this case, the dispute is over one company (Matis) attempting a hostile takeover of another company (Petro Group), whereby the control over the latter has been acquired by a third company (Amaris). Following this acquisition, Amaris began facing financial difficulties and Matis extended a loan to it which was secured by a pledge over Petro Group shares owned by Amaris and also received an option to purchase these shares. Matis realised the option and also bought Petro Group shares as well as bonds on the market. It then passed a decision for immediate repayment of bonds at the general meeting of bondholders of Amaris. The bondholders dispute the set price, claiming it was too low.

58. With the exception of private placements which are exempt from tender requirements of the transaction if approved by the general shareholders meeting.

59. Shareholders objecting to the compulsory sale can appeal to the court regarding the valuation of the proceeds from the compulsory sale, but not the sale itself.

60. The list will include resolutions such as the approval of transactions with controlling shareholders or officers (related party transactions); appointment of external directors; approval of a compromise or arrangement between a company and its creditors or shareholders and other resolutions requiring a special majority under the Companies Law.

61. For instance, the Control of the Provident Funds Law requires a separation between the management company and the provident fund that it manages. For insurance companies, the relevant investment regulations stipulate that transactions with parties related to the insurer for which the consideration is paid out of the yield-dependent liabilities, be ratified by ⅔ of the external directors. As for the mutual fund companies, the Joint Investment Trust Law provides that any transaction where a potential conflict of interest may exist must be approved by the fund manager's board of directors.

62. "Extraordinary transactions" are defined as "those which are not carried out in the ordinary course of business, or pursuant to market conditions and that can have substantial effect on the company's affairs."

63. As mentioned, the Ministry of Justice is currently considering a proposal, where these thresholds would be revised to ½ of shareholders and 2% of voting rights, respectively.

64. That being said, representatives of the legal profession were of the opinion that some approval mechanism is necessary to avoid frivolous actions.
65. Inside information includes information on a development or expected development in a company; a change or expected change in the company's situation, or any other information on a company, which is not known to the public and which, if it became known to the public, might cause a significant change in the price of the company's security or the price of another security which has the company's security as its underlying asset.
66. Naturally, only a few of these cases are related to insider trading or abusive self-dealing matters.
67. This requirement does not apply when the office holder or a controlling shareholder's interest stems from a relative's personal interest in a regular transaction.
68. Where the majority of the directors of the board have a personal interest in approval of a transaction, the transaction shall also require the approval of a general meeting.
69. This figure does not include government companies in which a negligible percentage is held by other entities or in instances where non-active companies hold shares in a government company. Mostly, the minority shareholders in the 11 companies are government bodies at the sub-national level.
70. Except for redeemable preference shares.
71. Specifically, the Israel Electric Corporation is subject to the application of the Securities Law, but has been exempted through a temporary provision.
72. Principally, IAS 19, 37 and 39 are not applicable for private enterprises, whereas IAS 27 and 28 will be applied to private enterprises after the revision of IFRS 3.
73. In the case of banks, this responsibility is shared by the BoI and the ISA.
74. As noted in the "ongoing reform" section above, the composition of the audit committee is currently subject to a proposed reform which is under review by the Ministry of Justice.
75. On the other hand, ICPAS is primarily responsible for the advancement of professional standards though updating members on professional developments, establishing norms and standards in the area of accounting and auditing, establishing appropriate ethical rules, etc.
76. An important caveat is that the state has some prerogative with respect to companies that are deemed to be operating for the public good. For instance, the Minister of Finance, may, after consultation with the Minister of Justice, determine the rules of compilation of financial reports of a government company which is determined as providing essential service to the public (*e.g.* Mekorot Water Company and Israel Electric Corporation). Both companies operate under rate-regulation.
77. Again, with the exception of Israel Electric Corporation.
78. The requirement to include managers' declarations and a directors review has become binding following the entry into force of government companies regulation "*Additional Report Concerning Actions Taken and Representations Given for Assuring the Propriety of the Financial Reports and Directors Review*" in 2005.
79. The scope of audit by the State Comptroller includes those mixed companies where the state remains a holder of control by virtue of being the largest shareholder and where it continues appointing directors in a company.
80. In general, SOEs can request to be exempted from the application of the Freedom of Information Law on a case–by-case basis.
81. Discussions with the Water Authority even revealed a degree of unease at this thought: water is a "strategic resource" which all Israeli households have a right to acquire at equal prices. Costing the provision of water to outlying or arid parts of the country was seen as irrelevant.
82. This can occur in cases where an SOE proposes to take on obligations what could restrict the government's ownership position, including with respect to structural changes, privatisation, promoting competition and regulatory coverage. Prior government approval is required.
83. None of the largest government companies have listed their common stock, but some, including the Israel Electric Corporation and Israel Aircraft Industries, have issued public debt.
84. The OECD was, however, informed that Mekorot is currently applying pressure to be allowed itself to compete for such subcontracts. This would be done through a wholly independent subsidiary.

Hence, it might not run counter to the principle of vertical separation, but could nevertheless give rise to competition concerns.

85. The small claims court has been created as a inexpensive and rapid mechanism for hearing small claims, which would be not be economically worthwhile to hear in through the regular court procedure.
86. This applies only to non-bank SOEs with more than 100 employees.
87. For example, the study by the State Comptroller cited earlier found SOEs where members of the staff-elected "work councils" had apparently used their position to secure the hiring of a large number of their own relatives.
88. This principle does not apply to statutory corporations, which for most part operate with other than commercial considerations.
89. According to the GCA, this section has hardly ever been used. For instance, it was used in a decision of the Knesset concerning the operation of El Al Airlines where it was decided the company was not to fly on Shabbat.
90. In addition to this, as mentioned above, another official is entitled to participate in SOE board meetings in the capacity of a non-voting director.
91. Office of the State Comptroller (2007).

Bibliography

Amzaleg, Yaron, Uri Ben-Zion and Ahron Rosenfeld (2007), "On the Duty of Care of Institutional Investors: Evidence on Participation of Mutual Fund Managers in Shareholder Meetings in Israel", *Issues in Corporate Governance and Finance. Advances in Financial Economics,* Volume 12.

Amzaleg, Yaron, Uri Ben-Zion and Ahron Rosenfeld (2005), "On the Role of Institutional Investors in Corporate Governance: Evidence from Voting of Mutual Funds in Israel", Working Paper.

Amzaleg, Yaron and Abraham Mehrez (2004), "The One Million Club: Executive Compensation and Firm Performance", *Israel Economic Review,* No. 1.

Banker, "Leumi On Top Despite the Privatisation Struggle", January 2, 2008.

Bank of Israel (2006), *Israel's Banking System Annual Survey.*

Bank of Israel (2007), *Israel's Banking System Annual Survey.*

Bebchuk, Lucian Arye, Louis Kaplow, Jesse Fried (1995), "Concentration in the Israeli Economy and Bank Investment in Commercial Companies", paper commission by the Israeli Anti-Trust Authority.

Ben-Bassat, Avi, ed. (2002), *The Israeli Economy, 1985-1998: From Government Intervention to Market Economics.* The MIT Press, Cambridge, Massachusetts.

Ben Simhon, Dani (2004), "The Unmaking of the Histadrut", *Challenge,* Workers Advice Center.

Ben-Zion, Yael (2006), "The Political Dynamics of Corporate Legislation: Lessons from Israel", *Fordham Journal of Corporate and Financial Law.*

Ber, Hedva and Sigal Ribon (2005), "Market Power of Banks Against Large Firms – What has changed with the opening of the Israeli economy", *Israel Economic Review*, Vol. 3, No. 1.

Blass, Asher A. and Richard S. Grossman (2001), "Assessing Damages: the 1983 Israeli Bank Shares Crisis", *Contemporary Economic Policy*, Vol. 19, No. 1.

Cohen, Yinon, Yitchak Haberfeld, Tali Kristal (2004), "The State of Organised Labour in Israel", *Journal of Labour Research,* Tel-Aviv University.

European Commission (2007), *Report on the Proportionality Principle in the European Union,* Study prepared by the European Corporate Governance Institute, Shearman and Stearling LLP and the Institutional Shareholder Services.

Government Companies Authority (2006), *Report on the Government Companies Authority Activity in 2005 to the Minister of Finance*, August 9, 2006.

Government Companies Authority (2007), *Presentation of the Government Companies Authority to the IMF,* Data provided as of December 31, 2006.

Globes, *Provident Funds Fees Rise Sharply*, 27 January 2008.

IMF (2003), *Israel: Report on the Observance of Standards and Codes – Monetary and Financial Policy Transparency, Banking Supervision, Securities Supervision and Payment Systems – Update*. Report No. 03/76.

IMF (2007), *Country Report No. 07/25: Selected Issues*.

IMF (2008), *Staff Report for the 2007 Article IV Consultation –Supplementary Information*.

IMF (2009), *Israel Article IV Consultation*.

Israel Securities Authority (2007), *Annual Report 2006*.

Hanieh, Adam (20003), "*From State-led Growth to Globalisation: The Evolution of Israeli Capitalism*", Journal of Palestine Studies, Vol. 32, No. 4.

Khanna, Tarun and Yafeh Vishay (2005), "*Business Groups in Emerging Markets: Paragons or Parasites?*", European Corporate Governance Institute, Finance Working Paper No. 92.

Lampert, Aaron, Naschitz, Brandes *et al.* (2005), "Listing of an Israeli Company on the NASDAQ Stock Market", NASDAQ Stock Exchange Publication.

Lauterbach, Beni and Alexander Vaninsky (1999), "Ownership Structure and Firm Performance: Evidence from Israel", *Journal of Management and Governance,* Vol. 3.

Lauterbach Beni and Shmuel Hauser (2003), *The Value of Voting Rights to Majority Shareholders: Evidence from Dual Class Stock Unifications*.

Lauterbach Beni and Ronen Barak (2007), *Estimating the Private Benefits of Control from Bloc Trades: Methodology and Evidence*.

Licht, Amir (2001a). "Managerial Opportunism and Foreign Listing: Some Direct Evidence", *University of Pennsylvania Journal of International Economic Law.*

Licht, Amir (2001b). "David's Dilemma: A Case Study of Securities Regulation in a Small Open Market", *Theoretical Inquiries in Law.*

Maman, Daniel (2006), "Diffusion and Translation: Business Groups in the New Israeli Corporate Law", *Sociological Perspectives,* Vol. 49.

Maman, Daniel (2004), "State-corporate Relationships in an Era of Shifting Regime: The Case of Corporate Law Reform in Israel", *Qualitative Sociology,* Vol. 27, No.3.

Maman, Daniel (2002), "The Emergence of Business Groups: Israel and South Korea Compared", *Organization Studies*, Vol. 23, No. 5.

Maman, Daniel (2001), "The Organisational Connection: Social Capital and the Career Expansion of Directors of Business Groups in Israel", *Social Science Research,* Vol. 30.

Ministry of Finance (2006), *The Pension Market in Israel – Ongoing Progress*. Presentation to the OECD Insurance and Private Pensions Committee.

Ofer, Ehud (2004), "Glass-Steagull: The American Nightmare that Became the Israeli Dream", *Fordham Journal of Corporate and Financial Law.*

Office of the State Comptroller (2007), *The Employment of Personnel in Eight Public Corporation*, report issued in November 2007.

Prager, Jonas (1995), "Banking Privatization in Israel, 1983-1994: A Case Study in Political Economy", *The Institute for Advances Strategic and Political Studies*.

Razin, Assaf and Efraim Sadka (1994), *The Economy of Modern Israel*. The University of Chicago Press, Chicago.

From:
Corporate Governance in Israel 2011

Access the complete publication at:
https://doi.org/10.1787/9789264097698-en

Please cite this chapter as:

OECD (2011), "Corporate Governance Review", in *Corporate Governance in Israel 2011*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264097698-3-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.

OECD