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Securities Law Regulations in Israel:

Minor Adjustment to the Model, Dramatic Change in the Market

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1. Introduction

The public discourse that took place about a decade ago on the question of the authority of the Israel Securities Authority (hereinafter: "**the ISA**") to intervene in public companies' modes of operation and in issues pertaining to corporate governance is no longer relevant. In the dispute between the approach whereby the regulatory model underlying the ISA's powers is based solely on information disclosure[2] and the approach whereby the compliance model also encompasses the ISA's mandate to decide matters pertaining to corporate governance and the way companies should run their affairs[3] – the latter approach clearly prevails over the former. In practice, the ISA routinely intervenes and frames companies' modes of operation – directly, through the ISA Staff's positions, preliminary guidance and plenary decisions– and indirectly, through its initiatives amending the Companies Law, 5759 – 1999 (hereinafter: "**the Companies Law**") and the Companies Regulations, with the view that this intervention is essential in order to protect the interests of the public of investors.[4]

Considering the significant developments that have occurred in the Israeli capital market in recent years, we believe that it is warranted, at the very least, to reconsider the activist regulatory model currently being employed by the ISA, since it is plausible that the adverse effects of excessive intervention in the activities of supervised entities exceed their advantages. It seems superfluous to expound on the difficult situation facing the Tel Aviv Stock Exchange; even the ISA, which is very well aware of this situation, has set goals for itself to devise reliefs for companies seeking to list their securities for trading in Israel, and to offer them incentives to recruit funds from the public in Israel, instead of raising cash overseas. In this context, we refer to the roadmap published by the ISA and the plethora of legislative amendments enacted on the basis thereof, which were designed to bring us closer to the desired objective.[5] Nevertheless, we believe that, within the scope of the efforts to revitalize the Israeli capital market, insufficient attention is being paid to another factor that is deterring companies from issuing securities in

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2 Neiger, Eyal and Alsheikh-Kaplan, Maya, "Peer Review – Intervention by Virtue of Supervision of Full Disclosure, ***Taagidim*** (Corporations) B/5 (2005) 20, 34, presents an approach whereby the ISA's original mandate did not extend to its authority to intervene in corporate governance.

3 Licht, Dr. Amir, "The Israel Securities Authority's Power to Regulate Matters of Corporate Governance," ***Taagidim*** B/6 (2005) 46, 60. At issue is an article in response to an article by Neiger and Alsheikh-Kaplan, whereby the Israel Securities Authority is empowered to decide "disclosure obligations, the aim and outcome of which are a change in the practice of corporate governance."

4 The role of the ISA is anchored in the Securities Law, 5728 – 1968. Section 2 of the law defines its purview in general terms: "*The Israel Securities Authority (hereafter – the ISA) is hereby established; its role shall be to protect the interests of the public investing in securities, as prescribed in this Law.*"

5 See the ISA website: http://www.isa.gov.il/roadmap/Pages/default.aspx.

Israel, which is the regulatory model applied in respect of securities law. Attesting to this: notwithstanding the ISA's tremendous efforts in this regard, it appears that the phenomenon of ventures recruiting funds from the public, other than under ISA supervision, is only gaining momentum, despite the dangers involved in doing so.[6]

In this article, we are proposing that the compliance model underlying the ISA's activities should be reconsidered, considering the dramatic developments over the last decade in the regulatory environment in Israel. Within this scope, we are recommending that policy-makers analyze and take inspiration from the Business Judgement Rule, which guides the courts on the question of their intervention in resolutions passed by companies' boards of directors, and curb the degree of its routine intervention in companies' internal affairs, when companies pass resolutions according to the accepted standards of corporate governance and when companies are, in practice, implementing effective compliance mechanisms. We believe that such a model will significantly enhance the regulatory and legal certainty that is currently lacking and that is dissuading a significant number of companies from listing their securities for trading on the Tel-Aviv Stock Exchange.

2. Tiers of protection for the investing public

Regulatory hypotheses

Three alternative hypotheses have proposed a theoretical framework for the optimal regulation of capital markets: the null hypothesis, which is based on the assumption that the optimal situation for markets is an absence of regulation, since the market forces will find equilibrium by themselves and no external intervention is necessary.[7] According to this hypothesis, securities laws, at best, are either irrelevant or are even damaging the functioning of the market.

On the other hand, the other two hypotheses recognize that securities law plays an important role in any effective capital market since companies' reputations coupled with contract law and tort law, are insufficient to create a self-operating market. These two hypotheses differ in the type and extent of appropriate intervention. According to the first of the two hypotheses, it is sufficient to formulate a distinct set of laws for the securities market to address unique aspects of disclosure and accountability, while enabling the players in the market to operate based on their own internal enforcement mechanisms.[8] Opposite this are the proponents of the second hypothesis, who argue that a distinct set of laws is insufficient and that an independent supervisory authority over the capital market is essential. Such an authority could intervene *ex ante* by clarifying the matters of the applicable law, and *ex post* by enforcement proceedings and the imposition of sanctions.[9]

Today, it seems that there is no argument that regulatory intervention is necessary in order to maintain an effective and developed capital market; nevertheless, we still need to address the nature and appropriate extent of this intervention, given the unique circumstances and characteristics of each market. In Israel, the framework of intervention is arranged through a system of securities laws, which, in practice, also encompasses many issues that are actually regulated in the Companies Law. However, in

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6 For example, "Adama," which engaged in organizing purchasing groups, crashed in 2016 and, shortly before that, the Inbal Or group of companies collapsed. In 2015, the Rubicon Group was liquidated and left a trail of debt in its wake totalling some NIS 300 million.

7 Coase, Ronald, "The Problem of Social Cost," ***Journal of Law and Economics***, 3 (1960) 1-44; Stigler, George, "Public Regulation of the Securities Market," ***Journal of Business***, 37 (1964) 117–142.

8 Easterbrook, Frank H. and Fischel, Daniel R., "Mandatory Disclosure and the Protection of Investors," ***Virginia Law Review***, 70 (1984) 669, 683.

9 Glaeser, Edward, Johnson, Simon and Shleifer, Andrei, "Coase versus the Coasians," ***Quarterly Journal of Economics***, 116 (2001) 853-899; Glaeser, Edward and Shleifer, Andrei, "The Rise of the Regulatory State," ***Journal of Economic Literature***, 41 (2003) 401-425; Pistor, Katharina and Xu, Chenggang, "Law Enforcement under Incomplete Law: Theory and Evidence from Financial Market Regulation," Columbia Law School (2002) mimeo.

addition to this framework, there is another supplementary framework that addresses the way these laws are enforced. The enforcement of securities law is no less important than the arrangements themselves, since it is enforcement that infuses substantive content into the principles comprising securities law.

Here, the question arises as to the appropriate purview of the ISA, which, on the one hand, has been mandated to enforce securities laws only, while, on the other hand, by law, its mandate includes "protecting the interests of the public investing in securities." Is the ISA in charge of any matter concerning the investors, even unrelated to securities laws, or is the ISA not allowed to intervene in affairs outside the scope of securities laws? At issue is a question with wide-scale repercussions since, if the ISA is not "constrained" solely to securities law, then there is nearly no limit to the extent of its intervention in the market. Prof. Amir Licht addressed the tension between the ISA's involvement in companies law – to differentiate from securities law – and its purview over securities laws, and explains that:

> "*The authority of a securities authority in a modern legal regime also fully extends to the field known as corporate governance. This is true in terms of the lex ferenda and in terms of the lex lata in Israel. In particular, the Israel Securities Authority is empowered to set disclosure obligations, the aim and outcome of which are a change in the practice of corporate governance … **the Israel Securities Authority's administrative power does not encompass two other forms of intervention: … and the second, the determination of codes of conduct unrelated to information disclosure and of structural requirements for companies' institutions, unless it has been authorized to do so in primary legislation***"[10]
> [the emphasis is not in the original]

In other words, even those supporting the ISA's intervention in matters external to securities law believe that the ISA has no authority to set codes of conduct unrelated to information disclosure. In fact, over time, a practice has evolved whereby the ISA also intervenes in areas outside the purview of securities law, and today – the ISA's intervention in the internal affairs of companies, whether by way of ISA Staff positions and directives issued to companies or by way of instituting enforcement proceedings – are a routine matter.

Enforcement of securities laws

As a rule, the enforcement of securities law is carried out through public enforcement – with the bodies responsible for enforcement being the enforcement and regulatory authorities, and private enforcement – which is achieved through initiatives of private parties and depends on their economic incentives to invest resources in enforcement.

Within the scope of public enforcement in Israel, there is a distinction between criminal enforcement and administrative enforcement. The purpose of criminal enforcement is to handle more serious violations of law, which involve, in most cases, the existence of a mental state of awareness, and perhaps even of *mens rea*. Criminal enforcement is carried out through the judicial system in a protracted and resource-intensive adversarial proceeding. The purpose of administrative enforcement is to handle technical violations or violations of lesser gravity that do not justify the opening of a criminal proceeding, with the mental state required in these violations being negligence or strict liability. Administrative enforcement is carried out by the ISA, and it might also require the involvement of the Administrative Enforcement Committee, which was formed by virtue of the law to streamline the enforcement proceedings at the ISA and was enacted at the beginning of 2011. *Nota bene*: coupled with these enforcement proceedings is another material tier of the ISA's intervention in the capital market, which derives from the ISA's wide discretion when interpreting securities laws over which it is responsible. This discretion is expressed

[10] *Ibid*, footnote 3 above, Licht, on p. 47.

through ISA Staff position papers, legislative initiatives, instructions and directives issued to the market, and individual rulings in specific cases that dictate norms of conduct.

Alongside public enforcement there is, of course, private enforcement, which is based mainly on two principal tools: class actions and derivative suits. During a class action proceeding involving securities law, a security holder seeks to conduct a proceeding on behalf of others without obtaining their consent to do so, while in a derivative suit, a shareholder or director seeks to conduct a lawsuit as a representative of the company and on its behalf in respect of damage caused to it. In both instances, the incentive to initiate these proceedings by lawyers and injured parties is a court-approved reward to the plaintiffs and the lawyers in cases wherein the lawsuit is successful. What determines the lawyers' and interested parties' desire to initiate class proceedings in appropriate circumstances is the extent of the reward and the prospects of success.

The extent of the enforcement in the market derives from these three tiers (criminal enforcement, administrative enforcement and private enforcement), which work as communicating conduits that impact the market and the norms prevailing in it. The strengthening or weakening of one of these tiers will affect all other components and the entire market. The better the balance between the three tiers, the greater the chances that the securities laws will promote an effective capital market. When this balance is disrupted, concerns arise that the securities laws might adversely impact the way by which the market forces operate and, in effect, might trigger a market failure, with the harm caused exceeding any benefits.

Scholars have devoted considerable efforts in comparing the various enforcement means and the extent of their efficacy.[11] The results of some of these research studies may be surprising, since they challenge some of the insights that we have become accustomed to adopting. For example, they found considerable empirical and theoretical evidence that the efficacy of public enforcement is inferior to the efficacy of private enforcement. Thus, for example, a comprehensive empirical research study analyzing the impact of securities laws on the capital market in 49 countries clearly found that securities laws do have a substantive impact on the development of the capital market, but with significant differences between the efficacy of private enforcement and the efficacy of public enforcement. Characteristics of public enforcement, such as investigative powers, criminal punishment and powers to promote secondary legislation, were found to have lesser impact than comprehensive disclosure requirements.[12] Similar findings were obtained in other studies that addressed this subject.[13] Furthermore, private enforcement usually succeeds in creating compliance and supervision mechanisms that lead, on the one hand, to effective deterrence, and, on the other hand, are also less disruptive to companies' routine management. To complete the picture, we add that these insights do not reflect a consensus among researchers in this field, since there are those who disagree with this conclusion and argue that public enforcement is no less essential than private enforcement.[14] However, according to our assessment, the very existence of these findings justifies, at the very least, a review of the manner by which the ISA exercises its powers, both in terms of its supervisory role and in terms of enforcement of securities laws.

The conclusion that we draw up to this point is that, in terms of efficient allocation of resources and the capacity to generate a positive change in the norms in the capital market, private enforcement plays an exceedingly important role, which might exceed the roles and expectations of public enforcement. Nevertheless, this conclusion alone, *per se*, is insufficient, and in order to examine the scope and mode

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11 Djankov, S., Porta, R.L., Lopez-de-Silanes, F. and Shleifer, A., "The Law and Economics of Self-Dealing," ***Journal of Financial Economics***, 88(3) (2008) 430-465.

12 La Porta, Rafael, Lopez-de-Silanes, Florencio and Shleifer, Andrei, "What Works in Securities Laws?" ***Journal of Finance***, 61:1 (2006).

13 World Bank, "Institutional Foundations for Financial Markets" (2006).

14 Roe, Mark and Jackson, Howell, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence," **Harvard Law School, John M. Olin Center for Law, Economics and Business Discussion Paper Series**, Paper 637 (2009).

of the ISA's intervention in the activities of companies subject to its supervision, one must also examine the extent of the protection that the investing public enjoys today in Israel. One of the customary indicators measuring market effectiveness, which reliably reflects the extent of the protection of the investing public, is the control premium indicator in the economy, which is the sum that a buyer is willing to pay for a controlling interest in a company over the current market price of that holding.

In essence, the control premium is supposed to embody the ability of the controlling shareholder of a public company to reap asymmetric excess benefit from the company, which is not attainable by the minority shareholders. When a capital market is ineffective and enables the controlling shareholder to indirectly extract personal benefits from the company that are usually at the expense of the other shareholders, buyers will be prepared to pay a higher premium above the market price for a controlling stake, with the expectation that the compensation for the premium will be returned through the value added to be generated in the future from control over the corporation. These benefits include, for example, interested-party or controlling-shareholder transactions, which include the possibility of diverting exorbitant executive compensation to the controlling shareholders and their associates,[15] charging private expenses to the company's account, and more. Effective corporate governance is supposed to prevent the controlling shareholders from reaping asymmetric excess value lacking any practical justification and thus, lower the control premium.

We note that there is another approach, besides this school of thought, whereby the control premium also derives from the controlling shareholder's right to control the company's operations and enhance the company's value. In poorly managed companies with significant potential for improvement, the control premium can be expected to be higher than for effectively managed companies lacking potential for change. Since this right is not available to minority shareholders, the buyer of the control, who acquires the ability to enhance the company's value, will be willing to pay a high premium for this *'opportunity"*.[16]

In this context, it is interesting to note the international study by Dyck and Zingales,[17] which analyzed the average ratio of control premium-to-market value of companies in dozens of developed countries. Their analysis of transactions executed between 1990 and 2000 found that the control premium in Israel had been nearly double the average in the survey and reached 27%, when the average was 14%. These gloomy findings relative to Israel positioned it among the group of countries with weak corporate governance. For the sake of comparison, the control premium in countries with a sophisticated capital market, such as Hong-Kong, the United States and England was, at most, 2%.[18] Subsequent to this study, two Israeli researchers analyzed the control premium in transactions executed in Israel between 1993 and 2003 and arrived at very similar results, with the control premium in Israel reaching approximately 30%. As stated, at issue is an extremely high control premium that is typical for problematic capital markets with deficient norms of corporate governance.[19] These findings explain why the ISA was required to act with determination and vigor in order to rectify market failures that it identified, while it assumes authorities that expand its purview. As shall be described and demonstrated below, the ISA has succeeded – through a long list of measures and structural reforms, in conjunction with the natural evolution of the market – in bringing about a substantive change in relation to this issue.

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15 Dyck, A. and Zingales, L., "Private Benefits of Control: An International Comparison." ***The Journal of Finance***, 59(2) (2004) 537-600.

16 Damodaran, Aswath, "The Value of Control: Implications for Control Premiums, Minority Discounts and Voting Share Differentials," ***SSRN Electronic Journal*** (2015).

17 *Ibid*, footnote 15 above, Dyck and Zingales.

18 Dyck, A. and Zingales, L., "Control Premiums and the Effectiveness of Corporate Governance Systems," ***Journal of Applied Corporate Finance***, 16 (2-3) (2004), 51–72.

19 Barak, Ronen, "The Value of Control in Israeli Companies and its Relation to Ownership Structure and Firm Characteristics," doctoral thesis, Prof. Beni Lauterbach, advisor.

3. Regulatory developments in securities laws in Israel

Developments in public and private compliance and enforcement

At the ISA's initiative, far-reaching changes were instituted, both in securities laws and in the modes of their enforcement. In 2005, a committee was appointed in Israel to examine the corporate governance code, chaired by Prof. Zohar Goshen. The committee recommended a list of measures to change corporate governance and corporate laws, which were adopted in Amendment 16 to the Companies Law. The amendment prescribed compliance and supervision mechanisms in companies, while seeking to resolve market failures relating to corporate governance; however, at that time, the amendment raised obstacles and restrictions on the activities of public companies in Israel, which were forced to adapt to the new situation. Continuing this trend, the ISA promoted Amendment 17 to the Companies Law, which imposed similar principles of corporate governance on "bond companies" as those imposed on public companies. Amendment 20 to the Companies Law continued the trend of imposing burdensome regulations and added a layer of obligations pertaining to decision-making procedures and the structure of executive compensation in public companies and in bond companies.

Another milestone was the Streamlining of ISA Enforcement Procedures Law, which was enacted in 2011 and granted the ISA means of administrative enforcement against companies and officers in respect of securities-law violations, inter alia, through: the imposition of pecuniary sanctions, occupational limitations, the obligation to perform various actions and limitations on the possibility of granting indemnity and liability insurance. The ISA has been making extensive use of the tools given to it and is applying means of administrative enforcement against companies and individuals which, in its opinion, have committed securities-law violations, even when the violations were merely technical in nature, and even when the offenders' actions were done with *bona fides*. Parallel to this, the courts also began taking a far stricter stance against law-breakers committing economic offenses, including securities-law violations. This stance was demonstrated, *inter alia*, by sentencing guilty parties to significant periods of actual incarceration for offenses of use of insider information, violations of the antitrust laws and the like.

Changes were instituted in the private enforcement realm that were no less dramatic. The increase in private enforcement measures, which was expressed in a large number of class actions and derivative suits lodged in recent years, has fundamentally changed the work methods of public companies and supervised entities. The formation of the economics department in the Tel-Aviv District Court, called the "Court for Economic Affairs," also contributed to this, and the multitude of actions lodged with this court (and with the other courts) enables it to develop the securities laws, to increase the legal certainty and to clarify for companies and their officers the standards of conduct expected from them.

Thus, for example, in the ***Makhteshim Agan*** case,[20] a shareholder filed a motion to certify a class action on the grounds of shareholder minority oppression, relating to the distribution of the consideration in the transaction for the sale of the control over Makhteshim Agan. According to the lead plaintiff's allegation, the distribution of the consideration for the transaction unfairly favored Koor Industries, the controlling shareholder of Makhteshim Agan. The court ruled that the controlling shareholder is not entitled to receive excess consideration in respect of its share of the shares being sold, and that the value of that excess consideration must be distributed among all of the company's shareholders, both the public shareholders and the controlling shareholder, in respect of all of their holdings. True, the court had stated that the excess consideration does not constitute a control premium, but it is hard to exaggerate the importance of the court's ruling in the ***Makhteshim Agan*** case, which constitutes an important milestone in the rules governing permitted/prohibited actions that are imposed on a shareholder in relation to a sale of control or to exploiting a business opportunity that is supposed to belong to the company and to all of its shareholders.

[20] Class Action 26809-01-11 ***Dov Kahana vs Makhteshim Agan Industries Ltd. et al***, of 5.5.2011, published in Nevo.

Another example may be found in the ***Ostrovsky*** case,[21] which involved a derivative suit on behalf of the public company – Discount Investment Corporation Ltd. – against its incumbent directors, at the time that the acquisition of the control over Maariv Investments Ltd. was approved. The motion alleged that the resolution by DIC's board of directors to acquire "Maariv" newspaper, as well as the subsequent resolutions passed to increase the investment in the newspaper, which had been in an extremely difficult financial situation at that time, and which led, in the final analysis, to a monumental loss totalling approximately NIS 370 million – are resolutions that had been passed recklessly and negligently, while the directors were breaching their duty of care and causing damage to DIC. The court accepted the motion and was not sparing in its criticism of the directors, who, instead of challenging the controlling shareholder, sought to please him. It should be noted that, pursuant to section 263(2) of the Companies Law, liability insurance is invalid in instances when the breach of the duty of care was committed intentionally or recklessly, as the court ruled when it accepted the motion. Also here, there is no need to expound on the deterrence that the court ruling created in the ***Ostrovsky*** case vis-à-vis members of boards of directors who are asked to approve a transaction presented to them by the controlling shareholder of the company for which they are serving as directors.

Another good example to note during our discussion is the consolidation of two derivative suits in the ***Dayan*** case,[22] which brought the volume of the consolidated suit to a total of NIS 1.3 billion, on the grounds of the allegation that the dividend distributions in IDB had been prohibited distributions because the company had not passed the solvency test. Within the scope of this action, a partial settlement arrangement was reached with some of the defendants, who agreed to return a dividend to the company that had been distributed in the sum of approximately NIS 70 million. This was something that had never before occurred in the Israeli capital market, and certainly not in such a significant sum. Here too, it is hard to not recognize this precedent's contribution to increasing the deterrence vis-à-vis controlling shareholders seeking to draw dividends, and vis-à-vis directors desiring to approve these distributions that are beneficent for the controlling shareholders, but which are liable to undermine the financial stability of those companies whose interests they are supposed to protect.

These examples are just a handful of the ensemble of judicial rulings relating to securities laws and corporate laws that caused an earthquake in the market, but, coupled with them, one should keep in mind that other rulings also changed the "world order," such as: controlling shareholders losing their control over companies after they failed to meet debt repayments to creditors,[23] the settlement of a lawsuit against controlling shareholders which personally exploited a business opportunity,[24] the setting of stringent norms for issuing immediate reports to the investing public, and more.[25]

But we must remember that the many advantages inherent in improving corporate governance and in setting new norms of conduct for managers, directors and controlling shareholders of companies, as occurred in recent years – come at a price. The practical significance of all of the changes, some of which were referred to above, is that a burden is imposed on companies, both in terms of the managerial inputs they are required to devote and in terms of the financial inputs involved in formulating and assimilating effective corporate governance and compliance mechanisms. In fact, the ISA itself admits that the current situation is ineffective and is burdensome for the capital market. The roadmap

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21 Derivative Suit 10466-09-12 ***Ostrovsky vs Discount Investment Corporation Ltd.***, of 9.8.2015, published in Nevo.

22 Derivative Suit 45914-09-12 ***Dayan vs Ganden Holdings Ltd. et al***, judgment of 31.10.2013 http://www.isa.gov.il/%D7%97%D7%A7%D7%99%D7%A7%D7%94%20%D7%95%D7%90%D7%9B%D7%99%D7%A4%D7%94/Enforcement/Private_Inforcment/4494/Documents/IsaFile_8022.pdf.

23 In major holdings groups, such as IDB and Elbit Imaging, the control was transferred to other owners due to a failure to comply with the conditions of the bonds issued by the companies.

24 Class action 55970-12-13 ***Israel Canada (T.R.) Ltd. vs Biton et al***.

25 Class action 26912-02-14 ***Shavit vs. Hagag Group Real-Estate Initiatives Ltd.***, judgment of 29.4.2015, published in Nevo.

published by the ISA was the opening shot in a long and slow deregulation process. Now that the regulatory pendulum has swung too far, it is evident that the ISA is striving to back-step and retract a number of initiatives that, *prima facie*, had been intended to improve corporate governance, such as: revoking (or not enforcing) the obligation to publish an annual corporate governance report, significant relief in relation to compulsory publishing of reports on the assessment of the effectiveness of internal control and more.

The ISA's intervention in decision-making processes within companies

As stated, about a decade ago, the extent of the control premium in Israel attested to a market failure in upholding appropriate corporate governance, but since then, the Israeli capital market has undergone numerous changes, as clarified above. Accordingly, the new findings show that these changes also attest to that same market failure. As arose in the study performed by Prof. Hannes,[26] the control premium in Israel has plummeted and is currently about 1.2%. Furthermore, in recent years, Israel has constantly ranked at the top of the World Bank's Index of Investor Protection and, in 2015, was ranked in eighth place in this index.[27] Specific indicators also point to controlling shareholders' difficulties in reaping an excess consideration when selling control: the Bronfman Group was unable to sell a controlling stake in Israel Discount Bank and dispersed its shares on the market; correct to the time of the writing of this article, the controlling shareholders in the insurance companies "Clal" and "Phoenix" are having a hard time selling their control in these companies, despite their dogged efforts, and there are other instances. Nevertheless, one cannot say that the regulatory environment in Israel has reached optimal equilibrium. Running parallel to favorable reforms that increased the protection for minority shareholders and investors was the disturbing persistent phenomenon of companies delisting from the Tel-Aviv Stock Exchange in order to "go private," coupled with the absence of adequate incentives to prompt companies to offer their securities to the public in Israel. In response, the ISA implemented a strategy of providing extensive reliefs as stated above;[28] however, even considering this course of action, no changes are yet evident in the market. The reform has not yet been completed, and we believe that the missing piece relates to the excessive involvement and intervention on the part of the ISA in the internal management of companies under its supervision.

The summary report of findings on the subject of dividend distributions and share buy-backs, which was published by the auditing unit in the ISA's corporations department,[29] constitutes, in our humble opinion, a good example of this intervention. The auditing unit in the ISA's corporations department performed an audit on the subject of dividend distributions and share buy-backs in six companies. The distributions that were examined related mainly to 2012 and 2013, but some also included earlier years. The report examined the decision-making processes for dividend distributions and procedures for approving share buy-back plans, including the work of the board of directors during these processes. In its report, the ISA explained its objectives when performing the audit:

> "*This report will elaborate on the issues that arose during these audits, including the ISA Staff's comments about them. The objective of this summary report of findings is to present the ISA Staff's positions in these matters to reporting corporations in order to contribute to improving their procedures and to improving the way they implement the "Best Practice" provisions of law. We emphasize that the audit did not examine companies' passing of the solvency test, but rather only the distribution approval procedure.*"

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[26] Hannes, Sharon and Blum, Ilan, "There is Almost No Control Premium in Transactions in the Economy" **Corporate Governance Website of Tel-Aviv University**, 3.3.2015: http://www7.tau.ac.il/blogs/law/2015/03/03/1559

[27] World Bank, "Doing Business Report" (2015): http://www.doingbusiness.org/data/exploretopics/protecting-minority-investors.

[28] Israel Securities Authority, "Roadmap – Blueprint and Strategic Goals": http://www.isa.gov.il/roadmap/Pages/default.aspx.

[29] http://www.isa.gov.il/Corporations/Report/Documents/15062015.pdf.

Naturally, the ISA expected that the release of this report would cause the market to "fall in line" with its recommendations, and this indeed did happen. In essence, the release of these findings was so effective that there is evidence of private companies also implementing parts of the report. Apart from the problematic haziness in delineating the bounds of the ISA's authority in relation to all matters pertaining to securities laws on the one hand, and the provisions of the Companies Law on the other hand, this report demonstrates, in a most straight-forward manner, how the ISA actually intervenes in the discretionary affairs of decision-makers in corporations.

One could, of course, argue in this context that when companies operate improperly, then external intervention is necessary in order to cause them to mend their ways, and this is exactly what the ISA did in relation to decision-making processes relating to dividend distributions. However, on the other hand, it is important to not forget basic concepts. As demonstrated above, in many instances, private enforcement is more effective than public enforcement, and the ISA's intervention is not always necessary in order to bring about a change in the modes of operation of corporations and of their controlling shareholders. This intervention causes substantive harm to the legal certainty of supervised companies, which must take into account during their routine course of business that a resolution passed by the company's competent organs might be overturned by the ISA. In addition to the price involved in the ISA's very intervention, one must keep in mind that not every instance of intervention by the ISA is necessarily justified. True, this does not happen often, but even the ISA sometimes makes mistakes. An example of this can be seen in the ***Leibowitz*** case,[30] during which the court deliberated a motion to certify a class action against officers and directors in respect of transactions that the petitioner alleged were tainted with a conflict of interests. In the said transactions, the company's board of directors resolved to invest in an oil and gas exploration company (an investment which, in the final analysis, came to nothing), while relying on a legal opinion that a "triple" approval process, which is required in controlling-shareholder transactions pursuant to section 275 of the Companies Law, is unnecessary. The lawsuit was based, *inter alia*, on the position of the ISA Staff, which was issued to the company in the wake of an immediate report on the approval of the transaction. The ISA demanded that the company publish its position regarding its transaction approval procedure and attach the ISA's position as an appendix to the immediate report, pursuant to its inherent authority to order a public disclosure and report about how the company intends to act, in light of the ISA's position. Nevertheless, the company did not back down from its position regarding approval of the transaction.

In the end, the court that deliberated the motion reached the unanimous conclusion that the transactions had been duly approved, contrary to the ISA's position, and the court exercised the Business Judgment Rule. After it ruled that the board of directors' resolution had been passed with *bona fides*, without any conflict of interests and on the basis of full information, the court recognized the application of the Business Judgment Rule and dismissed the motion. In our humble opinion, the Business Judgment Rule can and should serve as a significant factor also in the ISA's considerations when it decides whether or not to intervene in corporations' internal decisions. As evidence of this – in the ***Leibowitz*** case, it turned out that the ISA's judgment has no advantage over the judgment of a company's competent organs and legal advisors who analyzed the matter. In essence, in that case, it was evident that the ISA had acted under the assumption that all of the said parties had acted improperly, while the court, which relied on proper procedure and on the Business Judgment Rule, had acted under the opposite assumption, whereby the actions of the organs and legal advisors had been proper unless proven otherwise. In our humble opinion, this also needs to be the working assumption during the ISA's work, if it intends on increasing the legal certainty under which companies operate.

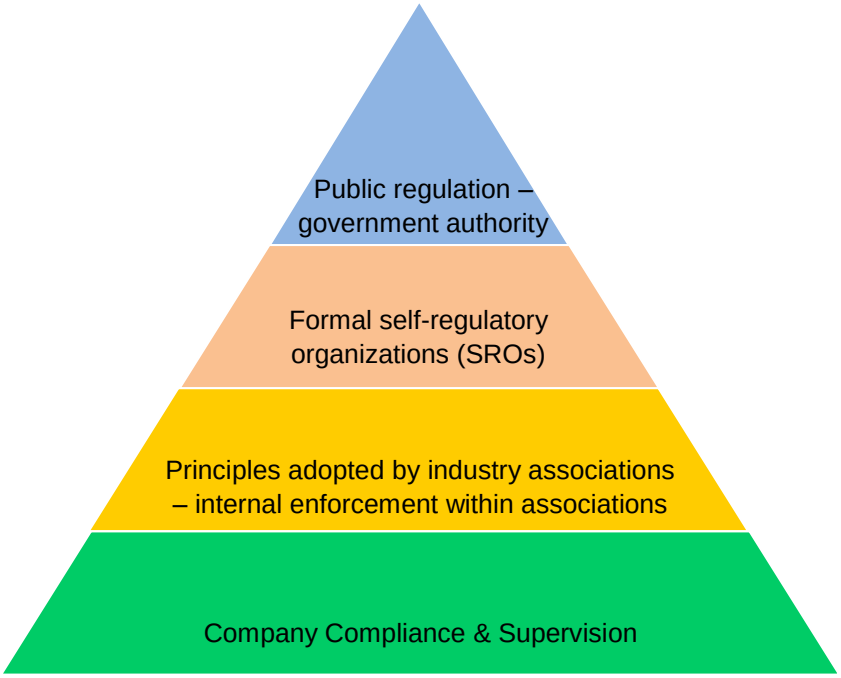
Here, in our opinion, lies the additional tier that is currently missing in the spectrum of measures that the ISA is taking in order to revitalize the Israeli capital market. Beyond this or that short-cut, or cancelling reports whose cost outweighs their benefit, a slightly different approach should be adopted, that draws its inspiration from the Business Judgment Rule and from its underlying assumption that, under

[30] Derivative Suit 7541-12-14, ***Leibowitz vs Yoresh et al***, judgment of 2.6.2016, published in Nevo.

particular circumstances, and in the absence of evidence to the contrary, corporations' internal resolutions should be deemed sound. The adoption of this approach will necessarily lead to lesser involvement of the ISA in the internal mechanisms of supervised entities, to enhanced legal certainty and, as a result, to significant relief in companies' routine operations. *Nota bene*: reducing the ISA's involvement will not necessarily translate into harm to the investing public. Self-regulation, which is based on systems of intra-mural incentives and corporate responsibility, is a familiar regulatory model, which is customary and practiced in countries with sophisticated, developed capital markets. We are not arguing here that Israel should necessarily adopt all aspects of this model, but we are arguing that the very existence of such a model and the manner by which it is being implemented internationally, should dissipate concerns about reducing the ISA's involvement in companies' daily routine.

4. **Self-regulation**

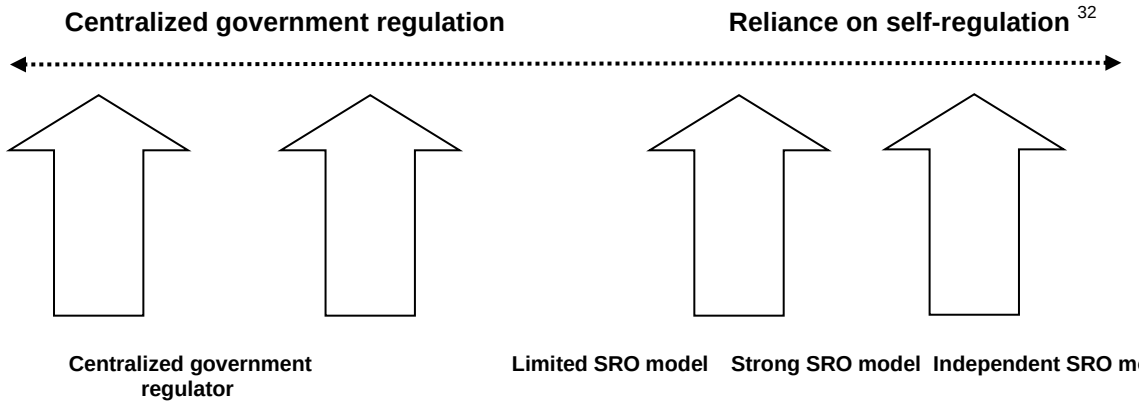
The concept "self-regulation" does not necessarily translate into a single regulatory model for every instance where this concept is applied, but, for the most part, the intention is to have regulation that is formulated using one or more of the following three formulas: (1) through self-regulatory organizations – SROs that regulate the activities of their members; (2) through standards set by financial industry associations to their members; or (3) through internal supervision and compliance functions within companies.[31]



The SRO model as a single regulatory model does not exist in Israel, but is common in developed countries and plays an important role in financial regulations. An SRO serves as a regulatory link between government regulations and internal regulations, within a particular financial industry or within a particular company. Thus, for example, FINRA (Financial Industry Regulatory Authority) is a private, non-governmental U.S. entity that supervises financial brokers in the United States (such as: brokerage firms, investment counselors, investment managers, and the like), while the role of the U.S. Securities and Exchange Commission is to prescribe regulatory rules and disclosure requirements that are implemented, *inter alia*, through the rules prescribed by FINRA. A model that grants power to an organization assuming the role of a private regulatory authority that is independent of government

31 Carson, John, "Self-Regulation in Securities Markets," World Bank (2011).

regulatory authorities, has been adopted in very prominent markets, such as the United States, Canada, Australia and Hong Kong. *Nota bene*: at issue is not a single, absolute model, and one can certainly discern various types of self-regulation among economies with SROs and the extent of the power delegated to them. For the sake of illustrating the widest possible gamut, literature addressing this model has depicted an axis of self-regulation of varying degrees of power, ranging from exclusive self-regulation to centralized government regulation:



Most developed countries integrate SROs within their regulatory compliance model, but in Israel, regulation is based nearly exclusively on the existence of an independent government regulatory authority, positioning it at the extreme end of the supervisory spectrum.[33] In our opinion, this is the major challenge facing the ISA, which is operating out of its absolute belief that only in this way is it fulfilling its role and purpose of protecting the investing public; however, sometimes, its activities diminish legal certainty and interfere with decision-making processes in companies, as demonstrated above. The prevalent use of the SRO model in many countries shows us that the ISA does not have to see itself as the first and last "line of defense" for the investing public, and that a sound and balanced capital market can exist even when the degree of intervention by the government regulatory authority is lower, and allows supervised entities to exercise broader discretion. Therefore, as part of the welcome deregulation processes underway in the Israeli market, we believe that the ISA should take action to strengthen the internal control mechanisms in companies, which can only be done when the regulatory authority allows companies broader discretion and maneuvering room. True, it is certainly possible that, as a result, there might be instances when the ISA will not agree with the manner by which this or that company acted, but this does not mean that the company is necessarily making a mistake in such instances. Moreover, even if the company did make a mistake, this does not mean that at issue is a matter that requires the ISA's intervention.

And how will the ISA know when to intervene and when not to intervene? This is where the Business Judgment Rule – applied by the court when deciding whether or not to intervene in decisions that a

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[32] *Ibid*, review of various models of self-regulation.

[33] It should be noted that the Tel-Aviv Stock Exchange may be described as an SRO, but, considering the ISA's involvement in the TASE's activities and its dominant role in the Israeli capital market, the TASE's ability to operate as an independent regulator, which lays down rules and delineates codes of conduct, is limited.

company reaches through its competent organs – comes into play. It is true that there might be differences between the manner by which this rule is applied by the court and the manner by which the regulatory authority applies it. We are not arguing for absolute adoption of this model. However, the judicial test can serve as a source of inspiration for the regulatory test and, in any event, even when translating the Business Judgment Rule to a regulatory model, the basic assumption needs to be that a company's actions are sound, as long as the decision-making processes that preceded it were sound. Naturally, if failures are discovered in the process, then the regulatory authority's intervention would be justified, just like when the court applies the Enhanced Scrutiny Rule or the Entire Fairness Rule. We believe that this is an appropriate model, since it incorporates the assumption that the court (and, in this context, also the regulatory authority) does not have an advantage over a company's management, which reached decisions in a fair and information-based process, and any retroactive intervention in these decisions definitely diminishes legal certainty and the independence of corporate organs in reaching business decisions and guiding the corporation's businesses. On the other hand, when there is a failure in corporate governance and in a company's internal control processes, in a way that provides particular parties an unfair advantage over other parties, and certainly when such a failure prevents or torpedoes the private enforcement option – then intervention by the regulatory authority is justified.

5. Concluding remarks

In recent years, the Israeli capital market has undergone dramatic processes resulting from the intensive activities by the ISA, which were required in order to rectify distortions that, over the years, had rooted in the Israeli capital markets, and by the courts, whose voices became far louder with the increase in private enforcement in Israel. As a result of the courses of action elaborated in this article, new standards of conduct were determined for companies' managements and boards of directors, in a way that benefits both companies and shareholders. However, these courses of action also charged a complex price from the local capital market, including a very cumbersome and costly regulatory burden and, in essence, turned the Israeli capital market into an "unfriendly" arena for raising capital. No one disputes that the regulatory pendulum has swung too far, and that deregulation is what is warranted now. However, besides the gamut of actions that the ISA is taking in line with the roadmap that it published in this regard, we believe that the new situation is an opportunity to fine-tune the regulatory model and to create a new equilibrium in the multi-player equation that includes the ISA, the TASE, supervised entities and investors. In arriving at a proper balance, the ISA will be taking a step backwards in its regulatory activism and, no less important – will declare its intention in this regard, and thus, will create greater legal certainty and will clarify its expectations from supervised entities. As a result, the managements and boards of directors of these companies will enjoy wider business and legal maneuvering room, and alleviation of that constant concern of the ISA's intervention in their decision-making processes. In instances of a failure being discovered in internal compliance and corporate governance mechanisms, the ISA will intervene, initially, through the disclosure principle, which allows for private enforcement (which, over time, is more effective) and, only in extreme cases, through substantive intervention in the company's activities.

Although at issue is a regulatory model that is slightly different from the customary one in Israel, and although there might be those who raise an eyebrow at our call to have more faith in supervised entities, the very existence of independent regulatory mechanisms in the prominent capital markets around the world demonstrates that it is possible, certainly if the re-adjustment is done wisely and gradually. We believe that the conditions are ripe for this regulatory model, and that, coupled with evidence of the maturation process that the Israeli capital market has undergone in recent years, it could contribute to a reset of the Israeli capital market in a manner that will be beneficial for both companies and investors.