OECD PEER REVIEW

MINORITY PROTECTION: RELATED PARTY TRANSACTIONS

Chapter on Israel

This chapter on Israel of the OECD report on the corporate governance framework for managing related party transactions describes the structure of listed companies and especially the concentration of ownership and the use of company groups, all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions and to protect minority shareholders is analysed, and the potential for improvements discussed.

1. The OECD's review of Israel, carried out during 2008-2009, identified highly concentrated ownership and the prevalence of pyramidal company groups within the Israeli market as a key risk to the enforcement of shareholder rights and equitable treatment, and noted the Israeli authorities' active efforts to address this issue. In the time since the review was completed, Israel has taken steps to further strengthen its framework for upholding minority shareholder rights. New company law amendments that took effect in May 2011 enhance the enforcement tools available to the securities authority and give disinterested shareholders strengthened powers in the election of independent directors and the review of related party transactions. In addition, a specialized economic court was established earlier this year in Tel Aviv, allowing for more rapid resolution of cases involving shareholder abuse. Nevertheless, the dominance of company groups in the Israeli economy and the risks associated with them remain a subject of active consideration and debate, both in the press and through deliberations of an intergovernmental working group established to look at issues related to their role in the economy.

2. This report briefly describes Israel's principal market characteristics before setting out the requirements for approval and disclosure of related party transactions in Israel. It then describes the wider set of measures in place that are intended to protect minority shareholder rights and more specifically to prevent the abuse of related party transactions, before concluding with an overall assessment of the situation.

Ownership and Control of Listed Companies

3. Recent research has estimated that three-quarters of Israeli listed companies (613 as of the end of 2010) are controlled by family or individual interests. Twenty business groups, nearly all of them family-owned, controlled 160 publicly-traded companies with a 40 percent segment of the market. The market segment of the 10 largest groups was estimated at 30 per cent, quite high relative to other OECD countries (Bank of Israel, Kosenko, 2008).

4. Israeli corporate pyramids tend to be quite complex and diversified, spanning a wide range of industries, with several of the large groups including financial concerns such as banks and insurance companies at their lower levels. Reforms have curtailed banks' ability to play an active role in the pyramids, principally due to the fact that they have been limited in their investments in industrial companies and through company law restrictions on related party transactions (OECD, 2011).

5. Nevertheless, many of the groups continue to maintain ties to institutional investors that create a potential conflict of interest between their role of representing their beneficiaries and the interests of other companies within the group. While most shares in the Israeli market are owned by individuals including blockholders, institutional investors owned 18 per cent, foreign investors 17 per cent, and government 1 per cent, according to 2007 data from the Tel Aviv Stock Exchange (TASE) provided for the OECD review of Israel (OECD, 2011)[1].

6. The free float in most Israeli companies is low, averaging less than 25 per cent for more than 250 companies, and 31 per cent overall excluding Israel's largest company, TEVA, a pharmaceutical group which has a 91 per cent free float, according to the TASE 2007 data. While the OECD review of Israel covered the structure and characteristics of the Israeli market in greater detail than is required here, one of its key conclusions was that, with no trends apparent toward significant changes to the current market

[1] The statistical data for Israel were supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

structure, "The Israeli approach so far has been to accept the concentrated ownership and take steps, mainly through *ex ante* regulatory means, to avoid abuse." (OECD, 2011).

Approval processes for related party transactions

7. A special approval process is required under the Companies Law for the following related party transactions:

- Audit Committee, Board and General Meeting approval is required for all extraordinary transactions[2] of a public company with a controlling shareholder or with another person in which the controlling shareholder has a personal interest, including a private placement; a contract with the controlling shareholder or relative for the provision of services to the company; if he is an officer in the company, regarding the terms of his service and his employment; and if he is a company employee but not an officer, regarding his employment by the company.

- To obtain General Meeting approval, the transaction must attract the support of a majority of the votes of the shareholders who do not have a personal interest in the transaction and who are present and voting. The company itself has the responsibility for the classification of shareholders for such votes, but the Israel Securities Authorities (ISA) also checks *ex post* on whether shareholders have been correctly classified, particularly in cases where they judge that incorrect classification would have the potential to change the outcome of the vote. This "majority of the minority" provision was recently strengthened through Companies Law Amendment 16 to be increased from one-third of disinterested shareholders to a majority requirement. To reduce the risk of abuse by a small minority in cases where few disinterested shareholders are present and voting, the law also allows a measure to be approved even without a majority of the votes of disinterested shareholders if the level of opposing votes among these shareholders does not exceed 2 per cent of total voting rights (increased from 1 percent under the same amendment).

- Other transactions relating to employment contracts and remuneration, including employment of company officers, controlling shareholders or their relatives, are also subject to RPT approval processes but are not the focus of this particular review.

Disclosure of related party transactions

8. Israeli Securities and company laws provide a quite detailed and specific list of interested parties and types of transactions subject to disclosure through either immediate or periodic reports. Securities law stipulates that immediate reports, known as transaction reports, must be filed following any company transaction with the controlling shareholder or with an individual or corporation in which the controlling shareholder has an interest, including details of who approved the transaction and the reasoning behind its approval. Company law further specifies that immediate reports must be filed in the case of an "extraordinary transactions" (see previous footnote for definition) between a public company and one of its controlling shareholders or another interested party.

9. The company must give notice of these transactions and their terms along with the convening of a general meeting for the purpose of approving the transaction within 14 days of its approval by the Board of Directors. The transaction report "must include every detail concerning the transaction that may be important to a reasonable investor . . . for the purpose of voting at the general meeting, including, *inter*

[2] Companies Law defines an extraordinary transaction as a transaction not in a company's ordinary course of business, not undertaken under market conditions, or a transaction that is likely to materially influence the profitability of a company, its property or liabilities.

alia: a description of the main points of the transaction; the name of the controlling shareholder who has a personal interest in the transaction; details of the rights that give him control in the company, including his proportional stake in voting rights; the nature of the personal interest; and approvals required or terms that were determined for carrying out the transaction. The report must also include the reasons of the audit committee and the board of directors for approving the transaction, the value of the consideration and the manner in which it was determined, and the reasons of the directors opposing it, if there were any, and the names of the directors who participated in the board and audit committee meetings with regard to the approval of the transaction, indicating who of these is an external director; the manner in which the consideration was determined and the name of each director who has a personal interest in the transaction and the nature of this interest."[3]

10. Separate but similar requirements are established for extraordinary transactions involving a company officer or between the company and another person that the officer of the company has a personal interest in; for contracts between the company and its CEO regarding the terms of his employment; contracts between the company and one of its directors regarding terms of service, including the granting of loans in the context of employment terms; or a contract between the company and one of its directors regarding terms of employment in other positions. If a transaction involving an officer or director was not approved due to conflict of interest or lack of good faith, it must still be reported.

11. Finally, Securities Law specifies a set of related party transactions, essentially recurrent transactions, subject to less detailed, "periodic reports." Company annual reports must specify the identities of the parties to the transaction; its details; the date and authorizing body; and the controlling shareholder's personal interest in the transaction.

12. In addition, Israeli public companies are required to follow International Financial Reporting Standard (IFRS) requirements, including IAS24. Because IAS24 defines related parties as including parent companies and subsidiaries, and companies of the same group (among other related parties), intra-group disclosures are treated under IAS24 as part of the disclosure of consolidated financial accounts.

Provisions concerning board duties and the role of independent directors

13. On a broad level, Israel's legal framework provides a wide range of protection and support for minority shareholder rights. In the case of boards, this protection is established both through the definition of directors' duties as well as through provisions that give minority shareholders special powers in the appointment of a special type of independent director known as an "outside director." These provisions may be seen as reinforcing the requirement for independent judgement of both the Audit Committee and the board, which both play a role in reviewing related party transactions.

14. The Companies Law stipulates that directors owe a duty of care and fiduciary duty to the company (i.e. a duty of loyalty) rather than specifically to shareholders. However, they also have an obligation to maximise profits, although within this scope they may take into account the interests of the company's creditors, employees and the public. The Companies Law also requires that directors use independent judgement and may not be a party to voting agreements or instructions. Directors must also refrain from any act that involves a conflict of interest, competing with the company, and exploiting corporate opportunities for their own benefit. Shareholders can seek redress for violation of directors' fiduciary duties mainly through derivative suits on behalf of the company, although it is possible to file

[3] Securities Regulations, 2001, Section 3, Transactions between a Company and a Controlling Shareholder. The reference to "external director," also known in Israel as an "outside director," refers to independent directors who must be elected by a majority of disinterested shareholders, i.e. not including the votes of the controlling shareholder or others associated with the controlling shareholder.

individual or class action suits against directors if the breach of duty relates to disclosure or an attempt to defraud, covered under Securities Law. The issue of shareholder suits is covered in greater detail under the section on enforcement.

15. In addition, the Companies Law provides specifically for the appointment to the board of at least two independent directors, including at least one "outside director" who must be both independent and have special qualifications, i.e. accounting or finance expertise. If one outside director with such expertise is already in place, other professional qualifications are also acceptable to be designated as an "outside director." To be classified either as independent or outside directors, they must also not possess any connection to the company or hold any position that gives rise to a conflict of interest, including economic or family relations to corporate management or major shareholders (OECD 2011). Outside directors play a crucial role in chairing the Audit Committee, and along with at least one additional independent director (but not necessarily "outside director"), comprise a majority of the Audit Committee. This committee has the first responsibility to review related party transactions before board or shareholder approval. The Audit Committee also has been given a new role under Israel's recent Company Law amendments obliging it to set up arrangements to protect whistleblowers and to treat reports dealing with deficiencies in management.

16. The 2011 Company Law amendments also increased the percentage of non-controlling shareholder votes required to appoint outside directors from one-third to at least half (or that the total number of votes opposing the appointment from among the non-controlling shareholders is less than 2 per cent of the total voting rights in the company). While these "majority of the minority" provisions apply to appointment of outside directors, independent directors do not require such minority shareholder approval, but they must meet the above described criteria for independence. Outside director elections are further facilitated by the fact that directors are elected individually, rather than as part of a slate. The controlling shareholder is also no longer able to prevent the appointment of an outside director for a further 3-year term, if a majority of minority shareholders approve the appointment. There must also be at least one independent director on all board sub-committees other than audit.

17. For the more specific case of reviewing related party transactions, Companies Law requires that a Director not be present for the discussion and abstain from voting on any transaction for which he or she has a personal interest in its approval. Likewise, company officers with a personal interest in a transaction may not be present unless the Chairman of the Audit Committee or the Chairman of the Board requires their presence in order to present the issue before the board or the committee. An exception can be made to allow a board member with an interest in the transaction to participate in the discussion and to vote if a majority of the Directors of the company have such a personal interest in the transaction, but in such a case, the transaction also requires approval of the General Meeting.

18. Beyond these legal provisions, the Companies Law recently adopted a Corporate Governance Code setting out voluntary recommendations that a majority of directors within a company with dispersed shareholding should be independent, and at least one-third of the directors in a company with a controlling shareholder. The ISA is still working to implement reporting requirements associated with the Code, whose reporting corporations will have to disclose non-compliance with recommended provisions ("comply or disclose"). Most likely, it will not take effect before 2012.

The Role of Shareholders in reviewing Related Party Transactions

19. A central provision of the Companies Law establishes that all shareholders are required to "act in good faith and in a customary manner" towards the company and towards other shareholders, including a duty to avoid discriminating against other shareholders. More specifically, shareholders shall refrain from abusing their power in the company when voting, *inter alia*, on alteration of the articles of association, increases in the registered share capital, mergers, approval of acts and transactions requiring the approval

of the general meeting. A controlling shareholder or shareholder who knows that he or she has a decisive vote on a resolution has an additional duty to "act fairly" towards the company. These duties have been interpreted by the courts to generally require that in transactions with interested parties, these categories of shareholders are under an obligation to disclose their personal interest. Failure to comply with these approval and disclosure requirements is subject to either administrative or criminal liability and sanctions (OECD, 2011).

20. For the system of disinterested shareholder approval to function effectively to protect minority shareholders, it is crucial for minority shareholders to play an active role in reviewing and opposing transactions that may be found to be contrary to the company's and their interests. In this regard, the Israeli framework has focused particularly on the role of institutional investors (mainly pension funds and mutual funds), who represent 18 per cent of the market's shareholdings, by requiring them to vote. First, these institutional investors have a general "duty of care" to vote on issues that could affect their own investors; and second an explicit duty to vote on self-dealing transactions involving controlling shareholders, directors, and senior officers. They are also required to disclose their votes (Hamdani and Yafeh, 2011).

21. This public disclosure of voting decisions enabled Hamdani and Yafeh to carry out a review of 26,000 votes by pension and mutual funds occurring during 2006 (including 10,000 decisions not to vote). Their review raised a number of concerns about institutional investor voting patterns and their implications for the protection of minority shareholder rights. They found that institutional investors tended to be active primarily when legally required to do so, but often failed to use their voting powers on other significant votes, most notably in the case of independent director elections. They noted that proposals related to compensation triggered the highest percentages of their negative votes, even when it was clear that their votes could not influence the overall outcomes. On the other hand, cases for which minority shareholders had a greater legal power to influence the outcome did not have a significant impact on their voting decisions, such as for votes on extraordinary RPTs requiring approval of at least one-third of disinterested shareholders (modified in 2011 to require more than 50 percent approval of disinterested shareholders).

22. Hamdani and Yafeh also examined concerns expressed by some in the market that institutional investors' inclination to play an effective monitoring role as a minority shareholder is inhibited by potential conflicts of interest involving owners of some of these funds, since a number of them are part of larger company groups. While they stated that data on business ties between an institutional investor and any given firm were not publicly available, they divided institutional investors into two categories: one group, involving funds expected to have fewer commercial ties due to government or employee ownership; and a second group of commercially-owned mutual funds with higher potential for conflicts of interest. They found that the support rate for AGM proposals favouring corporate insider positions was 10 percentage points lower among the "non-commercial" pension funds than among "commercial" institutions that they considered to have a higher potential for conflicts of interest. They concluded that "One policy implication of these findings could be that measures to empower minority shareholders may not bring about considerable improvement without parallel measures to remove potential conflicts of interest that impede institutional investor involvement in corporate governance."

23. While the requirement for mutual and pension funds to vote does not extend to cases in which they have a conflict of interest, the multiple group structure to which many of these funds belong may undermine their willingness to act in shareholder abuse cases, particularly in cases where groups have cross-shareholdings with each other. However, some provisions related to mutual fund disclosure of voting decisions and cases of conflicts of interest are in place or under consideration. The fund manager's director or board members may not vote on transactions for securities issued by a corporation in which the fund is the principal shareholder. In other cases where a transaction may involve a conflict of interest for the mutual fund, mutual fund managers are required to submit decisions on shareholder votes to their board of directors. Proposed new regulations of the Joint Investment Trust Law, which are not yet enacted, would

also require the fund manager to explain the reasoning behind its vote on each specific resolution on which it is required to vote. The regulator is also currently considering a proposal that investors should undertake and report on their market analysis related to their votes, which may either be conducted in-house or by paying an external market analyst. These provisions, however, do not apply to pension funds, provident funds and insurance companies, which are not regulated by ISA.

Enforcement

Shareholder Suits

24. Apart from shareholder voting, the main enforcement tool available through the Companies Law is individual enforcement by shareholders of their rights. These may take the form of both individual and class action civil suits to recover damages stemming from related party transactions they regard as abusive, or against directors for breaches of duty. They may also initiate a derivative suit on behalf of the company when the company fails to take action, following a petition in writing by the shareholder.

25. An important new development is the amendment 16 to the Companies Law allowing ISA to financially support derivative suits filed by plaintiffs. This is a significant change, since the costs of bringing such suits are considered to be one of the barriers to such suits. This new capacity to support the filing of derivative suits adds to a similar provision of financial support available for class action suits. Equally important, the new amendment 16 facilitates access to information needed to support the plaintiff's case, by allowing the plaintiff to receive information from the company that would assist him in the preparation of the claim.

26. The ISA received and granted six requests for financial support for class actions that were filed during 2011, five of which are still pending. Eight requests for ISA support of class action suits were filed in 2010, all of which are still pending (not necessarily dealing specifically with related party transactions). While ISA does not disclose the individual amounts provided to support these suits, it reported that overall it provided more than USD100,000 in financial assistance for class action suits from 2009-2011.

27. Perhaps most significantly, the resolution of such suits has been facilitated by the establishment in December 2010 of the new Tel Aviv District Court's Specialized Department for Securities and Companies Law litigation. The specialized department may consider claims arising in the fields of Companies Law, Securities Law, Joint Investment Trust Law, Regulation of Investment Advice, Investment Marketing and Portfolio Management Law and regulations under these laws. Its judges hear all criminal and civil cases deriving from these laws, class actions and derivative claims, as well as petitions with regard to administrative decisions made by ISA, TASE and the Companies Registrar.

28. Its first decision, issued on May 15th, 2011, a class action suit brought against Makhteshim Agan and Koor Industries, supported the action by stating that despite the fact that all correct procedures were followed (audit committee, board and shareholder approval), the related party transaction in this case needed to also pass a fairness test. The implication of this fairness test is that the shareholders were entitled to the best possible price, and that the controlling shareholder was not entitled to extra consideration at their expense. The Court also held that if the Company wished to avoid the application of the fairness test, it should consider setting up a sub-committee of the board with independent directors and excluding representatives of the controlling shareholder empowered to negotiate the transaction (or decide against the execution of the transaction). This finding marks a change in that, while controlling shareholders or other related parties are not allowed to participate in decisions of the Board or shareholder meetings, they are not excluded from participating in the negotiations over the transaction itself.

29. The judge approved a settlement in the case so it will not be appealed. Market observers interviewed for this report suggested that this would have an important impact on the market, as controlling shareholders will understand that even if they follow all procedures, if a related party transaction is not fair to minority shareholders, they face a risk of having to pay damages. Their view was that big cases such as this, even if they do not occur every year, are enough to put the market on notice that abuse of minority rights on related party transactions will be punished and that controlling shareholders must be careful in this regard. Some investors suggested that more such suits are needed to ensure strong protection of minority shareholder rights. Nevertheless, the establishment of the economic court and its quick action in support of minority shareholder rights appears to be a major development, providing both more consistent judicial expertise, and a speedier process (90 days) to resolve shareholder disputes.

Regulatory Review of RPTs

30. The Israel Securities Authority (ISA) actively reviews all material related party transactions except those involving liability insurance for directors, both through formal and informal processes. While no specific guidance or thresholds are in place regarding what constitutes a material transaction, the ISA reviews every transaction which it considers to materially affect the reporting of a corporation's business, including in some cases relatively small transactions. For example, they review all transactions regarding compensation to related parties, sale of affiliated companies, and provision of services by a controlling shareholder. They check whether procedures were followed, whether shareholders are correctly classified as interested or disinterested in voting procedures, and whether disclosure requirements have been followed, with particular attention to the question of whether sufficient information has been disclosed that would be important and necessary for a reasonable investor to cast an informed vote. If they feel information is insufficient, they may send a letter to directors asking them to explain the reasons why they approved a deal, while providing ISA's legal opinion. Board members' answers are made public to all investors, potentially exposing them to liability if their reasons are not justifiable. In some cases, they have required a company to obtain an external opinion concerning the fair market value of a related party transaction, and cited one example in which the board of one of the concerned companies voted against the transaction following the issuance of the external opinion.

31. Overall, they reviewed 400 related party transactions in 2009 and 470 in 2010, 93 per cent of which were approved under company RPT approval processes. ISA was not able to provide more specific breakdowns on the number of companies that reported such transactions, or the average number of transactions reported per company (excluding those who reported none), or to classify what types of transactions are most commonly submitted for review. ISA noted that there are many other cases on which informal feedback is sought but which leads to the proposed transaction being dropped or altered. With recent reforms and court decisions that have supported minority shareholder protection, they would expect these numbers to come down in the future.

32. An important new development is a Securities Law amendment that allows ISA to impose administrative sanctions (such as fines, suspension of licenses, requirement to repair the violation and not repeat it, etc.) or negotiate a settlement. Prior to this amendment, they only were allowed to pursue criminal cases, which are more time-consuming and complex, involving a higher burden of proof. It was suggested that the securities law amendment would enhance ISA's accountability by formalizing the processes available to them to challenge violations that are not at a level of criminal intent. It also greatly increases their flexibility and ability to more efficiently address less serious cases and cases where criminal intent is not provable.

33. In addition, the State of Israel also initiates criminal prosecutions in some cases based on joint work carried out by ISA's investigations department and the District Attorney's office, filed by a jointly staffed Securities Division. Powers of discovery and in some cases strong co-operation with foreign

regulatory authorities for cases involving transactions occurring outside of Israel have helped lead to successful prosecutions for most cases, according to ISA. While precise statistics on the number of cases brought to court were not available, ISA stated that the State has won a majority of the cases and lost no more than five such cases over the past five years. Not all of these cases have dealt with related party transactions; some for example have dealt with disclosure and insider trading.

34. An important recent criminal related party transaction case, the *State of Israel v. Aviv Algor and Ian Nigel Davis*, resulted in the January, 2009 conviction of Mr. Algor and Mr. Davis, the controlling shareholders for Middle East Tubes, Ltd, for obtaining the approval of one-third of disinterested shareholders by fraudulently presenting an associated shareholder as independent, when in fact this "straw man" had been given a loan by the controlling shareholders to buy shares. The main transaction concerned the payment of management fees, while a second decision concerned an extraordinary transaction between the controlling shareholders and the Company for the Company's undertaking liability insurance for its directors and officers. Mr. Algor was sentenced to 24 months in prison plus a fine of 2 million Israeli shekels (approximately 400,000EUR), substitutable for 18 months in prison, while Mr. Davis received a similar sentence but with six months less of prison. The case was appealed and subsequently upheld by the Supreme Court in June, 2009, but with a modification of the sentence for each of the defendants to two years in prison, of which one year suspended sentence, provided that they not commit any further violation of which they were convicted for a period of two years. The fines and possibilities to substitute the fines with 18-month sentences were also upheld.

35. Some market participants have expressed a concern that too many powers are concentrated in ISA, and that the administrative court, to be staffed by ISA employees, will further concentrate power in ISA's hands. However, ISA's Chair has responded to these concerns by announcing an appointment process under which two-thirds of the court's appointees will be appointed by Ministry of Justice and one-third by the ISA Chair. The new Chair also announced that his appointees would be ex-judges, and that the Ministry of Justice appointees should have either capital markets expertise or expertise in companies and securities law. The independence of ISA's budget also provides some degree of protection against political intervention in such cases.

Transactions involving Company Groups

36. While numerous recent steps have been taken to strengthen the tools available to shareholders and enforcement authorities to ensure that related party transactions are not abusive, the prevalence of pyramidal company groups in Israel continues to be recognized as enhancing the risk of such transactions. This may be the case particularly where such groups include private companies that are subject to lower levels of disclosure than those required of publicly listed companies. However, the Israeli legal framework does seek to address such situations by requiring that any matter relating to a private company that is considered to be of material importance to a public company (where both companies belong to the same group) has to be reported to ISA and to the public. This is further reinforced by IAS 24 disclosure requirements applying to related parties within company groups. Contractual agreements between a public company or its subsidiaries and affiliated companies in the group must be disclosed in detail, if they are substantial for the public company. Existing case law provides some evidence of the application of this legislation (OECD, 2011). In addition, director's duties are clearly defined to be in the interests of the company, stipulating that in upholding fiduciary duties, the director is not permitted to consider the interests of other companies in the group.

37. Nevertheless, the large holding company group structure that dominates Israel's listed market is an issue of continuing debate, and a special inter-governmental committee called the "Market Concentration Committee" has been reviewing this issue since its establishment in October 2010. The

Committee, led by the offices of the Prime Minister and Ministry of Finance, issued interim recommendations to the Prime Minister in September, 2011.

38. The recommendations focus on two major areas:

- The first set of recommendations aims to separate financial holdings (banks, insurance companies and investment firms) from "real" business enterprises, if the dual holding exceeds a certain threshold. Owners of dual holdings would be required to divest either their financial or non-financial holding within a period of four years. In addition, the Committee recommended that directors be prohibited from serving on the boards of both a financial and non-financial firm within the same group.

- The second issue the Committee seeks to address is corporate pyramid structures. The Committee outlined a number of recommendations aimed at strengthening the rights of minority shareholders within such structures. For example: (1) a company owned through a pyramid structure would be required to appoint at least one-third of the board members as outside directors; (2) outside directors could only be appointed by a majority of the minority shareholders; and (3) remuneration of corporate officers would require approval by the majority of the minority shareholders.

39. Two recommendations of the Market Concentration Committee specifically address related party transactions: (1) the committee proposed that the company "comply or disclose" if it has put in place a competitive process before approving the sale of an asset or receiving a service or loan from an interested party; and (2) the Audit Committee would be required to review and approve all transactions with an interested party even if it is not an extraordinary transaction, unless it is deemed as being only a negligible transaction.

40. While these proposals are quite new and the Committee will now undertake a public consultation process before considering its final recommendations and possible legislation, they clearly involve significant steps to enhance minority shareholder protection and to reduce potential conflicts of interest within company groups and for directors serving on boards of companies within such groups.

Assessment and Conclusions

41. Since the time of its OECD corporate governance review (OECD 2011), Israel has taken numerous additional steps to strengthen an already robust framework to prevent the abuse of minority shareholder rights, including for related party transactions in particular. Among the key, positive recent steps highlighted in this report are:

- Provisions that require at least 50 per cent of the votes of disinterested shareholders to approve "extraordinary" related party transactions, up from one-third previously;

- Increased power of these shareholders to also appoint independent "outside directors", requiring a similar majority of disinterested shareholders. Outside directors cannot have any economic or family ties to the company or its controlling shareholders. Controlling shareholders also are no longer able to block reappointment of these directors after three-year terms if a majority of disinterested shareholders approve the appointment;

- A stronger role for "outside" and "independent" directors in the Audit Committee. The Chair of the Audit Committee must be an outside director, and at least one outside director must be present for any decision by the Audit Committee. The Audit Committee must also be comprised

of a majority of independent directors, and a majority of independent directors must be present for any Audit Committee decision. Lastly, the Audit Committee plays a specific role in approving related party transactions and establishing safeguards for whistle-blowers to report concerns;

- ISA has gained new authority to impose administrative sanctions including monetary sanctions in relation to certain Companies Law requirements such as failure to appoint outside directors or failure to appoint an audit committee. It also has new discretion to settle cases;

- ISA also gained new authority to financially support derivative suits filed by plaintiffs, which are further supported by the plaintiff's right to petition the court to instruct the company to reveal information relating to the derivate suit. The court may approve the request for information if it is convinced that the plaintiff has sufficient preliminary evidence for the fulfillment of the conditions for the filling of a derivative action.

- Finally, the establishment of the Tel Aviv District Court's Specialized Department to consider class action and derivative suits as well as criminal cases filed by the State is seen as having a significant impact in speeding up the resolution of court cases and enhancing the expertise brought to bear by these courts. Its first decision was seen as sending a strong signal to the market that minority shareholder rights will be supported.

42. Yet, Israeli authorities do not claim to have "solved" the problem of preventing related party transactions that could be abusive. Even with extensive protection in place, a question remains as to whether institutional investors or other minority shareholders are fully willing to play the role assigned to them to monitor transactions that could be to their detriment, given the costs and time involved in analyzing and voting on such transactions, and in enforcing against abuses through shareholder suits. Questions have also been raised as to whether the ownership structure of some institutional investors, involving cross-shareholdings and in some cases pyramidal ownership, establishes inherent conflicts of interest that undermine any realistic possibility that they will effectively monitor minority shareholder rights. For these reasons, the new, interim recommendations emerging from Israel's Market Concentration Committee represent significant new measures to minimize potential conflicts of interest and mitigate the risk of abusive related party transactions within such groups.

43. Israel has broadly implemented the OECD Principles relevant to the prevention of abuse of related party transactions, with one of the most elaborated systems of disclosure and review among OECD countries reviewed. By providing for the appointment of two independent directors including at least one "outside director" who must obtain a majority of non-controlling shareholder votes, and giving them majority status on the audit committee, Israel has established significant safeguards to promote scrutiny of related party transactions at the board level. Audit Committee and Board review and approval is complemented by an active role of the regulator to ensure that adequate information is provided to the market and that additional safeguards enabling disinterested shareholders to also review and decide on these transactions are implemented correctly. While some questions remain about the incentives and capacity of minority shareholders to safeguard their interests to prevent abuse, particularly in light of the predominance of company groups with potential conflicts of interest, Israel has taken a number of steps to try to mitigate these concerns and is currently considering additional actions. The key Principles are:

- Principle III.A.2 (*Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders, acting either directly or indirectly, and should have effective means of redress*). While some doubts remain about minority shareholder incentives or capacities to enforce their rights against abusive actions, Israel has a wide range of measures in place that support this Principle's implementation.

- Principle III.C (*Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). Israel has such requirements in place.

- Principle V.A.5 (*Disclosure should include, but not be limited to, material information on …related party transactions*). Legal requirements are in place for disclosure of related party transactions both through adherence to IAS 24 for consolidated accounts and through requirements for immediate and periodic reports.

- Principle VI.D.6 (*The board should fulfil certain key functions, including .. monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*). The legal requirements are in place, while insufficient information on actual board practices is available to make a clear judgement on its full implementation.

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