



Lawmaking, Regulation and The Financial Crisis In Israel

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Selected Views Regarding Regulation In Light of the Crisis

- “... Regulators should beware of over regulation. Regulation too has its price and therefore we must understand the fine intricacies of the roots of the crisis, in order to provide the suitable solution to the problem”.
Prof. Zohar Goshen, Chairman of ISA, Knesset Finance Committee, 27.10.2008;
- “Regulation can be very expensive, but the current crisis demonstrates that the cost to the public of failures of a major financial institution, is far greater than the costs to attorneys, accountants and corporations following regulation...”
Prof. John C. Coffee Jr., annual conference of the International Organization of Security Commissions (IOSCO), June 2009- Tel Aviv (as quoted by Globes Magazine);
- “For many months now the Israeli Securities Authority has been acting to prevent the loss of trust in the Israeli market. It requires a tremendous effort and implementation of a long line of measures on a daily basis, which represent a massive clampdown on the regulation of the capital markets, its mediators, the public companies and the doormen of that market...”
Prof. Zohar Goshen, Chairman of ISA, Knesset Finance Committee, 21.1.2009;

Main Legal Reforms (completed or in the pipeline)

Commercial Debt Market:

- Draft proposal for the Amendment of Chapter 5A of The Securities Law, 1968 concerning Trusts and Trustees of Debentures;
- Interim Report of “Hodak Committee”; A committee appointed to determine parameters for consideration by institutional investors providing credit through purchases of commercial debentures;
- Significant broadening of the disclosure requirements regarding traded debentures; Amendments of the Securities Regulations, February 2009;
- ISA’s SLB regarding disclosure of self purchase plans and self purchase of debentures, December 2008;
- ISA’s SLB regarding disclosure of a company’s status of financial debt according to repayment dates, November 2008;
- Law memorandum; Regulating the Activity of Rating Companies, 2009.

Main Legal Reforms (completed or in the pipeline) (Continued)

Corporate Governance:

- Disinterested Directors; Companies Law (8th amendment), 2008;
- Corporate Governance; Proposed 10th Amendment to Companies Law (Memorandum, 2008)
- Reporting requirements regarding Disinterested Directors; Securities Regulations (Periodic and Immediate Statements) (3rd amendment), 2009;
- Poalim Sahar's Position Statement regarding voting policy while exercising Proxy in general meetings, September 2009;
- ISOX; Securities Regulations (Periodic and Immediate Statements) (amendment), 2009;
- broadening the disclosure requirements regarding compensation of executives; Amendments to the Securities Regulations, July 2008.

Main Legal Reforms (completed or in the pipeline) (Continued)

Corporate Governance (continued):

- Broadening the disclosure requirements regarding transactions with controlling shareholders; Amendments of the Securities Regulations, July 2008;
- Risk Management.

Enforcement:

- Proposed amendment to the Courts Law, regarding the establishment of an economic department in Tel Aviv District Court, 2009;
- Law Memorandum; Complementary Enforcement by ISA (Legislation Amendments), 2009.

“Crisis Regulation”

Setting the Landscape

- “Failures in corporate governance were not the direct cause for the economic crisis... notwithstanding, an examination of the companies which survived the crisis or managed to avoid substantial traumas, reveals that they were characterized by stable and organized corporate governance systems. The obvious conclusion is that corporate governance is a dominant instrument in ensuring a company’s ability to deal with extreme situations, as well as for enabling efficient coping by the economy as a whole with financial crisis;
- “Problematic risk management is one of the prominent characteristics of the failures of financial institutions across the world...Greater emphasis must be placed on the Board’s responsibility for risk management... The Board must create a tighter link between management’s incentive policy and risk management. Management’s compensation should reflect not only short term income generated by it, but also the long term risks created by management’s actions”;

Prof. Zohar Goshen, Chairmen of ISA, the International Organization of Security Commissions (IOSCO) annual conference, June 2009 - Tel Aviv.

Setting the Landscape (continued)

- “The numerous difficulties that aroused in the formation of debt arrangements emphasized the existence of failures in the issuance process of non-governmental debentures, especially concerning the relationship between the issuing companies and the institutional investors which invest the savings of the public in such debentures”.

Hodak Committee interim report.

Sources of Legislative and Regulatory proposals

- The Justice Department;
- Israel Securities Authority (ISA) - Responsible for investors' protection, regulates disclosure by public companies, responsible for regulation and supervision of the mutual fund industry and of portfolio managers, investment marketing agents and investment advisors;
- The Supervisor of the Capital Market (the Capital Markets, Insurance & Savings Division of the Treasury) - Responsible for supervision and regulation of insurance companies, provident funds, pension funds and insurance agents;
- The Supervisor of Banks (within the bank of Israel) - Responsible for supervision and regulation of banking corporations;

Pros and Cons of Multiple Regulators vs Single Regulator

- **Pros of Single Regulator, Cons of Multiple Regulators:** the financial market is an integrated whole and a single regulator can avoid conflicting regulation and create consistency; many important players in the financial markets operate in more than one area; existence of multiple regulators increases the probability of overlapping supervision, creates additional costs on the regulators as well as the supervised entities, and blurs the over-all comprehensive sight of the market as well as the boundaries of responsibility of each of the regulators.
- **Cons of Single Regulator, Pros of Multiple Regulators:** danger of too much power in a single regulator; requires a major overhaul of system to ensure harmonic and effective legislation and enforcement; multiple regulators creates the special expertise required for more effective enforcement of complex and highly specialized laws; competition between regulators is healthy.
- Suggestions and recommendations to unite all or part of the different regulators are frequently heard. Recently, both Prof. Goshen suggested the government appoint a joint committee of the three regulators, which shall inquire and draw conclusions of the crisis and the main problems the capital market has encountered during it.

- Inadequate Risk Management on “Sell” side??
- On the “buy” side – lack of accountability? Inexperience?? “Short-termism” pressures?
- Disconnect between compensation and long-term performance?
- Concentration of control in Israeli market creates unique pressures on public debt market.
- Accountability of controlling shareholders
- What should be the regulatory approach/philosophy?
 - Disclosure, disclosure, disclosure;
 - » Or
 - Substantive Intervention in commercial terms;

Commercial Debentures Securities Law Proposed Amendments

- **Proposed amendment of Chapter 5A of The Securities Law, 1968 concerning Trusts and Trustees to Certificates of Indebtedness*** ;
- The proposal constitutes an extensive overhaul of the Trustee's roles, responsibilities and authorities, and is aimed at enhancing a Trustee's ability to act as the bond holders' representative vis-à-vis the issuer of commercial paper.
- Providing for ability to demand immediate repayment of debentures upon the existence of a **well-founded concern (חשש ממש)** that the issuer will not be able to repay the debt or meet its obligations to the bondholders;
- Substantially increasing Trustee's discretionary powers when negotiating with the issuer: granting of authority to adopt decisions without bondholders' approval, including upon the occurrence of an event entitling the Trustee to demand immediate repayment, and authorizing the Trustee to determine optimal course of action in such case (namely, either reaching a settlement or a compromise with the issuing company or demanding immediate repayment).
- Trustee must monitor the issuer and the collateral throughout the lifetime of the note series. Affording Trustee's BJR-like protections.

Commercial Debentures Hodak Committee

- **The Supervisor of the Capital Market appointed a committee to Determine Parameters for Consideration by Institutional Investors Providing Credit Through Purchases of Commercial Debentures (the Hodak Committee);**
- The Hodak Committee issued its interim report in September 2009;
- The Committee identified two main problems:
 - “Quality of Product”
 - Potential discrepancies between interest rates and levels of risk inherent in the debentures
- Due to the structural weaknesses in the market, regulatory intervention by the Supervisor of the Capital Market is required to resolve two main problems:

1. Establishment of internal procedures concerning the institutional investor's methods of operation prior to making an investment decision;

Such as: analysis regarding the potential investment profitability; determining an investment threshold which shall require special approval by an investment or credit committee; requiring that all investment documents (namely, the prospectus, rating report, trust deed etc.) be received by the investor at least 7 business days before making the investment; types of information to be received in respect of debentures to be issued by private companies; information to be received during the debentures "lifetime".

2. Improving the "product quality" of issued debentures;

Requiring the existence of financial covenants and contractual limitations, such as the creation of a negative pledge, the ability to demand repayment upon the existence of a legislated list of events (including deviation from financial covenants which must be defined from a recommended list).

Commercial Debentures

Amendments to the Securities Regulations

- On January 2009 the Knesset Finance Committee approved amendments to the Securities Regulations (Periodic and Immediate Reports) (2nd amendment), 2009 and the Securities Regulations (Details, Structure and Form of Prospectus and Draft Prospectus) (2nd amendment), 2009; which amendments serve to significantly broadened the reporting requirements of public companies with regard to their issued debentures;
- The major supplemental reporting requirements are to publish: (1) upon the existence of certain “red flags” (such as a “going concern” qualification, negative working capital) the company’s anticipated cash flow for the next two years (including a list of liabilities and sources); (2) updated valuations of assets pledged in favor of bondholders; (3) immediate reports with regard to: any changes of the trust deed or the trustee, any event which has or could have material influence on the value of any collateral, any breach of the company’s obligations to its bondholders or the occurrence of any event entitling the trustee to demand immediate repayment of the debt.

Commercial Debentures ISA SLB's

- **ISA SLB regarding disclosure of self purchase plans and self purchase, December 2008;**

The SLB specifies the disclosure required regarding a public company's authorized repurchase plan with respect to its securities (including debentures), and regarding the performance of such self acquisitions;

- **ISA SLB regarding disclosure of the company's financial liabilities, November 2008;**

The SLB establishes a reporting requirement, in an immediate report along with the company's financial statements, of the status of the company's financial liabilities, pursuant to their respective repayment dates, and itemized according to type and location of creditors (namely: banks, institutional investors and the public, in Israel or abroad).

Commercial Debentures

Proposed regulation re Rating Companies

ISA proposed Law memorandum: regulating the activity of rating companies , 2009 [approved by ISA's assembly on 30.3.09];

- The purpose of this proposed law, is to protect the public investors who rely on the rating process, and to ensure that the rating itself as well as the rating process shall be reliable, qualitative, independent and equalitarian;
- Rating companies shall be required to disclose their rating methodology and the information they rely upon, in a manner which will enable to evaluate the credibility and quality of their rating;
- The proposed law define “rating” and a “rating company”; determine minimal performance standards of a rating company; determine conditions and qualifications required of a rating company, including organizational and operational requirements designated to ensure the independence and credibility of a rating company’s controlling shareholders and management; and appoint the ISA to supervise and regulate rating companies.

Disinterested Directors - Companies Law (8th amendment), 2008 (initiated by the Justice Department):

- Section 219(E) of the Companies Law, 1999, now provides that a public company may establish in its Articles of Association that its Board of Directors shall include Disinterested Directors and may establish that the number of Disinterested Directors shall be most of the members of the Board, if the company has no controlling shareholders, or, at least one third of the members of the Board, if the company does have a controlling shareholder (“The Directive Regarding the Percentage of Disinterested Directors”);
- A Disinterested Director is defined as a director that the Audit Committee has approved as fulfilling the qualifications of an External Director* and who has not served on the company’s Board for over nine continuous years.

* other than the requirements to be Israeli resident and to have financial and accounting or professional skills.

Reporting Requirements regarding Disinterested Directors: Securities Regulations (Periodic and Immediate Reports) (3rd amendment), 2009;

- A public company is required to state in its annual report whether its Articles of Association include the Directive Regarding the Percentage of Disinterested Directors (“adopt or disclose”);
- In addition, it is required to inform in the annual report as well as in an immediate report, whenever the percentage of Disinterested Directors falls below the required percentage according to its Articles, and to disclose the actions it means to take in order to obtain the required percentage, including the time schedule for such actions.

Corporate Governance Proposed 10th Amendment to Companies Law

Law Memorandum –The Companies Law (10th Amendment), 2008

- The goal of this proposed amendment is improve the Corporate Governance of companies in Israel and adjust it to the customary principles of Corporate Governance around the western world.
- The proposed major changes: to require approval by a majority of “non-controlling” shareholders for: (1) approval of transactions with controlling shareholders, and (2) appointment of Independent Directors; enhance the separation between the CEO and chairman of the Board; strengthen the role and independence of the Board Audit Committee; implement a policy of “adopt or disclose” with respect to a list of Corporate Governance recommendations, including: (a) that a majority of the Board members be “disinterested”; (b) officers who are subject to the CEO shall not serve as directors, (c) performance of quarterly discussions regarding the performance of the CEO and executive management (in absentia), (d) guidelines regarding approval process of executive compensation; provisions to enable easier access and funding of derivative actions; provisions targeted at streamlining “full” tender offers.

Corporate Governance Poalim Sahar's Position Statement

Poalim Sahar's Position Statement regarding voting policy while exercising a Proxy in General Meetings, September 2009;

- Poalim Sahar provides various services to institutional investors with regard to their decision making as shareholders at General Meetings of public companies, including consulting services;
- The Position statement includes an extensive review of the significant and common decisions shareholders in public companies are required to consider, including, among others: appointment of directors, executive compensations plans, interested parties transactions, mergers and acquisitions, poison pills, D&O insurance and indemnification, appointment of auditors and amendments to the Articles of Association, and states Poalim Sahar considerations, views and recommendations for each topic.

Examples of Poalim Sahar's recommendations:

- object to the appointment of officers "inferior" to the CEO as directors;
- object the appointment of the CEO as chairman of the Board of Directors;
- support the appointment of Disinterested Directors, according the Directive Regarding the Percentage of Disinterested Directors;
- object to the establishment of staggered board;
- object to retroactive approvals of compensation plans;
- object to repricing of options for directors and officers;
- object to poison pill mechanism;
- object to employment agreements with officers exceeding the terms of 5 years;
- object to amendments of the Articles of Association reducing the majority required to approve material resolutions in general meetings.

Securities Regulations (Periodic and Immediate Statements) (amendment), 2009

- The amendment partially adopts sections 302 and 404 of the Sarbanes - Oxely Act of 2002, and requires that the company's CEO and CFO certify and approve the integrity of their company's financial statements, that the Board of Directors report on the adequacy of the company's internal controls over financial reporting, and that the auditors opine on the adequacy of the representations in the financial statements, and the company's internal controls over financial reporting.

Corporate Governance Disclosure of Executive Compensation

Broadening disclosure requirements on compensation of executives, Amendment to the Securities Regulations, July 2008;

- A company is required to disclose its five highest paid employees, and the following details with respect to them: compensation (salary, bonuses, stock based compensation), current shareholding in the company, benefits, and any other recompense or benefit ;
- The company is required to disclose whether compensation is linked to the company's performance. The Board is required to state its opinion regarding the relationship between the executive's contribution to the company and his/her compensation, as well as whether the compensation is fair and reasonable;
- In immediate reports submitted by the company with regard to new employment agreements with executives or interested parties, the company is required to provide similar disclosure, and as well as information regarding the process for approval of the compensation, including the reasons for such approvals.

Corporate Governance Disclosure of Transactions with Controlling Shareholders

Broadening disclosure requirements on transactions with controlling shareholders; Amendments to the Securities Regulations, July 2008;

- The Amendment widened the scope of disclosure regarding transactions with controlling shareholders and added a requirement to disclose transactions “in the ordinary course” (other than negligible transactions), in addition to the existing requirement to disclose significant transactions;
- This amendment was implemented in light of the influence of the classification of such transactions (as “ordinary” or “significant”) on their approval process.

ISA Chairman Goshen has publicly expressed his views with regard to companies' risk management on numerous occasions:

- "...There appears to be a dramatic failure in risk management, on both the side of the players creating the financial instruments and the players who bought them. Risk Management should play a key role in today's regulation and in the companies activities, in both the financial and real markets..."

The Knesset Finance Committee, 27.10.2008;

- According to the ISA's publications, it is considering alternative models of regulation of risk management by local entities. The basic tenet would be to highlight and emphasize the Board of Directors' role in designing the company's risk management policy. The Board should determine and understand the company's risk factors, form a clear policy of risk management and supervise its implementation;

Enforcement Establishment of a "Special Economic Court"

Proposed Courts Law (amendment), 2009 -the Establishment of an economic department in Tel Aviv District Court

(initiated by ISA in light of "Goshen Committee's" recommendations and approved by the Knesset's Ministers Committee for legislation on November 2009);

- The draft amendment proposes mainly to (1) provide district courts with the material jurisdiction to adjudicate "Economic Matters", a term which shall include mainly issues of corporate and securities laws, and (2) to establish an "economic department" in the Tel Aviv District Court comprised of judges who specialize in economic law, namely corporate and securities laws, which shall concentrate and focus on all civil, criminal and administrative matters involving these matters;
- This proposal is aimed at creating a permanent and organized basis to an efficient and professional judiciary, in order to increase the consistency and stability of norms in economic law;
- The Goshen Committee expressed its view that the existence of a such specialized court will prevent exploitation and discrimination of minority shareholders, and will constitute a key factor in enhancing the quality of public company management, developing the capital market and improving the economy.

Enforcement Complementary Enforcement by ISA

Law Memorandum: ISA Complementary Enforcement Law (Legislation Amendments), 2009

(Initiated by ISA and approved by Knesset's Ministers Committee for legislation on December 2009);

- The current enforcement tools available to day under the Securities Law are mostly criminal, and therefore, limiting and costly. The Memorandum propose to establish an administrative committee, comprised of experienced jurisprudent specialists in the capital market, and chaired by ISA's chairmen, designated to handle breaches of the securities laws which constitute "negligence";
- The committee shall be able to apply enforcement tools such as, among others, financial sanctions in substantial sums, payments of compensation to those damaged by the performance of the breach, constructive actions in order to correct the breach and prevent its repetition, and probation punishment.

“Crisis Regulation”

- During the crisis, the ISA issued various SLB’s concerning certain events and matters resulting from the crisis, mainly with respect to companies in difficulties;
- Few examples:
 - SLB regarding the necessary disclosure of debt arrangements, November 2009;
 - Draft SLB regarding the reporting requirements of companies in difficulties, August 2009;
 - ISA’s Assembly resolutions 2009-1(A) – 2009-1(C), which established a basic structure enabling the formation of debt arrangements between bondholders and the issuing companies.



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