



The Committee on Increasing Competitiveness in the Economy has Submitted its Interim Recommendations to the Prime Minister, the Minister of Finance and the Governor¹

The Committee on Increasing of Competitiveness in the Economy that was appointed by the Prime Minister, the Minister of Finance and the Governor of the Bank of Israel has concluded the interim stage of the formulation of its recommendations.

The members of the Committee, which is headed by the Director General of the Ministry of Finance, **Chaim Shani**, include **Prof. Eugene Kandell**, Head of the National Economic Council in the Office of the Prime Minister, **Prof. Shmuel Hauser**, Chairman of the Israel Securities Authority, **Dr. Karnit Flug**, Assistant Governor of the Bank of Israel, **David Zaken**, Supervisor of Banks, **Gal Hershkovitz**, Budget Director, **Prof. Oded Sarig**, Commissioner of Capital Markets, Insurance and Savings, **Dr. Avi Licht**, Deputy Attorney General, **Prof. David Gilo**, Antitrust Commissioner and **Dr. Gitit Gur-Gershoren**, Economics Department Director in the Israel Securities Authority.

The Minister of Finance, **Dr. Yuval Steinitz**, welcomed the members of the Committee and noted that this is a historical turning point in the Israeli Economy, which has the potential to bring about a real and fundamental change in the business structure of the economy that will ultimately be beneficial to all members of Israeli society. “The Committee, on all its members, has performed to the highest professional standard. I am confident that, similarly to other reforms

¹ **Disclaimer: The binding version is the Hebrew text only**

that we had passed, these recommendations too will be brought to the approval of the Knesset [Israeli Parliament] and will enter the codex after the public's positions will have been heard. The implementation of the recommendations will result in a more effective distribution of capital in the economy and a further wise elaboration of the Israeli capital market.”

The Chairman of the Committee, the Director General of the Ministry of Finance, **Chaim Shani**, added: “we are concluding a comprehensive professional study that has been performed over the duration of many months; we had met and consulted with numerous functions in Israel and overseas and I believe that the recommendations that are being presented today represent a solid infrastructure that, in the long-term, will have increased the competitiveness in Israel. It should be noted that the submission of the recommendations is only the first step of a journey and that we are currently preparing for hearing the public's positions, after which we will finalize the recommendations and bring them to the approval of the Government. I would like to thank all members of the Committee for their dedication and professionalism and even more so for the outstanding team work.”

The Committee has been requested to examine the effect of the existing structure of the economy on the level of competition in the various sectors of the economy, on its financial stability and on its economic efficiency. The Committee has been asked to recommend advisable policy measures with emphasis on the issue of the control of real companies over financial companies, the issue of the control of a public company using a pyramid holding structure and the manner of the allocation of public assets. Based on this mandate, three work teams were appointed to review each of the said issues.

As part of its work, the Committee had held more than 20 discussions in full session and numerous other discussions in the smaller forums. Following the call to the public to present its position prior to the formulation of the recommendations, the Committee had received 30 statements of position from organizations and individuals and close to 20 speakers had appeared before the Committee, including experts and academics and NGO's representatives and organizations and bodies that represent interested parties. Additionally, the Committee had consulted Prof. Arye Bebchuk, an international expert in economics and law from Harvard University.

The recommendations of the Committee in each of the chapters are as follows:

Team for the review of real and financial holdings - headed by Prof. Eugene Kandel

The level of competition in the Israeli market is affected by the existence of a limited number of major business groups that are involved in a large number of different activities in the market, raising concern for adverse effect on the competition in various sectors and on the economy in general. According to economic literature, whenever the same players simultaneously compete in various sectors, each of them will seek to maximize the profit across all of the sectors in which it operates rather than consider each individual sector. This concern is intensified when the business groups in question incorporate a financial entity, such as a bank or a pension fund, which is exposed to all sectors of the economy and therefore serves as a source for business information on competitors as well as on customers and vendors of the members of the business group.

Financial entities are responsible for the allocation of resources, most of which belong to the public, with the assumption being that given a free and competitive market the allocation of resources will be efficient on the level of the economy. Real entities, on the other hand, seek to secure, each for its own, the largest availability of resources possible. The combination of real and financial entities under a single control or holding raises, in addition to the possible hindering of competition, a concern for the ineffective allocation of resources in the economy as a result of the possible emergence of conflicts of interests between the real and the financial activity.

Corporate governance principles in Israel assign the institutional investors (pension funds, insurance companies, provident funds) the responsibility to play a central role in protecting the investors and savers. The lack of separation between real and financial pursuits, despite the existence of comprehensive and advanced regulatory arrangements, could create a conflict of interests for the institutional investors between their membership in a business group with real operations and their role in corporate governance and might affect the ability and the willingness of these intermediaries to properly fulfill their duties.

The very existence of a select group of major credit consumers on the level of the economy that dominate groups of companies through complex holding structures might give rise to systemic risks that grow in proportion to the size and complexity of the real and financial entities. Such systemic risks are greater than the direct influence of those entities on the economy, since the business groups operate in a large number of markets, with a variety of customers, vendors and competitors in each of the markets. When the ownership of financial entities is combined with

ownership of those major credit consumers that have different goals, interests and risk preferences, a link may also be created between the strength of the financial institution and the stability of the business group. Evidently, this link intensifies in proportion to the size and complexity of the real and financial entities.

Accordingly, the Committee recommends:

1. Prohibiting control or holding in a significant financial entity by a significant real entity or by the controlling shareholder in a significant real entity. A significant financial entity is an entity that manages assets in excess of NIS 50 billion (about 2.5% of total financial assets in the market). A significant real entity is an entity with a sales turnover of more than NIS 8 billion (about 0.5% of the total turnover in the market) or total assets (balance) in excess of NIS 20 billion and the assets in Israel are more than 5% of total assets. Hence, the same controlling shareholder will not be permitted to hold both a significant real entity and a significant financial entity.
2. Restrictions on the concurrent office of directors in a significant financial entity and a significant real entity.
3. Restrictions on the control in a significant financial entity that is a bank and in another significant financial entity (supplement to the “Bachar legislation”²).

Implementation mechanisms:

- The Committee determined that the entities will be required to implement the recommended changes over the next four years, this in order to create a reasonable transition period that will allow for the preparations that such process requires.
- Additionally, the Committee set a principle that will contribute to encouraging competition, particularly among smaller entities, which would be permitted to exceed the threshold under the following conditions:
 - a. If a financial entity becomes significant following the obtaining of an authorization for the control or holding therein by a significant real entity or the controlling shareholder in a significant real entity, the aforesaid prohibition shall not apply if the increase in the total assets of the significant financial entity is not the result of the acquisition or merger of another financial entity, and provided that the aforesaid total assets does not exceed NIS 75 billion. If the total assets of the financial entity

² Bachar Committee: a controlling shareholder in a bank may not hold provident or mutual funds; Competition Committee: nor an insurance company.

exceed the aforesaid amount, the Supervisor of Banks, the Director of Capital Markets, Insurance and Savings Department or the Chairman of the Israel Securities Authority, each in his respective area of responsibility, may prescribe conditions under which the holder of the authorization will be deemed to be in compliance with the threshold conditions.

- b. If a real entity becomes significant after obtaining an authorization for the control or holding in a significant financial entity, the aforesaid prohibition shall not apply if the increase in the sales turnover of the real entity in Israel is not the result of the acquisition or merger of another real entity, and provided that the sales turnover of the real entity in Israel does not exceed NIS 12 billion or its total assets is not greater than NIS 30 billion and the assets in Israel are not more than 5% of total assets. If the sales turnover of the real entity exceeds the aforesaid amount, the Supervisor of Banks, the Director of Capital Markets, Insurance and Savings Department or the Chairman of the Securities Authority, each in his respective area of responsibility, may prescribe conditions under which the holder of the authorization will be deemed to be in compliance with the threshold conditions.

Team for the review of control using a pyramid holding structure - headed by Prof. Shmuel Hauser

Several major and significant business groups operate in Israel. These groups account for a substantial portion of the business activity in the State of Israel. For example, the sales of the six largest groups in the economy represent about a quarter of the GDP, the 10 largest groups lead about 50% of the issuances of debentures on the local market and the shares of the 24 largest groups represent about 70% of the market value of the Tel Aviv Stock Exchange (excluding Teva). The common denominator of all the major groups in Israel is their incorporation under a pyramid structure, all with a controlling shareholder. Numerous rationales are provided in literature for the existence of pyramid groups, which are very common worldwide (with the exception of the United States and the United Kingdom); nevertheless, it is the Committee's impression that its prevalence in Israel is far greater, both in terms of the depth of the pyramids and in terms of their size in relation to the overall market.

What, in practice, is a pyramid or a “pyramid of control”?

- A chain of companies or a compilation of several chains, at the top of which there is a joint controlling shareholder.
- Each company in the chain controls the company directly below it, but does not hold 100% of the equity therein.
- The controlling shareholder controls the top of the chain directly, and the entire chain indirectly.

The literature offers advantages and disadvantages for the pyramid structure. The advantages include intercompany backup within the pyramid where necessary, sharing of knowhow and business relations between the companies, business exposure and penetration of new areas. In the absence of institutions such as a developed capital market, an effective legal system and regulatory institutions, belonging to a pyramid affords certainty as to the supply of services and the upholding of contracts. In opposition, several potential problems may arise in a market that is characterized by multiple pyramid structures. The pyramid structure may result in the “tunneling of resources” - the transfer of resources between the companies in favor of the controlling shareholder at the expense of the minority shareholders, the ineffective allocation of resources, the excessive assumption of risks, internal capital market, double leverage between the companies and the entrenchment of control by the one standing at the top of the pyramid, even if he holds a small portion of the equity (“persistence” in professional literature). Additionally, on the level of the economy, there is some concern for the impairment of the stability of the economy in the long term in the event that several major entities face a crisis, foreign investors are deterred by investment in a pyramid market that is complex and difficult to understand, the indexes of the Stock Exchange reflect misleading market activity and, if few major business entities operate in the same markets or decide to divide the market between them this could result in a “multi market contacts” that could be detrimental to competition.

Clearly, the advantages are primarily suited for emerging markets. Nevertheless, there is evidence that while the advantages are diminished (following the development of the markets) the disadvantages remain and the pyramids persist due to the absence of mechanisms for their dismantling (the persistence problem).

Consequently, the Committee identifies a “market failure” that requires intervention by the Government. The Committee has long deliberated whether the pyramid structure is a fundamentally faulty structure or a legitimate tool that is abused under certain circumstances. The members of the Committee have concluded that this tool is not prohibited prima facie, but embodies a high potential for the exploitation of the minority shareholders within the pyramid by the controlling shareholder in the pyramid. Additionally, it raises problems of competition and in certain cases also problems in connection with the overall stability of the economy. The solutions are designated to address the problems in the existing state of affairs, as identified by the Committee.

The Committee has recommended corporate governance tools that will ensure that any company in the structure is managed in accordance with the interests of all of its shareholders rather than solely based on the interests of the controlling shareholder. Thus, the Committee does not preclude pyramid structures, but allows investors to distinguish between cases in which the pyramid creates value for them - in which case it may continue operating in its existing form, and cases in which the pyramid serves the interests of the controlling shareholder - in which case the shareholders will be able to balance the manner of its management or quit the pyramid should they choose to do so.

A significant part of the Committee’s recommendations focuses on instances in which the interests of the controlling shareholder may differ from the interests of the public companies that he controls

On the macro level, the Committee identifies a risk to the economy as a result of the existence of several pyramids whose weight in the economy is substantial. The business relations within the group and between the groups create a situation in the market that could be detrimental to the dynamics of the economy and the level of competition therein. Consequently, the Committee recommends reinforcing the authority of the Antitrust Commissioner in order to ensure that the existence of a number of strong business groups does not hinder the competition in the economy and in the various sectors.

A final point that was identified by the Committee as a risk to the economy is the high leverage that exists in the business groups (as well as in the market as a whole) in relation to customary global practice. Since the Committee believes that this problem exists throughout the market, it has recommended tools that have a cross-section effect - a tax tool that addresses the recognition

of financing expenses and reduces the incentive to take loans to finance leveraged acquisitions. The second measure that the Committee opted for is a reexamination of the investment restrictions imposed on institutional investors in order to reduce the exposure of these institutions to the major borrowers in the market and to minimize the potential damage to the public's savings in the event of the crashing of a business group.

A public company will be deemed as a wedge company if it meets all of the following conditions:

- 1) The company has a controlling shareholder, as defined in the Securities Law.
- 2) The percentage holding of the controlling shareholder in the company does not exceed 50%.
- 3) a. The percentage holding of the controlling shareholder in the voting rights in the company exceeds his equity holdings in the company as a result of the holding of equity interest through another public company (pyramid structure).

Or

- b. In other cases of entrenched control, as shall be defined by law³.

Accordingly, the recommendations of the Committee are divided into 4 chapters:

Chapter A - Corporate Governance

1. Strengthening the Board of Directors
 - a. In a wedge company, at least one third of the members of the Board of Directors will be outside directors that are not connected to the controlling shareholder.
 - b. The approval of the outside directors by the general meeting will require a majority that does not represent the controlling shareholder.
 - c. The appointment of a director in a subsidiary by the controlling shareholder will be subject to the approval of the Audit Committee.
2. Executive compensation - the Committee recommends advancing the amendment to the Companies Law with respect to executive compensation pursuant to the recommendations of the Neeman Committee. The Committee supports the

³ The legislation will define an overall approach to the issue of entrenched control as well as the arrangements that would apply in each case of the entrenchment of control.

recommendations of the Neeman Committee that provide for the establishment of a special approval procedure in wedge companies and the conditioning of the compensation on special approval in general meeting by an untainted majority.

3. Transactions with interested parties

- a. The execution of a competitive process prior to the approval of a transaction with a controlling shareholder for the sale of an asset, the receipt of operating services, the purchase of a shelf product or of the receipt of a loan, under an “adopt or disclose” format.
- b. Authorization and supervision by the Audit Committee of transactions which, although not “extraordinary”, are also not financially negligible.

4. Strengthening the position of the minority shareholders

The following decisions will require the approval of the general meeting by a majority of the minority shareholders:

- a. Acquisition of a significant operation
- b. Acquisition of a control core in another public company
- c. Raising of capital or debt in a significant amount

Additionally, it is proposed to allow shareholders and debenture holders to vote via the Internet.

5. Encouragement of individual enforcement by the shareholders

- a. The Israel Securities Authority will expand the financing of class actions and derivative claims
- b. Arrangements will be determined with respect to the financing of class actions or derivative claims that are submitted by institutional investors

6. Encouragement of Activism of Institutional Investors

- a. Institutional investors will be allowed to coordinate positions ahead of the general meeting
- b. Institutional investors will be required to take into consideration the quality of the corporate governance when making an investment decision
- c. The disclosure requirements that are applicable to the voting by institutional investors at general meetings of public companies will be expanded

Chapter B - Structural Changes

7. Prohibition of the listing for trade of a duplicate activity and prohibition of dual listing in the indexes of the Stock Exchange
8. Restrictions on the creation of a new wedge company - a company that is interested in acquiring a control core in a public company, as a result of which the public company will become a wedge company, will be required to offer to purchase all of the shares of the acquired company for the price offered for the control core
9. Granting an “exit” right to shareholders - if an outside bid has been made to purchase all of the shares of a wedge company and the controlling shareholder rejects the bid and undermines it although the other shareholders are interested in the offer, the controlling shareholder would be required to accept the bid or alternatively to offer to buy all of the public’s shares at the price of the bid
10. Restricting the influence of the controlling shareholder over the general meeting - the Committee requests to receive the public’s comments on the proposal: in a wedge company, the effective voting rights of the controlling shareholder at the general meeting will not exceed his equity interest.

Chapter C - Reducing the Leverage and the Systemic Risk

11. Disallowing financing expenses for tax purposes - it is proposed that financing expenses will be initially allocated to dividend income (which is tax exempted). If the financing expenses exceed the dividend income – the difference will be added to the cost of shares for tax purposes.
12. Restrictions on credit from public institutions - expansion of the restrictions on the exposure of public institutions to a single entity and group of borrowers (similarly to the restrictions imposed by Banking Supervision).
13. The team in charge of systemic risk, headed by the Bank of Israel, will allocate resources to the monitoring and handling of business groups based on the applicable indicators

Chapter D - Encouragement of Competition - broadening the authority of the Antitrust Commissioner

14. The Antitrust Court will be authorized to enforce changes (structural remedies) in concentration groups

15. The Committee recommends that the Ministerial Legislation Committee approve the amendment to the Antitrust Law that confers upon the Commissioner administrative enforcement powers, including the use of financial sanctions

Team for the review of the conditions for the allotment of public assets - headed by Prof. David Gilo

Until the 1970's, the State had established and owned central industries. The involvement was effected through the operations of the Government ministries that had directly provided the services, occasionally through companies that were controlled by the State and in practice had acted as its operating arm.

Since the 1970's, the Israeli economy has undergone structural changes: the State had limited its involvement in the economic life and has made a transition (which is still in progress) from a model of the direct supply of services and the control of a variety of assets (including infrastructures) to a model of regulation of private bodies, inter alia, by setting principles that regulate the operations of private entities that had acquired the State's assets or had been granted licenses or concessions.

The members of the Committee believe that, in the current state of affairs, considerations of competition and centralization, which are essential to the allocation of State assets, rights, licenses and concessions are not sufficiently weighed in. Occasionally, questions arise as to the competence of the allocating function to take into account wider considerations, other than price considerations.

The Committee has examined the manner in which the functions that are in charge of the procedures for the allocation of State rights and assets (sale of assets to private entities, granting of concessions, licensing, BOT) operate and recommends that these functions will be authorized to consider as part of the allocation process considerations of competition in the sector and the decentralization of control in essential infrastructures, so as to prevent the transfer of control in State infrastructure to the hands of few.

16. A prerequisite for the allotment of rights by the State will be consulting the Antitrust Commissioner whenever the value of the right or the asset is in excess of NIS 150 million, or in lower values wherever the economic value of the asset does not reflect its significance to the public
17. A prerequisite for the allotment of rights in essential infrastructures (as shall be defined by law) will be consulting an Advisory Committee whenever the value of the right or the asset is in excess of NIS 150 million, or in lower values wherever the economic value of the asset does not reflect its significance to the public. The consultation requirement relates to the implications on the overall centralization of essential infrastructures.
18. As aforesaid, the essential infrastructures to which the recommendations relate will be defined by law. These relate, inter alia, to the following areas: water, energy, communications, transportation, healthcare and natural resources. The list would be adjustable and expandable.

Members of the Advisory Committee: Director General of the Ministry of Finance, the Antitrust Commissioner, the representative of the Attorney General and the Head of the National Economic Council.

The Committee notes that a draft report will be published for public comments within three weeks. The final report will be submitted to the Government in about three months and, to the extent that it is approved, it will be transferred to the Knesset (Israeli Parliament) to complete the required legislation.