



Israel: licensing of online financial trading

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TRADING online financial services, be it foreign exchange, commodities, share prices or stock indices, attracts customers from all over the world. This has led several jurisdictions to introduce legislation aimed at licensing and regulating the online financial trading market.

However, Israel, being the home to some of the most innovative operators in the online financial trading industry, and a country whose residents are very much keen to trade online, lacks itself any regulatory regime which is applied to this industry (or at least this is the stance of the Israeli authorities).

Indeed, over the years there has been a glaring omission in Israel in respect of regulating the market of online financial trading. In the absence of regulation, some unscrupulous operators in Israel promise their customers quick, effortless profits through tantalising online advertisements, only to have these customers end up losing their money.

One only needs to read the Israeli financial newspapers to understand the gravity of the situation, as lawsuits filed by customers against such operators, due to these practices, is commonplace in Israel. However, given the lack of regulation, in many instances the customers have little protection and limited recourse in connection with such practices of these operators. Of course, this is not the modus operandi of most operators, but a few problematic operators are sufficient to paint an ugly picture.

Given this state of affairs, the Israeli authorities have recognised that the online financial trading industry has to be regulated to protect the Israeli public. Credible operators operating in the Israeli market also realised the benefits for licensing and regulation of their activities - on top of serving the needs of their customers, such licensing and regulatory regime would also lead to an increase of customers who trade with "reputable" regulated operators.

In 2010, the Israeli parliament enacted the Securities Law (Amendment no. 42) (the "Act"), creating the general framework for the licensing and regulation of the online financial trading industry in Israel. The Act, while creating the overall general regulatory framework, leaves the details of the regulatory and licensing regime to be provided in secondary legislation (the "Regulations"), to be prepared by the Israeli Securities Authority (the "ISA"), which was also appointed as the regulator with primary oversight of the industry.

The Regulations have been drafted and reviewed by the Israeli parliament's Finance Committee, but have yet to be finalised and approved; as the approval of the Regulations is a precondition to the entry into force of the Act, the Act too has not as yet come into force. As such, the Israeli licensing regime remains dormant and the industry unregulated. This has led to an invidious situation of uncertainty, not only as to when the Act will come into effect, but also further as to the contents of the Regulations. The industry is left in a vacuum, left to speculate how the final regime will look.

The Act

The Act applies to a financial operator offering its customers, through a computerised system, to buy or sell financial products into the operator's own account, referred to in the Act as Own Account Trading Activity. The Act sets out for the first time the requirement from such operators to obtain a licence in Israel, and creates a criminal offence for operators that offer their products and services without a licence.

According to the Act, the licensee does not have to be an entity incorporated in Israel, but rather can be a foreign incorporated entity. This constitutes a major advantage for foreign operators, as it allows them to avoid the burdensome need to operate via an Israeli entity and may also be beneficial from a tax perspective.

The Act does not fix a limit on the number of licensees, nor set exclusive time periods in which applicants can apply for a licence. Therefore one can apply for a licence at any time, although, as noted below, there is a benefit in applying for a licence shortly after the Regulations (and the Act) enter into force.

The Act has certain mandatory requirements as to how the licensee has to conduct itself:



1. The licensee may not conduct any other activity other than the licensed activity;
2. The licensee is prohibited from providing credit to its customers;
3. The licensee is prohibited from providing misleading information in any publication provided by it. This obligation also extends to information provided by third parties providing services on behalf of the licensee;
4. The ISA may define the specific types of financial products that the licensee may offer to the customers as well as the types of customers to whom the products may be offered;
5. The licensee may not do anything that exploits the lack of knowledge or experience of a customer, in order to contract in unreasonable conditions or to give or receive consideration which is unreasonably different from the common consideration;
6. The ISA may issue a licensee with orders as to its means of operation, as well as to its officers and anybody employed by the licensee, in order to ensure the fair management of the financial trading operation and the oversight of the customers' interests.

As part of the licensing process, anyone in control of the licensee is required to receive a permit from the ISA; whether such permit will be granted depends, inter alia, on the reliability of the person applying for such a permit. The Act provides the ISA with the authority to revoke such a permit, and (in some instances) to limit the controlling powers of the permit holder, to require the permit holder to sell the means of control held by that permit holder and even to revoke the license issued to the licensee associated with that permit holder.

The Regulations

Creating the regulatory framework has not been a simple nor short procedure. While the Act was enacted in June 2010, the Regulations are still being debated in the Israeli parliament's Finance Committee. As noted above, as long as the Regulations are

not approved by that committee, the Act will not enter into force. Despite the fact that the Regulations are still subject to debate and may be altered, I will review below the main components of the draft of the Regulations (the "Draft") as issued by the ISA, bearing in mind that the final version of the Regulations could differ from the current version.

The Draft deals with a variety of issues; probably the first and foremost is the licensing process, and the requirements and submissions that must be made as part of the licence application. In addition, the Draft sets out several substantive requirements and arrangements in respect of the licensed activity. Set out below are the main requirements and arrangements detailed in the Draft:

1. The Draft sets a limit on the leverage ratio the licensee may offer to the customers; this varies between 1:5 and 1:25, depending on the risk factor of the relevant financial product traded; it should be noted that during the initial two years from the entry into force of the Act, some financial products may be offered with a 1:50 leverage ratio.

2. There are requirements as to how the customers' funds are to be dealt with and deposited, including, inter alia, the obligation to separate customer funds from licensee funds and to keep the customers' funds in a ring-fenced account. It is noteworthy that the customers' funds may be deposited in financial institutions outside of Israel.

3. Certain information must be provided to the customers including licensee's policies and the agreement that regulates the relationship between the licensee and the customer. Daily and monthly reports must also be provided to the customers.

4. The licensee is required, prior to allowing a customer to trade, to ascertain the suitability of the customer to trade in financial products; where the licensee finds that the prospective customer is not suitable to trade, it must not allow that customer to trade.

5. There are requirements concerning the marketing and advertising activities performed by the licensee or on its behalf.

The marketing materials must be accurate and must not be misleading.

6. The licensee may not induce customers to trade by offering them payments, gifts and bonuses. However, the licensee may still provide a customer with a discount on the commissions charged by the licensee.

7. Various reports must be filed by the licensee with the ISA including immediate, monthly, quarterly and annual reports.

8. The licensee's record-keeping requirements in respect of each and any trade performed by the customer are set out.

9. There are requirements relating to the licensee's equity, insurance and the minimum liquid assets that must be maintained by the licensee; these are determined, inter alia, on various risk factors.

10. The licensing fees will be either NIS 50,000 (about \$13,500) or NIS 100,000, depending on the scope of the licence. The annual fees vary between NIS 50,000 and NIS 360,000 (about \$98,000) depending on the income of the licensee. The fees are linked to the Israeli consumer price index.

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Once approved by the Finance Committee of the Israeli parliament, the Regulations will enter into force within one month of their publication in the Official Gazette. And here is where the ISA provides a major benefit for the licence applicants - anyone applying for a licence within two months from the entry into force of the Regulations, will be allowed to continue offering its online financial trading products and services, without being subject to the arrangements of the Act and Regulations, until the earliest of (i) a



decision made by the ISA in respect of the license application, or (ii) a year from the application date (although this can be extended by the ISA). That is, such an applicant may continue offering its online financial products and services in Israel without the need to adhere to the provisions of the Act or of the Regulations.

This allows operators seeking to start or continue offering their products and services to seize a market share in Israel on account of operators that fail to submit a license application within this timeframe; by way of example, the eligible licence applicants will not be subject to the cap on the leverage ratio, nor to the prohibition to offer bonuses to customers.

Analysis

There has been some criticism in respect of the requirements of the Act and Regulations, due to the conditions and limitations that are placed on those operators that will obtain a licence from the ISA. The point has been raised that the conditions are harsher and stricter than regulations enforced by financial regulators in other territories, and that they present a major obstacle in front of quite a few operators; by way of example, holders of a full license must have equity of at least NIS 4m (a little more than \$1m). This, so it is argued, will lead to several operators to opt out of applying for an Israeli licence, leaving room for other unlicensed operators to offer their products and services to Israeli customers; such operators, which are not subject to the Israeli licence requirements, will be able to offer better pricing, bonuses etc. to the Israeli customers (compared to the licensed operators), leading many Israeli customers to use the services of these unlicensed operators. Naturally, this would defeat the purpose of the Act and Regulations, which is to channel Israeli customers to licensed operators that are subject to the supervision of the ISA.

If, on the other hand, the ISA relaxes some of the provisions of the Draft, I believe we will witness a flourishing online financial trading market in Israel. Where there will be sufficient licensed operators that are able to provide the Israeli customers with attractive offerings, the Israeli customers will prefer these operators over the unlicensed ones. Combine this with the prohibitive stance of the Israeli police and financial institutions towards unlicensed online activities aimed at the Israeli public (as witnessed in their relentless efforts to take action against online gambling activities), there is no doubt in my mind that relaxation of the Draft's requirements will provide the Israeli customers with a safe and fair online financial trading experience.

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As to the timeline for the enactment of the Regulations - this remains somewhat unclear. As noted above, the ISA has been working on the Draft for almost three years now, and has yet to approve them in the Finance Committee of the Israeli Parliament. This is due to different reasons, including ongoing debate as to the nature of the various arrangements to be included in the Regulations. Adding to that is the fact that in the past several months the Israeli Parliament has practically adjourned due to elections that were held in January 2013.

While the Israeli parliament started to slowly resume its operation after the elections, the main task of the Finance Committee is the approval of Israel's 2013-2014 budget; naturally, such task could delay the review of the Draft by the Committee.

Therefore, it is possible that the approval of the Regulations will still take some time, but I am hopeful that this will occur during 2013. Indeed, the Israeli market cries out for the legislature to finally licence and regulate it in a proper manner.

Conclusion

The Act and Regulations present themselves as an extremely important development in the Israeli market for online financial trading, making the necessary step forward from an unregulated industry to a regulated one. This promises to allow the customers to enjoy increased protection and transparency and will give credibility to the industry as a whole.

However, it seems as if some of the regulatory arrangements are somewhat disproportionate and have gone too far. While it is understandable that the cause for this may have been owing to the detrimental actions of some of those rogue operators currently operating in the Israeli market, it is important that the licensing and regulatory regime will not deter worthy and credible operators from applying for a licence and providing the Israeli customer with competitive products and services, as such environment will serve the interests of all parties.

On top of the above, I believe that it is crucial for operators interested in the Israeli market to prepare themselves for applying for a licence. Given that the Draft allows a licence applicant to operate on the basis of a licence application submitted within a specific and relatively short period of time, without the need to adhere to the Act and Regulations, it seems that failing to prepare for a licence application to be submitted within this tight timeframe could lead to a major loss of market share in Israel. Therefore, I suggest all interested operators to stay tuned to the Israeli regulatory developments and prepare themselves accordingly.