To: Mr. Moshe Tery
Chairman of the Israel Securities Authority

January 3, 2006

Dear Sir,

We hereby present you with the report of the Committee for the Examination of Corporate Governance in Israel.

The Committee held numerous discussions during which it had approached various public bodies, accountants, money managers, lawyers, business people, underwriters and public institutions active on the Israeli capital market.

The report contains detailed recommendations pertaining corporate governance, which in the opinion of this committee, ought to be adopted as the standards for Best practice in Israel.

The recommendations relate to improved independence of the Board of Directors, particularly in the area related to controlling shareholders' transactions, improvement in the workings of the auditing/balance committee pertaining authorization of companies' financial reports, improving in the quality of disclosure and reporting done by corporations, deepening the involvement of public institutions as an auditing entity of corporations in which they invest and the creation of a specialized court for Securities and Companies Law.

Due to the importance of the issue we propose to open this report to public scrutiny and to consider public feedback prior to the adoption of the recommendations contained in this report.

We would like to thank all those who cooperated with this committee. In particular we would like to thank Ms. Sara Batito, who accompanied the work of the committee.

Sincerely yours
Members of the Committee

Content

Committee report

Examination of Corporate Governance in Israel

A. Foreword

During the last few years we have witnessed the development of a new concept on world financial markets, the concept of Corporate Governance. The issue of Corporate Governance (CG for short) and the central place it occupies in the public debate is largely due to unfortunate circumstances – crises that capital markets had experienced after the burst of the High-Tech bubble and managerial/accounting scandals that have been exposed within leading international corporations such as Enron, Parmalat and WorldCom. Those scandals did not occur on developing world markets; on the contrary, they are deep-rooted within the leading and established financial markets of the world.

Those scandals led international investors to the recognition of significance that is implanted within appropriate management and supervision mechanisms of companies in which they invest. CG that stems from appropriate rules and principals is intended to reduce the risk of improper use of investors' money. Appropriate corporate governance is expected to prevent occurrences which are difficult for regulatory bodies, professional as they might be, to uncover *post factum*. Sometimes by the time the events are uncovered, the damage done is already irreversible.

In 1999 the Organization for Economic Co-operation and Development (OECD) had published a set of principals for appropriate corporate governance in order to establish an international benchmark and provide specific guidance for legislative and regulatory principals of proper management of public companies, for OECD member countries.[1]
Countries such as the US, Britain, Holland, Germany, Australia, Turkey and others have adopted CG principals in light of the OCED regulations, in accordance with the law of the country.

The Principles of Corporate Governance are a collection of rules and regulations that define appropriate ways of auditing and supervision procedures within public companies. Occasionally these CG principals differ from the local law, but they do not come to replace or amend it, they are intended to provide additional stratum to the law.
In light of the globalization processes taking place on financial markets, the importance of CG principals – beyond creation of a general system appropriate for different countries – lies is in the creation of certainty, transparency and uniformity that will assist investors, creditors and international financial bodies to evaluate various corporations, incorporated and traded in different countries. The aforesaid was the reason for the creation of the EC Governorship Forum whose task is to unify the CG principals of all the EC states.

Despite the fact that the CG principals are mainly intended for listed corporations with publicly traded securities, in many countries these rules are used as guide lines by other

[1] The latest version of the document has been publishes in January 2004 and can be viewed on the OECD site www.oecd.org/dataoecd/32/18/31557724.pgf

organizations and corporations, which are of interest to the public, in some cases they are adopted by entirely private organizations.

This Committee was appointed by the Chairman of the ISA, Mr. Moshe Tery, to examine the structure and character of Corporate Governance suitable for Israel. The recommendations of the Committee will assist the Chairman and the ISA to examine the appropriate way of action in this field. Committee members include representatives of public companies and other entities that are active on the Israeli capital market, lawyers specializing in companies' law and securities, academics, representatives of the Tel-Aviv stock exchange and the Israel Securities Authority.

The recommendations, made by the Committee, take into account special characteristics of the Israeli economy while at the same time referring to the CG principals adopted in other countries.
In view of the present day globalization processes and increased competition among financial markets, particularly due to the fact that Israeli economy is considered to be a developed market economy, specification of appropriate standards and rules in the field of corporate governance in Israel, similar to those adopted in leading western countries – is of paramount importance in the eyes of this Committee.

Corporate Governance is a dynamic concept which is bound to change from time to time, particularly due to a great deal of activity in this field throughout the world, therefore the Committee is of opinion that there will be a need for periodic adjustment of the following recommendations – subject to new developments that on world financial markets.

The recommendations are made public in order to gather feedbacks and to hear opinions, regarding appropriate ways of applying them, from all entities acting on the Israeli capital market. After completing the examination of the above mentioned opinions the Committee will formulate its final recommendations and will submit them to the Chairman of the ISA, Mr. Moshe Terry.

Most countries have chosen to implement the CG principals by means of the "adopt or explain" approach. According to this approach, even though the adoption of the aforesaid principals is not compulsory, a corporation is required to state, as part of its annual report to the public, whether is has adopted the regulations of the Code and if not – to explain why it has decided not to adopt them, all or in part.

Accordingly, we hereby propose that the implementation of principals shall be by means of disclosure requirements imposed on public corporations as part of their reporting to the public: "adopt or explain". This disclosure will be carried out according to regulations enclosed as Appendix B to these recommendations.

Nevertheless the Committee is not of opinion that companies have to be bound to submit explanations as to why they have chosen not to adopt a particular rule or principal. This recommendation is based on the conclusion reached by the Committee in light of other countries' experience, particularly those that require explanations by law. Explanations

provided by companies do not contribute material information to investors; sometimes they even act as smoke screens and forestall disclosure requirements. Naturally, there is nothing to prevent a company from publishing an explanation regarding its decision not to adopt a certain principal.

The principals of Corporate Governance are aimed at creating appropriate standards that will allow their voluntary adoption by the market. Disclosure requirements, point the lime light on ways in which companies are managed, and are based on the assumption that capital markets will process and use the disclosed information during their decision making process pertaining investment and pricing of securities of various companies.

The Committee recommends observing market behavior over a period of a few years, in order to conclude whether obligatory discloser regulations and the adoption of CG principals are effective, and whether there is a need to establish other mechanisms for the assimilation of Corporate Governance principals.

The recommendations are focusing on the following subjects:

1. Composition and workings of the Board of Directors
2. Composition and workings of the Auditing Committee
3. Authorization of transactions with principal shareholders
4. Creation of additional control mechanisms: internal enforcement, voting authorizations (Proxy) and directors' declaration s
5. Requirements related to public institutions
6. Establishment of a court that will specialize in Companies Law and Securities Law.

It is worth noting, that under the Israeli law the majority of cognitive regulations pertaining CG principals, recommended by the OECD, are stipulated under the Companies Law 5759-1999, (henceforth – "Companies Law") and under the Securities Law 5728-1968, (henceforth – "Securities Law") and related Regulations. Therefore the Committee found it appropriate to state, at the opening of each section, what are the existing regulations and **to concentrate on recommendations that will be appropriate if added, or might underpin the existing regulations**.

Main considerations that guided the Committee in consolidating its recommendations, together with recommendations on each subject, will also be brought up; including various approaches and opinions that had been presented and voiced before the committee during its deliberations.

B. Recommendation of Committee for Examination of Corporate Governance

5. Composition and workings of the Board of Directors

5.1 Independence of the Board of Directors

5.1.1 One of the more significant CG principals that had been adopted in various countries is – the independence of the Board of Directors. Different arrangements have been stipulated in different countries in accordance with the market characteristics of a country and by considering costs to benefits ratio. The issue of board independence requires careful preservation of balance between objectivity, professionalism and risk taking in management. For example, an exterior director might be objective but his knowledge of the company inner workings and business might be superficial, while a director who is part of the company and possesses deep understanding and knowledge of the company's business might lack objectivity. The balance is required because the board of directors has to fulfill two functions that might create a conflict of interests: one – to chart company's business policy, second – supervise the management of a company. While the first mission requires deep business sense and a trustful relationship with the company's management, which will allow the board of directors to act as a consultative and business policy formulating body, the second mission requires objectivity and certain distancing from the company's management. In order to carry out these functions the board of directors is authorized to appoint and dismiss company's CEOs. The point of balance relates to a situation where a principal shareholder, who carries most of the risks and prospects of business decisions, himself as well as the investing public have an interest in allowing him to carry out his business policy. Consequently, the nature of business decisions on the agenda affects the point of balance. For example, when a deal at stake contains elements of the conflicts of interest – *objectivity* becomes of paramount importance by comparison to an independent business decision where *professionalism* is of paramount importance. The point of balance, regarding the independence of the board, largely depends on market characteristics of a particular country; hence different countries have found different points of balance regarding independence of the board of directors.

For example, in the US, where capital market is characterized by a high rate of public holdings (dispersed ownership) - and the problem of a representative on the capital market is rooted mainly in potential conflicts of interest between the company's CEO and its shareholders - the stock exchange rules stipulate that most of the members of the

Board of Directors have to be independent of the company[2], regardless of the company's size. Also, according to the rules of the stock exchanges this regulation does not apply to companies that have a controlling shareholder. Nevertheless regarding the Audit Committee the rules stipulated by the SEC and stock exchanges require that most of the committee members shall comply with stringent independence requirements. According to this strict requirement director must be independent of principal shareholders, holding more than 10% of the capital, or of the company's subsidiary or of its subsidiary's subsidiary[3]; all this in addition to his independence from the company itself. Also, regarding transactions involving conflicts of interest with controlling shareholders, the Companies Law of the state of Delaware – the leader in matters of incorporation in the US – stipulates that these transactions have to be approved by the Board of Directors who are independent of the controlling shareholder; or else the burden of proof regarding the impartiality of the deal will fall on the controlling shareholder.

On the other hand, in the UK, where capital market is also characterized by a dispersed ownership, it was stipulated that the requirement for the majority of directors (with the exception of the Chairman) to be independent of the company[4] shall apply only to companies listed on the FTSE 350 register. It appears that cost considerations have prevented the application of the aforesaid regulation on other public companies in the UK. However, according to the stock exchange regulations, all transactions with principal shareholders (min.10% of voting rights) require majority authorization by independent shareholders.

5.1.2 In Israel, the apprehension of dispute between shareholders and management is smaller since most of the public companies have a controlling shareholder. On the other hand, the apprehension pertaining conflicts of interest between controlling shareholders and public shareholders is great. Thus the Committee decided to concentrate on the independence of the Board of Directors in relation to controlling shareholders, particularly regarding endorsements of transactions containing conflicts of interest, and to allow controlling shareholders to manage their corporate business according to business considerations that will benefit the company where there is no conflict of interests.

[2] Section 4350(c)(1) of the NASDAQ rules and section 303A of the SYSE rules.
[3] Section 10A-3(b)(1) of the Commission's Exchange Act Rules, that have been stipulated under section 301 of the Sarbanes-Oxley Act, section 303A.06 of the NYSE rules, section 4350(d)(2)(A) of the NASDAQ rules.
[4] The Combined Code on Corporate Governance, July 2003, section A.3.2

At first, the Committee considered recommending for most of the board directors to be independent of the company and its controlling shareholders. However, in light of the discussions and feedbacks received from consulting entities, the Committee had decided to use other means to establish balance between the rights of controlling shareholders to run their companies and the need to protect the existence of a balanced and professional Board of Directors, which will act in the interests of the company as whole.

5.1.3 Strengthening of the Board's independence, without stipulating that most of its directors must be independent of controlling shareholders, is made possible by concentrating on professionalism and independence of the auditing committee; since according to the Companies Law the auditing committee is the one which approves contracts that are affected by conflicts of interest as far as the controlling shareholders are concerned.

With the development of the capital market in Israel and significant growth in the number of companies that do not have a controlling shareholder – it will be appropriate to examine the application of rules stipulating that most of the directors must be independent of the companies, similarly to the rules customary in the US and the UK.

5.1.4 Presently, the Companies Law stipulates that two external directors have to sit on the board of a public company. The complexity of this regulation is in the fact that a number of external directors might appear smaller than desired if one takes into consideration the overall number of directors in a company. For example, in a company that has ten acting directors, the power of two external directors will be relatively puny by comparison to a company that has six acting directors. In light of the aforesaid, it is proposed that every public company shall have at least three external directors (as defined under the Companies Law), and in no case shall their number be less than two, as required by the Companies Law. In order to allow preparations for the realization of this regulation the Committee proposes to fix its effective date on the - 1.01.07.

Also, in order for the Board of directors to carry out its supervisory functions objectively, the rule barring directors from holding other offices within the company, (which might create conflicts of interest), must be strictly observed. The Committee therefore proposes that company directors shall not hold official positions subordinated to the company's CEO.

5.1.5 We would like to point out that the Companies Law provides for a number of supervisory means to be enacted over listed corporations:

obligatory appointment of two external directors[5], obligatory appointment of an auditing committee[6] and obligatory appointment of an internal auditor[7]. In essence, these regulations relate to the corporate governance of public corporations and the legislator has chosen to stipulate them as cognitive regulations. The purpose of these stipulated means of control is to ensure adequate management procedures in public companies and to preclude, or at least to limit actions or decisions which might harm a company or the investing public. With that, there are no sanctions stipulated for the breach of the aforesaid regulations. We would like to point out that where the ability to prove harm, imparted on shareholders by the breach of the aforesaid obligations, is lacking there is also a very slim chance of a shareholder turning to the court in order to bind the company to fulfill the aforesaid regulations of the law pertaining these issues.
Therefore, the Committee recommends that the Companies Law shall be amended so that in addition to the existing sanctions, a monetary sanction shall be imposed on a company that will not comply with the regulations of the law regarding the appointment of external directors, auditing committee or internal auditor and that the ISA shall be authorized to bestow the aforesaid monetary sanction.

5.1.6 In light of the aforesaid the Committee recommends:

(a) Effective 1.01.07 every public company shall have at least three external directors, and in no case shall their number be less than two.
(b) In a public company, a holder of the office subordinated to the CEO shall not act as a director.
(c) The Committee recommends that the Companies Law shall be amended in a manner that in addition to the sanctions already stipulated under the Law, a monetary sanction shall be imposed on a company that will not comply with the regulations of the Law regarding the appointment of external directors, auditing committee or internal auditor.

1.2 Meetings of the Board of Directors

1.2.1 Section 97 of the Companies Law stipulates that a Board of Directors of a public company shall convene its meetings according to company needs and not less then once every three months. The Companies Law also stipulates various rules regarding Board meetings and proceedings.[8]

[5] section 239 of the Companies Law
[6] section 114 of the Companies Law
[7] section 146 of the Companies Law
[8] Third Chapter of the third part of the Companies Law.

The Committee is of opinion that in order to ensure appropriate management, the Board of Directors has to stipulate, in advance, a framework of activity and to adjust it from time to time, according to company needs. Thus it is proposed that the Board shall specify minimal frequency of meetings per year, in advance; a step that will also comply with the requirements of the aforesaid Law. Besides the meeting of the Board to which members of management are invited (all or in part), it is proposed to hold meetings at which the management (CEO included) is not present (even if a member of the management acts as a director) and that in order to allow an open and critical discussion in different compositions.

1.2.2 Functions of the board are defined under section 92 of the Companies Law. Please note, that as part of its duties the Board of directors is responsible for the examination of risk to which a company is exposed, authorization of the overall budget, and other duties (as detailed below).

1.2.3 In light of the aforesaid the recommendations of the Committee are as follows:

(a) Once a year the Board of Directors shall discuss and stipulate minimal frequency of meetings for the upcoming year.
(b) The Board of Directors shall discuss and regulate the following:
- ✓ Define the policy of a corporation, including its branches, regarding exposure to various risks (credit risks, market risks, operational risks, legal risks etc.), feasance of various auditing and risk evaluating tools, formulation of the risk exposure policy and definition of permitted ceiling of this exposure.
- ✓ Authorization of the annual business plan and the follow up procedures to verify its implementation.
- ✓ Authorization of the overall budget of a corporation and the follow up procedures to verify the ongoing implementation of the budget plan.
- ✓ Realization of investments over a certain sum, which shall be stipulated by the Board of directors.
- ✓ Any other issue of material interest to corporate activities or to the supervision over its management.

(c) The company has to organize meeting of the Board members where management (including the CEO and directors acting in managing positions, as aforesaid the Committee does not recommend this duality of offices) is not present, present periodically, and present according to a pre-defined timetable.

1.3 Separation between the offices of the CEO and the Chairman of the Board of Directors

1.3.1 The Board of Directors is a body supervising the functioning of general management and its activities. The Chairman of the Board has a particularly important function on the Board; he is responsible for conducting the Board meetings and defining the order of the day during these meetings. In light of the aforesaid, it must be insured that Chairman of the Board is devoid of the conflicts of interests while holding this supervisory position, and that he is able to devote enough time to properly carry out his duties.

Since effective supervision can not be provided while the supervising body is at the same time a supervised body, the Chairman of the Board has to abstain from holding other offices in the company, particularly – the office of the CEO.

1.3.2 Section 95 of the Companies Law stipulates that in a public company the Chairman of the Board shall not act as its CEO. This stipulation is qualified under section 121 of the Law that allows the general meeting of a public company to decide, by special majority, that the Chairman of the Board shall also be appointed as CEO or shall acquire his authority, for a period that does not extend beyond three years.

The Committee is of opinion that although this qualification is allowed within the law, it is not perceived as commonplace, and it is more appropriate for different persons to act as Chairman and CEO of a company. In order to ensure that the aforesaid separation is safeguarded, not in title only, there is a need to stipulate in writing and approve by the Board of Directors the aforesaid separation of authority between the Chairman of the Board and the CEO. In addition, and for comparable reasons, there is a need to stipulate that Chairman of the Board shall not hold another office in a corporation and shall not engage in its routine management, including member participation in the meetings of its management.

1.3.3 The separation between the Chairman of the Board and the CEO has to to be expressed in a clear definition of their positions: the Chairman of the Board is responsible for the functioning and management of the Board, while its CEO is responsible for company's routine management within the framework stipulated by the Board of Directors and is subordinate to the decisions of the Board. In light of the aforesaid, the Chairman has to abstain from giving orders to managers subordinate to the CEO.

1.3.4 In light of the aforesaid the Committee recommendations are as follows:

a. Different persons have to act as Chairman and CEO of a company, there is a need to stipulate in writing and approve by the Board the separation of authority between the Chairman of the Board and the CEO.
b. Chairman of the Board shall not hold another office in the corporation and shall not engage in its routine management.
c. Chairman has to abstain from giving orders to managers subordinate to the CEO.

1.4 Eligibility and qualifications of Directors

1.4.1 Directors' qualifications are the key to their success in supervising the company activities. The recently passed Amendment no. 3 of the Companies Law[9], stipulates that all external directors in a public company must be qualified professionals and at least one of them must be an expert in the fields of accounting and financing. Company Regulations (Conditions and examinations for Director with the expertise in the field of accounting and financing and for Director with professional qualifications, 2005[10] (henceforth in this paragraph – "Companies Regulations regarding accounting and financial expertise), detail what are the examinations according to which the level of accounting and financial expertise, as well as professional qualifications must be determined.

1.4.2 In fact, it is very important that all directors in the company shall be professionally qualified to carry out their duties. The responsibility of a director to be qualified to carry out his duties falls, first and foremost, upon his own shoulders. Hence, it is appropriate for a director to make a statement, prior to his appointment, regarding his eligibility and qualifications and the Chairman of the Board shall validate that the aforesaid statement has been made (that without diminishing the responsibility of the Board of Directors to evaluate accounting and professional qualifications of the director-candidate, as stipulated under the Companies Regulations regarding accounting and financial expertise). More over, it is within the competence of a general meeting appointing the directors, to verify that directors are eligible and qualified for their office; therefore it is important to present all information relevant for the making of this decision to the general meeting.

[9] Books of Law 1989, 17.3.2005, p. 238
[10] Collection of Regulations 6445, 20.12.05, p. 198

1.4.3 Eligibility of directors and the manner in which they carry the duties of their office have to be periodically examined by the general meeting; also the possibility of terminating the tenure of acting directors, appointment of new directors in their place and the preservation of an appropriate rotation of the Board – all, have to be brought up before the assembly.

Since it is not appropriate to stipulate rules regarding the rotation of directors, it is proposed to regulate that, in general, it is desirable to have a rotation but the actual implementation of this principal should be left to the companies themselves.

1.4.4 Directors' knowledge of the corporation's business is also essential for carrying out the duties of his office. Under the Companies Law, the director is obliged to employ all reasonable means at his disposal in order to gather information regarding the feasibility of the deal or action brought up for his endorsement, as well as regarding any action carried out by him in his capacity as director, and to gather all other information that might be relevant pertaining the aforesaid actions.[11] Along with this obligation, every director is entitled to receive information from the company.[12]

In order for the relevant information to be systematically distributed to all directors, it is proposed to stipulate that beyond the responsibility of directors themselves, to take steps to receive the information, the Chairman of the Board must act as a coordinator, for the purpose of information gathering.

1.4.5 In light of the aforesaid the Committees recommendations are as follows:

a. Each director (including external directors) shall state that he has the time and the qualifications required to carry out the duties of the office, and that he also has the required accounting and financial qualifications (whether according to Companies Regulations regarding accounting and financial qualifications or whether according to the recommendations of the Committee, as stated under the section 2.4, henceforth).

b. The Chairman of the board shall verify that all directors (including external directors) have signed the appropriate declaration s.

c. Prior to the appointment (or re-appointment) of each director the shareholders have to be supplied with information regarding the Curriculum Vitae of the

[11] Section 253 of the Companies Law
[12] Section 265 of the Companies Law

director, his qualifications, his other tenures of office and his other occupations, as well as any other information essential for the making of an informed decision.

d. All re-appointments of directors (that are not external directors) have to be approved at every annual general meeting of the shareholders. Periodic rotation of the members of the Board of directors has to be ensured.

e. The chairman of the Board shall forward to directors all information relevant for carrying out their duties at, the appropriate date, and shall ensure that the information is clear and precise.

f. The Chairman of the Board shall ensure that all directors are given the opportunity to update their knowledgeability and to familiarize themselves with the company's business, as required by their office.

g. The Chairman of the Board shall ensure a proper channel of communication between the Board of Directors and company shareholders, (in an egalitarian manner, according to the law), and between the internal auditor and the external auditor and the auditing committee (or a balance committee, if created).

h. The Chairman of the Board shall be responsible, and entitled to exercise his authority, for the implementation of the CG regulations in the company and for updating the Board regarding all matters related to corporate governance.

1.5 Fees of Directors and other office holders

1.5.1 The agreement signed between a company and a director, regarding the terms of his tenure and employment, requires the endorsement of the auditing committee, the Board of Directors and of the general meeting.[13]

The way of recompensing directors for their work might seriously affect their professional performance, their dedication to the company and its successes, including even the way they choose to steer the company they lead.

Also, since directors' recompense is paid out of company's funds it has to be compatible with company's potential, financial situation, obligations toward third parties, etc. In general, the auditing committee has to examine and ensure the fact that directors' recompense does indeed promote company aims; the corporate

[13] Sections 270(3), 273 of the Companies Law

officers' recompense has to be reviewed, by the Board of Directors, in the same manner.

1.5.2 On the level of public disclosure it is proposed to increase disclosure regarding directors' and other corporate officers' recompense. Thus, it will be appropriate for the ISA to look at the detailed regulations regarding this matter, including financial details pertaining five highest paid corporate officers in the company.

1.5.3 In light of the aforesaid the Committees recommendations are as follows:

a. In approving Directors' fees the auditing committee shall take into consideration steps taken in order to ensure that the range of fees offered does indeed promote company aims. For example, one can define an appropriate freezing period for securities allocated to Directors and other corporate officers, or recompense on the basis of performance, etc.

b. It is proposed that the ISA shall consider stipulating rules regarding greater disclosure pertaining fees paid to Directors and other corporate officers. In this context it is also proposed that a company, shall present a table displaying correlation of fees paid out to the five highest paid corporate officers in the company (individually), listing various components of short term benefits (fees and bonuses) and long term benefits (such as frozen shares and options), as part of the company's annual report. Where the highest paid officials are not Directors it is proposed that a similar table shall be presented regarding the five highest paid Directors out of all company's Directors.

1.6 Fees and refund of expenses to external Directors

An external director is entitled to a refund of expenses according to company regulations (rules regarding compensation and refund of expenses to external Director), 5765-2005[14] (henceforth "Regulations"). In light of the decision to widen the involvement of external directors in supervision over the companies' business, particularly over their financial reports, it is proposed to re-examine the scheme of recompense for external directors with emphasis on the fact that a director's fee shall be directly related to the number of working hours. Also, due to high

[14] Collection of Regulations 6017, 27.01.2000, p. 290

responsibility cast upon the shoulders of directors in public companies, and in light of the need for external directors to be highly qualified and actively involved in the work of the Board of Directors, it is proposed that the upper limit allowed according to the Regulations for participation in Board meetings or Board Committee meetings shall be increased, for all types of companies.

2. Composition and functions of the Auditing Committee

2.1 Independence of the auditing committee

2.1.1 Financial reports with other accompanying reports are the real ID of any company. Without it a company can not be assessed on the capital market or any other economic market. The audited financial reports, compiled according to accepted accounting rules together with other accompanying reports, are the most efficient means of communication with a wide array of users – shareholders, financing entities, suppliers, clients, employees, supervising authorities and others. This communication is comprehensive, methodical and most reliable. Financial reports are used by the above mentioned entities for decision making, evaluation of directors/managers and for stipulation of recompense; they are also an important component of Corporate Governance and accountability. Financial reports in conjunction with other company reports, prepared in accordance with the Securities Law, provide investors with all necessary information required for the understanding of company activities and the state of its business.

2.1.2 Preparation of company reports is a particularly complicated business. The quality of company reports greatly depends on the quality of internal reporting, on integrity and professionalism of the management, on the implementation of accounting rules and the quality of the auditor as well as on other company consultants. The Board of Directors has direct and significant effect on each and every component of the aforesaid report compilation, the Board is also a "veto player" which either approves company reports or instructs the company to amend them. Hence the outmost importance of the Board in regard to company reports.

2.1.3 The Committee is of opinion that the processes of reporting and supervision are areas of key importance, which fall under the responsibility of a Board of Directors; hence all directors have to take an active part in the authorization processes of company's reports. The involvement of the Board, as a whole, in authorizing such important documents may increase its influence as an internal supervising mechanism of the company. In other words, the quality

of the Board's functioning pertaining company's reporting is an important element of the overall Corporate Governance.

2.1.4 Various committees of the Board of Directors can dramatically increase the effectiveness of the Board's functioning, particularly in areas of reporting and internal auditing that are connected to the Board. A special task committee that will carry out preliminary work on particular subjects would lead to a more detailed and factual examination of the issues, exposure and supervision; it will also make a decision making processes within the Board more efficient. This form of action will allow the Board to maximize the use of its members' expertise, knowledge and experience. The establishment of efficient committees in particular areas will contribute greatly to the company and to the effectiveness of its Corporate Governance.

2.1.5 The aforesaid committee has to ensure the eligibility and qualifications of its members on two levels. **One** – high qualifications and broad understanding of business matters, accounting and financial auditing on a level that will allow members to get to the bottom of reports presented to them and to bring up for discussion before the committee matters connected to the aforesaid company reports; **Two** – ability to carry out independent examination, be objective and not to become influenced by various processes related to reporting, internal auditing and their connection to an external auditor.

2.1.6 The application of these recommendations means – creating committees, made up from Board members, which will deal with the aforesaid issues. The responsibility for compiling and confirming financial reports will fall on all members of the Board. However, the Committee is of opinion that committees made up of Board members have to carry out groundwork work on the aforesaid issues. For reasons of efficiency the Committee proposes to assign the following tasks to the auditing committee: it shall discuss various aspects of corporation's internal auditing and the auditing of corporation's reports, in order to ensure proper compilation of financial reports according to the letter of the law; that in addition to its functions designated under the Companies Law.

The Companies Law stipulates that an auditing committee shall concentrate on deficiencies in business management of a company and decide if it is possible to approve transactions with principal shareholders.[15] An auditing committee is the only committee (in

[15] Section 117 of the Companies Law

public companies) whose creation is required by law (Companies Law[16]) and it is of paramount importance to the functioning of the Board of Directors. Hence, it will be natural for some companies to widen the scope of the committee's activities and to include the above stated recommendations. The recommendations of the CG Committee have been formulated in a way overlapping the existing regulations of the law pertaining the composition and activities of auditing committees.

Another alternative that has been presented to the committee, and which is practiced at present, provides for the creation of a special committee called a "balance committee" or any other name that will describe its function, whose responsibility is to carry out preliminary examination of company reports prior to their authorization. The CG Committee does not object to the creation of a "balance committee", where it is essential in the opinion of a company; providing that the composition of a "balance committee", qualifications of its members and the scope of its activities shall be regulated according to the recommendations made by the CG Committee in regard to the composition and qualifications requirements of the auditing committee members (according to the regulations of the law in that regard and with the addition of this committee's recommendations). Hence, form now on - where an "auditing committee" is mentioned it shall also mean a "balance committee" (providing one was created).

2.1.7 In view of the auditing committee's importance, as another facet that comes to ensure the independence of the Board of Directors en bloc, a great deal of importance is attached to the independence of its members and their financial qualifications. The Companies Law stipulates that a number of members in an auditing committee shall not fall below three and that all external directors shall be included in it.[17] It is also stipulated that a Chairman of the Board along with any director employed by a company or providing his services to a company on a permanent bases – shall not act as members of the auditing committee[18], as well as controlling shareholders or their relatives.[19]

During the CG Committee's work on finalizing its recommendations, it has taken into account all significant developments that have occurred on capital markets, including new regulatory developments regarding the tasks of an auditing

[16] Section 114 of the Companies Law
[17] Section 115(a) of the Companies Law
[18] Section 115(b) of the Companies Law
[19] Section 115(c) of the Companies Law

committee while, at the same time, taking into account the differences existing between the foreign markets and the Israeli capital market as far as the authority and duties of an auditing committee are concerned, including its relationship with the Board of Directors regarding the endorsement of financial reports.[20]

The CG Committee would like to underline the fact that nothing in its recommendations derogates from the authority and the responsibility of the Board of Directors as a whole, in regard to financial reports. Also, the Committee would like to point out that the responsibility for the preparation of financial reports lies first and foremost with the management; company management as a whole is responsible for preparation, completion and accuracy of financial reports as well as for the inclusion of appropriate disclosures in it, in accordance with the law and regulations for compilation of financial reports.

2.1.8 In light of the aforesaid the CG Committee recommendations are as follows:

a. External Directors shall constitute the majority of members on the Auditing Committee
b. An external Director shall act as the appointed Chairman of the committee
c. The quorum for committee discussions shall be based on majority of external directors among the meeting participants
d. The majority of the Auditing Committee members must be in possession of accounting and financial qualifications, as prescribed under section 2.4 henceforth, while at least one of them must be an external director
e. Members of the Auditing Committee are not permitted to actively participate in the compilation of company's financial reports
f. The recommendations of the Auditing Committee shall be presented to the Board of Directors; it is mandatory for the Board to discuss these recommendations prior to approving the aforesaid financial reports. The recommendations have to be submitted to the Board within a reasonable period of time, prior to the endorsement of financial reports
g. Where the Auditing Committee discusses financial reports of a company the Chairman of the Board of Directors of the company has a right to participate in those discussions as an observer.

[20] As stated under section 1.1.1 of the above, stringent rules of independence have also been regulated in the US, regarding qualifying terms for most members of a "balance committee"

h. A company's auditor shall be invited to participate in all meetings of the Board's auditing committee when it discusses financial reports of the company
i. The auditing committee shall express it opinion regarding the auditor's work and his fee, relative to the scope of work required from him
j. An internal auditor shall be notified regarding the aforesaid meeting and is entitled to participate in them

2.2 Tasks of the Auditing Committee in its preliminary work required for the endorsement of financial reports

2.2.1 To assist the Board of Directors in supervising the correctness of company's financial reports as well as any notification or official report pertaining to the financial situation of a company and the results of the actions it has taken, along with the review of important estimates carried out in connection with the aforesaid financial reports.

2.2.2 To assist the Board of Directors in their examination of the internal auditing reports related to financial reporting and evaluation of the internal supervision along with the company's risk management policy.

To assist the Board of Directors to supervise the objectivity of the company's internal auditor (where a "balance committee" has been established, this issue shall be dealt with by it)

2.2.3 To draw up recommendations for the Board of Directors regarding appointment of an auditor, his fees and terms of contract, prior to the endorsement of the auditor's contract by a general meeting.

2.2.4 To scrutinize and supervise the independence and objectivity of an auditor as well as effectiveness of his auditing work, all within compliance with the rules and regulations of the law and professional conduct rules, in order to draw up recommendations for the company's Board of Directors on this subject.

2.2.5 To develop and apply a policy of contracting an auditor for provision of accompanying services, all within compliance with the regulations of the law, professional conduct rules and ethical rules; and to report to the Board regarding failures on this subject as well as to make recommendations pertaining the appropriate steps to be taken.

2.3 Meetings of the auditing committee (or a balance committee where created)

2.3.1 The auditing committee shall meet according to the necessities of a company and according to the requirements of its duties, but no fewer than once every three months; the meetings should be related to dates of reporting and auditing. The Chairman of the Committee, and if the need arises other members as well, has to keep in touch - on ongoing bases – with key persons related to the corporate governance, including the Chairman of the Board of Directors, CEO, Financial Director, auditor, legal adviser, company's secretary and an internal auditor.

2.3.2 The committee should be allocated an appropriate period of time in which to hold in-depth discussions. The committee shall report to the Board of Directors on a regular basis regarding its decisions or recommendations, along with retaining an appropriate period of time in which to consolidate its conclusions and to submit them to the Board of Directors in good time.

2.3.3 The auditing committee shall hold at least one annual meeting with an internal and external auditors, without the presence of the management (CEO included), in order to discuss issues related to its functioning as well as issues related to the audit.

2.3.4 The Chairman of the committee must ensure that the auditing committee relays on satisfactory sources that will permit it to carry out its duties, and that the committee shall receive all required documents and information - in time which will allow it to hold in-depth discussions on the standing issues.

2.4 Legitimacy, proficiency and qualifications of the Auditing Committee members.

2.4.1 Members of the Auditing Committee have to posses financial and accounting qualifications, be highly proficient in business, accounting, internal auditing and financial reports, in a way that will allow them to understand in-depth the financial reports of a company and to raise questions regarding those financial reports.[21]

In evaluating director's proficiency one must take into consideration his education, experience, his familiarity with and the knowledge of - the following subjects:

[21] The proficiency underlined in this clause varies from that stipulated under the Companies' Regulations regarding financial and accounting proficiency since the proficiency required by the Committee is not necessarily in the field of the company's activities.

- ✓ Accounting and internal auditing topics, characteristic for large companies of complex structure
- ✓ Task and obligations of an external auditor
- ✓ The process of preparing and approving financial reports
- ✓ Mechanism of internal auditing in reporting corporations or other companies of similar size

2.4.2 A company has to prepare a training program for new committee members that, among other things, will deal with committee responsibilities, the scope of its activities, time required from its members to carry out their duties, and an overview of company activities along with the identification of main financial risks and characteristics.

2.4.3 It is recommended to provide, periodically, continuous and appropriate training to the members of an auditing committee. The training shall relate, among other things, to reporting requirements that apply to companies according to the law, to comprehension of the auditing principals and the laws applicable to them, as well as new developments in this field (the training might relate to the understanding of such subjects as – understanding of financial reports, generally accepted accounting regulations and practice, a legal framework for companies transactions, tasks of internal and external auditing and risk management).

The training program in general and a continuous training program in particular can be carried out in a number of ways, including professional courses and conferences, internal company seminars and briefings by external consultants.

2.5 Interconnectedness between the Auditing Committee and the Board of Directors, pertaining preliminary work for the endorsement of financial reports.

2.5.1 The tasks of the auditing committee (beyond the stipulations of the law) shall be defined by the Board of Directors, along with its duty to report to the Board.

2.5.2 The auditing committee shall re-examine its authority and the effectiveness of its performance, at least once a year, and shall report to the Board on the required changes.

2.5.3 The Board of Directors shall re-examine committee's effectiveness at least once a year. In case of the divergence of opinions, between the Board and the committee, the necessary time should be taken in order to resolve the differences. In case there is no solution for the

apparent differences, the committee has a right to report to the shareholders, through a periodic report, as part of the description of its activities.

2.6 Committee's emphasis in regard to financial reports

2.6.1 The auditing committee has to assist the Board of Directors in the examination of important issues contained in reports and prepared estimates as well as in examination of the considerations taken into account during the compilation of the aforesaid financial reports, internal reports and other official reports.

2.6.2 In general the management is responsible for the preparation of financial reports, their accuracy and comprehensiveness and particularly for disclosure contained in them, according to requirements pertaining company reports according to the law and its provisions. Committee members are not allowed to participate in the writing of company's financial reports. However the committee has to discuss the accounting policy implemented by the company, the changes that had occurred in it, as well as every other substantial estimate that had been prepared. The management, on its part, has to inform the auditing committee regarding the methods used to register irregular deals, where several accounting alternatives for handling them exist. The auditing committee, following the stand taken by the external auditor, has to determine whether the company has been implementing an appropriate accounting policy and whether it had used appropriate estimates in order to determine it.

2.6.3 The auditing committee has to examine the completeness of disclosure within financial reports of the company and to determine whether the provided disclosure is sufficient under the existing circumstances. The committee has to report to the Board of Directors on every case where, in its opinion, there is a problem pertaining financial reporting of the company.

2.6.4 The auditing committee has to review the accompanying information included in the financial reports, including information regarding financial and operational situation of the company, as well as information regarding corporate governance in connection with auditing and company risk management. Also, where permission of the Board of Directors is required for reporting financial information, the committee has to make an effort to review this information prior to its release.

2.7 Committee's emphasis pertaining internal auditing and risk management.

2.7.1 The auditing committee has to assist the Board of Directors to review and examine internal auditing related to financial reports, as well as the whole of the internal control and risk management system, in case the aforesaid systems are not managed by the Board as a whole.
For the purpose of this clause - *internal auditing*, related to financial reports and existing rules and procedures, is intended to ensure that information the company has to publish, according to the law, will be registered, documented, passes on and reported according to the provisions of the law.
More over, disclosure and auditing related procedures are intended to ensure that information which is about to be disclosed in company reports has been reported to the management, including senior executives and those responsible for financial matters, in a way that will allow them to make timely decisions pertaining required disclosures.

2.7.2 Company management is responsible for identification, evaluation, management and supervision of risks; at the same time it is also responsible for development, operation and supervision over the internal auditing mechanism and the report of the aforesaid activities to the Board of Directors. The auditing committee has to receive reports from the management, with the exception of cases where this is done by the Board of Directors, regarding the effectiveness of the established mechanisms and the results of inspections carried out by the internal and external auditors.

2.8 Protection of "whistle blowers"

The auditing committee has to examine and adopt provisions which will allow company employees to raise both reservations and complaints regarding possible failures related to financial reports and other issues, without endangering their positions. The committee has to institute provisions that will allow inquires related to the aforesaid issues to be brought forth as well as to ensure the means to act pertaining the findings. Periodically, the existence of the aforesaid arrangements shall be brought to the attention of the company employees.

2.9 Emphasis on the internal auditing process

2.9.1 The auditing committee has to review and approve every reference that appears in the periodic report in regard to internal supervision

and risk management, with the exception of cases dealt with by the Board of Directors.

2.9.2 The auditing committee has to review the effectiveness of the actions taken by the internal auditor of the company. The committee has to ensure that the internal auditor has at his disposal, all necessary tools, sources and accesses to information relevant to his work according to the accepted professional standards.

2.9.3 The auditing committee has to review the existence of checks and balances intended to identify the transactions of principal shareholders and bring them forward for authorization and reporting according to the letter of the law and company regulations. The executing authority, in this matter, shall be placed on the shoulders of the internal auditor and company secretary.

3 Authorization of transactions with principal shareholders

3.1.1 Section 275, of the Companies Law, provides for a mechanism for approval of irregular transactions between a public corporation and a principal shareholder or another person in which principal shareholder has a special interest, including agreements for compensation of a principal shareholder or a relative of his for employing him in a company or appointing him as a corporate office in a company. In accordance with this mechanism an authorization of the auditing committee, an authorization of the Board of Directors and the general meeting of shareholders is required – when with the consent of the general meeting one of the following transpires:

a. In the count of the general meeting majority voting - votes of 1/3 of all participating shareholder, which have no personal interest in the authorization of the deal, shall be included (the abstainers are not taken into account); or
b. The overall count of opposing votes of participating shareholders, which have no personal interest in the authorization of the deal, does not rise above 1% of all voting rights in the company.

3.1.2 From the examination carried out by the CG Committee it appears that the authorization of **majority** shareholders, which have no personal interest in the approval of the deal, is required in the US, UK and Canada. However, in Delaware, the leading US State in matters of incorporation – a company, whether private or public, is

not required to authorize the aforesaid transactions by special majority. Yet, the choice not to authorize the transaction by the aforesaid majority leads to a stringent approach on the part of the courts as far as fairness of the transaction is concerned (see section 3.2, henceforth). This approach of Delaware courts leads most companies to seek transaction authorization by **majority** shareholders, which have no personal interest in the approval of the deal.

Although in Delaware the requirement to receive majority from the non-nonaffiliated shareholders is not a prerequisite required for the approval of the transaction but a debating tool for determining the burden of prove at the time of court examination, in Canada and the UK (as is in Israel) this requirement is a pre-condition for the approval of a transaction.

In the UK, according to Chapter 11 of the London Stock Exchange Listing Rule, it is stipulated that the authorization of transactions with principal shareholders[22] requires endorsement of shareholders at a time when principal shareholders abstain from voting.

Under the Canadian Law[23], the authorization of deals with principal shareholders requires two compounded conditions:

1. majority authorization at the general meeting
2. majority authorization from minority shareholders (and in some cases by 2/3 majority within minority)

The aforesaid minority does not include "affiliated parties" as defined under the Canadian Law. This definition includes not only principal shareholders interested in carrying out the transaction but

[22] Principal shareholders are defined as:
   a. Material shareholder – whoever holds 10% of the overall voting rights in the company or in affiliated corporation.
   b. Director (or whoever has acted as a Director in the year prior to the approval of the deal) or "shadow director" on behalf of the company or an affiliated corporation.
   c. An entity related to a principal shareholder included in the Book of Laws or in the above.

2. A person related to an entity, is defined as:
   a. a spouse or a child of a person ("a family of a person)
   b. a Trustee of a Trusteeship whose beneficiaries are a person or his family.
   c. a company where a person, and his family, can jointly: (1) vote at least 30% of voting rights, or (2) appoint or dismiss directors that do not hold majority voting rights on the company's Board of Directors.

3. An entity affiliated with a corporation that is a material shareholder , is defined as:
   a. affiliated corporation
   b. a company whose directors tend to act according to instructions of a material shareholder
   c. a company where a material shareholder, together with any company listed in the Book of Laws or under b above, will hold rights as detailed in the Book of Laws C2 above.

[23] Ontario Securities Commission, Rule 61-501

also those who are affiliated with them act in consort with them, or whose considerations are influenced by them – whether directly or indirectly[24].

3.1.3 Historically, in Israel, the adoption of a "supporting one-third "had originated from blackmail apprehension which might arise from the absence of most shareholders from voting.[25] The requirement of "one-third" is not exceptional in the world, since as far as voting mechanisms are concerned, there is a meaning to gathering majority from members of a group defined as a group whose approval is required.[26] With the increased weight of institutional investors in shareholding, and with the creation of mechanisms of proxy voting, the apprehension of blackmail does not justify the reliance on "one third". It should be underlined: on the Israeli capital market, where an overwhelming majority of companies have a controlling shareholder, the main apprehension is of transactions involving conflicts of interest. Therefore the main protection given to minority is the requirement for a special majority in authorization of the aforesaid transactions, particularly in light of this Committee's decision not to recommend that the majority of Directors on a company's Board of Directors should be external Directors.[27]

The CG Committee is of opinion that in light of the increased amount of transactions, here in Israel, involving controlling shareholders it will be fitting to shore up the provision, which stipulates under section 275(a)(3)(a) of the Companies Law – that in majority vote count of the general meeting, a **majority** will be based only on the votes of the nonaffiliated shareholders present (while the abstainers are not counted).

Despite of the fact that the Committee did not find a parallel to an Israeli designation of an "irregular" transaction, where the overall number of opponents to a transaction (that do not have any personal interest in it) does not rise above one percent of all voting rights in the company – the authorization of shareholders (that do not have any personal interest in the transaction – henceforth "an irregular" transaction) will not be required, the Committee did not find it necessary to advice the abolition of the aforesaid designation. This conclusion had been reached in light of the

[24] There, part 8 of the rule p. 4526, clause 8.1(2)

[25] In the original section 96 in amendment to Company Ordinance (no.4)(responsibility of office holders),1991 "half of the votes" is required, under amendment no.7 of Company Ordinance, 1992 it has been changed to "one third"

[26] Once the support of "one third" is ensured, it means that "two thirds" of the group members oppose the decision and a preference for a minority opinion is created, which in itself is an anomaly.

[27] See section 1.1.1 above

feedback received from the public, which stated that in light of poor attendance of general meetings the requirement for a special majority might be detrimentally exploited by blackmailing shareholders that hold but a few percents in shares. The Committee is of opinion that it will be appropriate to amend the definition of the aforesaid "irregular" transaction, following the adoption of the majority requirement – as described above, in a way that will make it applicable in cases where the overall number of opponents (that do not have any personal interest in the transaction) is not higher than 2% of all the voting rights in a company.

In light of the aforesaid, the Committee suggests adopting its recommendations, regarding the approval of transactions with principal shareholders, in two stages:

First stage – prior to the establishment of the Securities and Corporate court as detailed under chapter 3 – the CG Committee recommends to raise the majority required for the approval of the transaction with principal shareholders from "one third" to "a majority" of shareholders that do not have any personal interest in the transaction, which will fall in line with what is acceptable in the UK and Canada. At this stage, it is proposed, in order to deal with the problem of blackmail, the possibility of broadening the Israeli definition of "irregular" will be considered; according to it the transaction will be approved, without a special majority stipulated under section 275 of the Companies Law, where the overall number of opponents to the transaction among those that do not have any personal interest in it will not rise above 2% of the overall voting rights in a company (by contrast to 1% at present).

Second stage - following the establishment of the Securities and Corporate court – the Committee is of opinion that it will be possible to adopt rules similar to those of Delaware in the US.

3.2 Recommendations regarding the creation of the Court for Securities and Corporate litigation.

a. Authorization of irregular transactions (as defined under the Companies Law) in which principal shareholders have personal interest, and in particular transactions in any way rewarding controlling shareholders (including by share allocation, etc) as well as those affiliated with them, will require the authorization of the Board of Directors, authorization of the auditing committee, as stipulated under the law, and authorization of the general meeting – while the majority vote will consist of votes of impartial shareholders, present at the meeting (while the abstainers will not

be counted) and that do not have any personal interest in the transaction. Henceforth – "special majority".

b. It is proposed to examine the possibility where the Minister of Justice will decree, under section 275(b) of the Companies Law, that where controlling shareholders had committed themselves, for a defined period of time, during which all transactions that require authorization as stipulated under section 275 of the Companies Law will also be authorized by the aforesaid special majority, the rate designated under section 275 (a)(3)(b) of the Law will stand at 2% of all voting rights in the company, during the aforesaid period.

Please note that these recommendations are not interdependent, it is proposed that companies shall voluntary adopt the "special majority" requirement even if recommendation **b** will not be adopted and the rate required for an irregular transaction shall remain at 1%.

3.3 Committee recommendations following the creation of the Court for Securities and Corporate litigation.

3.3.1 Following the creation of a court, as proposed under chapter 3, the committee proposes to adopt the Delaware, US model in addition to the regular authorization process of transactions by the Board of Director's and the auditing committee of a company, as stipulated under the Companies Law.

3.3.2 According to this model a company will have two alternatives for the approval of irregular transactions (as defined by the Companies Law) with controlling shareholders:

a. To authorize the transaction at a company's general meeting by regular majority (without the requirement for a particular majority among shareholders that do not have a personal interest in the transaction); or

b. To authorize the transaction at a company's general meeting by regular majority of participating shareholders who do not have a personal interest in the transaction.

When a company authorizes a transaction according to alternative **a,** the burden of proof of the transaction's evenhandedness pertaining the company and its shareholders which do not have a personal interest in the transaction - will fall on controlling shareholders and company directors'. When a company authorizes a transaction according to alternative **b,** the burden of proof pertaining its evenhandedness – will fall on the contending shareholder.

4. Creation of additional supervising mechanisms: Directors' declaration and voting by Proxy.

4.1 Directors' declaration

A number of accounting scandals had been uncovered in recent years. In many cases the scandals stemmed from deficiencies in financial reporting and disclosure procedures as well as from problems of internal supervision over these procedures.

In order to reinstate investors' confidence in the truthfulness and completeness of financial reports submitted by public companies, the increased international tendency is to require the companies as well as their executive officers to carry personal responsibility for companies' reports and to broaden the scope of information submitted as part of financial reports.
One of the means adopted, in order to reduce deficiencies appearing in financial reports, is the inclusion of directors' declaration , in the annual and quarterly reports of public companies, which affirms the accuracy of the reports and the information included in them.
The intend of the declaration is to increase the directors' involvement and responsibility regarding the reports, to strengthen the supervisory mechanism within the companies and to reinstate investors' confidence in the truthfulness and completeness of annual and quarterly reports submitted by public companies.

As part of the Sarbanes-Oxley Act 2002 ("SOA"), which amends the American securities laws and the SEC rules, the newly legislated sections 906 and 302 stipulate that every annual or quarterly financial report submitted to SEC has to contain a declaration by a company's CEO or Deputy CEO to the effect that the aforesaid reports have been examined by them and there are no misleading details included in them, therefore the reports reflect the true financial status of a company. Also, criminal sanctions have been stipulated for the bridge of precepts included in the aforesaid declaration or for false reporting – a fine of up to 5 million dollars and up to 20 years imprisonment, where an offence has been committed intentionally (and a fine of up to 1 million dollars and up to 10 years imprisonment, where an offence has been committed knowingly).

It must be noted that SOA regulations, pertaining CEO declaration s and sanctions where these regulations are bridged, are applicable to Israeli companies that are traded on the American stock exchange.

Also, in addition to the aforesaid requirements for declaration s by CEOs, in accordance with section 404 of SOA - the accountants of public companies in the US are required to supervise the effectiveness of audits

and regulations **regarding both the functioning of a company and the disclosure provided within its reports**. This requirement was harshly criticized in view of its high implementation costs (about $1,500,000 in initial and other on going costs). The cost considerations led to the realization that the application of section 404 to all public companies is too high a burden, hence its application to foreign issuers and small companies have been postponed. Presently, the SEC is debating the appropriate standards of limited application of SOA 404 to small companies in the US. The extenuations stem, mainly, from cost-effectiveness considerations. This matter is of considerable importance in Israel since most of the traded companies come under the American designation of small companies.

The Committee had considered a number of alternatives for declaration versions – starting with a general declaration regarding the existence of internal supervision over company reports and ending with full adoption of regulations SOA 404. The adopted version represents an equidistant approach, which requires a declaration regarding the effectiveness of internal supervision and not only its formal existence, in order to ensure real upgrade of the system of supervision that fulfills its purpose.
At the same time the Committee would like to point out that it does not recommend to adopt regulations, under section SOA 404, in full but in part only. The adopted part will not include the requirement to report on every change in the system of internal supervision over financial reports, which had occurred in the company during the report period.

Contrary to the SOA 404 requirements, there is no requirement to adopt a particular model of supervision (such as COSO model, for example); the companies are not required to comply with standards of recorded procedures, performance and recording of imparity analysis, performance and recording of annual checks of all substantial supervisory mechanisms, external auditing of managerial presentations and the audit of the external auditor. The declaration concentrates on supervision of reporting and not the supervision of management.

In light of the aforesaid, the Committee recommends adopting a small company model, here in Israel - similar to the one under discussion in the US at the present time. The CG Committee recommends affixing the unreserved declaration s by CEO's (as will be explained below) and carrying out limited audits, done by accountants, which will examine the effectiveness of audits and regulations pertaining disclosure and transactions with principal shareholders.

In light of the aforesaid the recommendations are as follows:

a. In their quarterly and annual reports public companies will be required to include declaration s by CEO's, in the format provided under Appendix C of this report. The proposed CEO declaration has to be signed, personally and separately, by the Chief Executive Officer and a Senior Financial Officer of the company. The declaration shall refer to disclosures contained in the aforesaid reports, as well as to the affirmation of: upholding audits, regulations related to financial reporting, inclusion of accurate data in the aforesaid reports and disclosures related to transactions with principal shareholders. There is also a requirement to state that there is an appropriate effectiveness to the audit, to disclosure related to the work of the auditor, appropriate effectiveness to audit carried out by the Board of directors and the company's auditing committee.
The declaration proposed by this Committee varies from the declaration used in the US in that it does not have reservations. The signatory of the proposed declaration states that the effectiveness of stipulated measures, regarding procedures and disclosure, has been found adequate. The Committee is of opinion that disclosure of failures in the auditing process, as is customary in the US, is problematic and raises questions regarding current reports and disclosures and might be used to absolve the signatories from the responsibility attached to their signing of the declaration .
In order to provide reporting corporations with sufficient time to implement this requirement – it is proposed to require the inclusion of the aforesaid declaration pertaining 2006 quarterly reports, only. Until then the company can verify that the audit and procedures pertaining disclosure are adequate.

b. As part of auditing companies financial reports the accountant shall apply audit procedures pertaining the adequacy of Directors' declaration and the effectiveness of the internal auditing and procedures, as stated above. The Committee calls upon the Institute of Certified Public Accountants in Israel to define this auditing procedure according to a clear and unequivocal standard. In light of special characteristics of the Israeli capital market, pertaining transactions with principal shareholders, the CG Committee recommends that the aforesaid auditing standards will contain an individual section on supervision of auditing mechanisms, which will deal with localization and reporting pertaining principal owners' transactions, according to the law and company's regulations.

c. Where the application of the aforesaid procedures will uncover that the effectiveness of audits, pertaining disclosures contained in company reports, is inadequate, including the lack of the unreserved declaration , the auditor will not be allowed to issue an unqualified professional opinion pertaining company's financial reports. Accountability declaration s (of similar phraseology), as proposed by the Committee, have been already adopted in Israel by Government Companies Authority and by Office of the State Bank

Commissioner. The first indication is that the adoption of the aforesaid requirements, and putting the auditing issue on the agenda of institutions supervising the banks, had created an enduring improvement in proper management of those institutions.

4.2 Voting by Proxy

4.2.1 One of the more important supervisory mechanisms, designed to ensure that company management and its Board of Directors act in the company's best interests – is the voting right of company shareholders. The possibility of shareholders enacting their right to vote acts as a deterrent to directors, in making decisions that can be damaging to the company; due to their knowing that a general meeting of shareholders can replace both the directors and the company management.

Although in Israel, the ability of a common shareholder to influence the appointment or dismissal of a director is limited, new regulations of the Companies Law, which require special majority of common shareholders for the approval of transactions with principal shareholders, for appointment of external directors and tenure confirmation of the Chairman of the Board as company's CEO, stresses the importance the Israeli Law ascribes to the voting rights of common shareholders and perceives them as an instrument of supervision over the company management and its controlling shareholders.

4.2.2 This mechanism has a number of drawbacks. One of the more pronounced once is - that individual holding rates in public companies are low; while the expenses and effort required to participate in the decision making process of the general meeting are relatively high. As a result certain apathy exists among shareholders that tend to accept management recommendations presented at general meetings or not to participate in the decision making process altogether. Thus, one of the more important instruments, of preserving the interests of a company and its shareholders, has been removed. In addition the Committee had heard arguments stating that due to the complacency of many common shareholders, the blackmailing phenomenon (exercised by a minority of common shareholders, which choose to attend general meetings and to resist categorically the proposed decisions) powered by the intent to force the company and its controlling shareholders to acquire the shares of the opposing shareholders at a price higher then their fair value – leaves the company open to such blackmail.
The Israeli legislator is aware of this problem and the importance of simplifying the voting process at general meetings as well as reducing the costs related to it. The Companies Law provides for a special arrangement which allows "a vote by Proxy" in public companies.[28]

[28] Companies Law 1999, sections 87-89

According to the agreement a shareholder can vote at a general meeting without being present, by means of using "a vote by Proxy". This voting option comes in addition to a vote by emissary on behalf of a shareholder. The existence of both these options is necessary to allow shareholders to exercise their voting rights.

The Companies Law authorizes the Minister of Justice to stipulate regulations pertaining a vote by Proxy statement of position.[29] Near in time to the writing of this report the aforesaid regulations were published; the agreement regarding the use of Proxy vote will come into effect in April 2006. The Committee welcomes the completion of the legislative process, particularly the stress put on the fact that the Proxy mechanism will ease, as much as possible, the burden placed on shareholders as far as costs and procedures, of participating in general meetings, are concerned.

5. Public Institutions.

5.1 Public Institutions as threshold guards on the Israeli capital market.

5.1.1 The importance of institutional investors, to the developed capital markets is the world, grows continuously. Their importance stems from managing public money (providence funds, pension funds, insurance companies, etc.) as well as from the fact that they concentrate the main activity on the market.

5.1.2 For example, the market share of institutional investors in the US had grown from a few percents to more then 50%, of all financial assets, during the last 50 years.[30]

In Europe the picture is similar. During the last decade the rate of institutional holdings had grown to more then 50% of all financial assets in the UK, France and Germany. In the mid 90's the institutional investors in the UK had held about 76.5% of the public companies' issued capital, in France they held about 59.8% and in Germany – about 39%.

5.1.3 This phenomenon did not leave out Israel, where the involvement of institutional investors in the capital market keeps growing. At the end of 1977, assets portfolio of the

[29] Companies Law 1999, sections 89

[30] See - Stuart Gillan and Laura Starks, 2001 Institutional Investors, Corporate Ownerships and Corporate Governance: Global Perspectives. TIAA-CREF Institute Working Paper Series, p. 5

Israeli institutional investors, including provident funds, professional training funds and mutual trust funds, had amounted to 103 billion NIS (1997 value), while almost 17% of it was invested in securities traded on the stock exchange; this amount constituted about 54% of the float traded on the stock exchange.[31] Presently, following the implementation of the Bachar Act, the scope of their involvement is much higher.

5.1.4 The amount of assets invested in shares traded on the stock exchange, and the share of institutional holders in this capital, testifies to a great influence these institutional investors have on the capital market.

This influence is expressed, among other things, in their active involvement in trade on the market, which in turn may influence the volume of trade on the stock exchange, negotiability of shares, fluctuation rate of shares and the way companies are managed - by exercising voting rights bestowed upon them by virtue of share ownership.

5.1.5 In light of the importance of the institutional investors to the Israeli capital market and in view of the fact that they hold public assets, the Committee is of opinion that it will be appropriate to strengthen their commitment to the public who entrusted them with its money. This can be achieved by improving the transparency of institutional investors' activities.

In particular there is a need to encourage institutional investors to exercise their power and to influence the proceeding in the companies in which they invest. Institutional investors, due to their size and resources, usually hold a large share of the company's capital; they can be involved in the company activities and to contribute to its more efficient management to the benefit of both the company and its shareholders.

5.1.6 Section 77, of the Joint Investment in Trust Law 1999, requires all fund managers to participate and vote in general meetings of corporations, whose shares they own, where a decision has a potential to harm or further the interests of unit holders (including transactions with principal shareholders). A fund manager that participated in

[31] Hauser, Rosenberg and Offir "Examination of advantages related to the obligatory participation of mutual trust funds in general meetings of public companies", ISA, Jerusalem 1999, p. 1

a general meeting of a corporation, where a raised proposal had, in his opinion, a potential to harm or further the interests of the unit holders – and there was a vote on the motion - is required to submit a report detailing the motion and the distribution of the vote.[32]

A similar regulation has been issued by the Capital Market Department pertaining provident funds[33]; presently the ISA is working on amendment to the Joint Investment Trust Law which will stipulate that fund managers can not avoid participating in the aforesaid general meetings.[34]
The Committee sees as appropriate the broadening, on two levels, of regulations requiring mutual funds and provident funds to participate in general meetings:

a. To encourage institutional investors to participate in a general meeting and vote when the results may materially affect the company it holds (even though there is no perceived damage to unit holders, due to the extent of the institutional investors' holdings in the aforesaid company).
b. It is appropriate to broaden this directive to include additional institutional investors, beyond provident funds and mutual funds. For that purpose one can use part of "investor" definitions listed under the First Appendix of the Securities Law (pertaining section 15a(b)(1)).

The Committee is of opinion that the involvement of institutional investors in the decision making process of public companies, particularly in decisions brought up for voting in a general meeting, is of great importance to the capital market due to their ability to act as effective threshold keepers and "opinion makers".

As we have stated, the Israeli capital market is characterized by the lack of intermediary which mediates between controlling shareholders and common shareholders. The Companies Law stipulates that a special voting majority, in a general meeting, is required for the approval of transactions where controlling shareholders

[32] Joint Investment in Trust Law Regulations (immediate report, monthly report, unit ownership report and report on voting in a general meeting) 1994, regulation 27.
[33] Regulation 41E1(a) of the Income Tax Act (Regulations of certification and management of a provident fund) 1964. Also see, Supervision of Financial Services Law (provident funds) 2005, legislated in the wake of the Bachar Committee, it discusses the participation of a fund manager in general meetings.
[34] Draft amendment of the Joint Investment in Trust Law, 1994, amendment 10.

have personal interest. Hence the participation of public institutions – as nonaffiliated shareholders – is essential, in order to ensure the effectiveness of majority voting mechanism.

5.2 Committee recommendations in regard to Public Institutions

5.2.1 In light of the aforesaid the committee recommendations are centered on three main principals:

- ✓ To encourage public institutions to participate in general meetings by means of Proxy and by presentation of a position statement.
- ✓ Broadening the disclosure requirements pertaining voting policy of public institutions and their actual voting.

5.2.1 Committee recommendations based on guiding principals

a. As part of quarterly reports presented to the public, public institutions, for the purpose of this paragraph listed under the First Appendix of the Securities Law, will be required to report on the following:

- ✓ Their voting policy on various issues, along with pointing out changes in this policy by comparison to the previous report.
- ✓ Concentrated report regarding the number of cases on which they had voted in general meetings of companies where they had investments, along with a detailed list of votes for, against or abstention (that in addition to a record kept on each vote)
- ✓ Provide explanation on their vote, when it differs from voting policy stated in the previous report.
- ✓ Description of the decision making process pertaining voting in meetings of companies held by them (to differentiate from considerations themselves).
- ✓ To state their policy and actions taken in order to resolve conflicts of interest, which might substantially affect their voting rights in companies they hold, including disclosure pertaining suspicion regarding conflicts of interest as well as detailed disclosure - in the immediate report - prior to exercising their voting rights.

- ✓ To state – what is their policy regarding the use of position statements and to detail a number of cases where position statements have been used.

b. Public institutions have to asses the quality of CG, in companies in which they invest, by taking into consideration the complexity of the aforesaid company, its activities and size as well as risks and challenges facing it. It will be appropriate, for public institutions, to allocate resources for the implementation of this policy.

c. Where, in Israel, a rating list of companies – based on the quality of Corporate Governance – will be published, a system of incentives may be established for public institutions to invest in companies highly rated for their Corporate Governance.

d. All reports, related to the issues contained in committee's recommendations, of public institutions have to be combined in a way that will make them accessible to the public via the "MAYA" system of the TASE. Regarding reporting corporations (defined by the Securities Law) – their reports have to be available through the MAGNA system of the ISA.

C. Creation of a Court for Securities and Companies Law litigation

The efficiency of public institutions stems from the quality of their business decisions as well as from their corporate culture pertaining the rights of small shareholders. The examination of the quality of business decisions comes under the Companies Law the "duty of prudence ", while the examination of transactions that might harm the minority in carried under the "duty of trust".

Courts and legislators all over the world have recognized their inability to scrutinize the nature of business decisions which are not related to the conflicts of interest – *post factum*, therefore they have adopted a principal of non involvement (business judgment rule) and even permitted shareholders to disregard the "duty of prudence ". The supervision over the nature of the managerial decisions taken had been transferred to various markets. Primarily to the commodities market. The quality of management is reflected in the quality and price of its commodities. A bad company will be defeated on the market and sustain losses until the management is replaced or the company itself - liquidated. The stronger the competition in the market place where the company operates, regardless of whether the competitors are local or foreign, the greater the need to ensure efficient management in order to survive and profit. In addition, the capital market prices the quality of management and this fact gets its expression in the value of company shares. The analysts, following the company, also are an important factor in the functioning of a capital market and its ability to supervise the quality of a company's management. The market for corporate control, in cases where it has control, can also

curb the lack of managerial efficiency. Share acquisition of failing companies, including by takeovers, and consolidation of a controlling group will allow, the one that acquired control, to replace the company's board of directors and to improve its management.

On the other hand, for discriminated minority holders, in cases where a company has a controlling shareholder, the only recourse is a court appeal. In these cases there is an apprehension of unequal division of company profits; hence none of the markets can be an obstacle to a controlling shareholder. For example, commodities market does not act as a deterrent since a controlling shareholder ensures efficient management that allows a company to compete well on the commodities market, but takes care not to divide equally, the profits created under his management, to minority shareholders. Also, the controlling market can not exercise its power since the controlling shareholder already holds control over most of the company shares. The capital market can price the discrimination and exploitation of the minority, but usually this is not sufficient to restrain the controlling shareholder. It appears that the capital market can make the raising of capital, for companies where the exploitation takes place, more expensive and by doing so to curtail the controlling shareholder. But a controlling shareholder has an option of using undivided profit and to raise capital from the bank and the public through bonds, an option that largely diminishes the need to raise expensive capital from the public. More over, the unique characteristics of the Israeli capital market, pertaining to its small size, such as lack of "commodities", conflicts of interest between underwriters and institutional investors, etc., sometimes make a "sanction" ineffective as far as the price of issue is concerned. Hence the only recourse for a minority shareholder - is a court appeal.

As a rule, the court for Securities and Companies Law deals with very complex economic and financing issues, because the dynamic business world continuously creates special business transactions that have to answer taxing requirements, accounting requirements and regulatory requirements. In particular, a court that examines questions of discrimination and exploitation – faces questions which require above all high judicial proficiency. For instance, in cases related to the examination of the transactions' integrity - when conflicts of interest are involved – the court has to deal with value estimation of the transaction in question. The examination of value estimation requires understanding of corporate financing and the ability to comprehend complex models of value estimation. Similarly, when controlling shareholders execute complex transactions in order to camouflage their effect on minority shareholders, including the use of complex financial instruments, the court has to examine secondary implications of these complex transactions and their effect on the rights of minority shareholders.

The existence of a specializing court that will be capable of preventing discrimination and exploitation of minority shareholders – is a central factor in enhancement of management within public companies, the development of capital market and general economic improvement. Empiric research has shown a clear connection between the quality of protection extended to the investing public, economic growth and developed capital markets. Moreover, since there is no court capable of preventing discrimination and exploitation of minority shareholders, a there is no change to develop a market with dispersed ownership. Controlling shareholders have no incentive to sell control on the

market, as long as they can "gain" benefits at the expense of minority shareholders. Only when "gaining" is restrained by the court, a controlling shareholder will conclude that risk spread considerations prefer dispersed ownership or that a gain from the sale of shares to the public justifies the relinquishment of control.

There is only one country in the world that succeeded in creating a specialized court – the State of Delaware in the US. The quality of this court is the main reason for the fact that more then 2/3 of public companies in the US are being incorporated in Delaware, under the Delaware law.

The Committee therefore proposes to create a court specializing in Securities and Companies Law litigation, here in Israel. This recommendation has been greeted by sweeping support from all parties that appeared before the Committee. A specialized court will concentrate all claims pertaining Securities and Companies Law, including criminal claims, class actions and derived claims. In this way the judges will acquire the required proficiency; the market will gain consistency and certainty of judgment; judicial decisions will be handed down at the pace required to the business world. A specialized court will deter companies and controlling shareholders from mistreating minority shareholders, which will lead to qualitative management, qualitative capital market and will encourage economic growth. In time, with the growth of the court's effectiveness the need for compensation mechanisms will greatly diminish, which are widespread at present due to the lack of effective enforcement pertaining the rights of minority shareholders.

The success of specialized court depends on the quality of judges that comprise it. The candidates, in addition to a deep understanding of Securities and Companies Law, have to be knowledgeable in corporate financing and have practical experience in the field. It is also important to train the judges continuously, as part of their corresponding vocational training prior to their taking to the bench and during their time on the bench. It is recommended to appoint the judges for a period of no less then 10 years in order to maximize the advantages of the experience they will accumulate while serving on the court.

Henceforth are the Committee's recommendations:

a. A court specializing in Securities and Companies Law litigation must be established along the lines of the family matters court (hence – a "specialized court")
b. The specialized court will be established within the framework of the Tel Aviv District Court.
c. **Jurisdiction**. All claims derived from Companies Law, Securities Law and pertaining Regulations (including Criminal Files, Class Actions and Derived Claims) will be forwarded to the Companies Court from allover the country and from any instance. In regard to reporting corporations, as defined under the Securities Law, the court's jurisdiction will be designated as the sole

jurisdiction, and in regard to other corporations the court's jurisdiction will be defined as equivalent to that of the District courts.

d. **Judges' Qualifications.** Qualifications of judges appointed to the Companies Court shall include, in addition to credentials to serve as a district judge, extensive understanding of the Securities and Companies Law, knowledge of corporate financing and extensive court room experience in the field.

e. The tenure of a judge appointed to the Companies Court shall be for a period of no less then 10 years.

f. Five judges have to be appointed to the court

g. **Composition of the Court**. The court will be presided over by one judge.

Appendix A: Letter of Appointment

To: Professor Zohar Goshen 30 August, 2004
Moshe Gavish, Attorney at Law
Mr. Yitzhak Devesh
Mr. Doron Debi, CPA
Ms. Ronit Harel
Dr. Yair Friedman
Professor Efraim Tzdaka
Mr. Josef Rosen
Amir Sharf, Attorney at Law
Yoram Nave, Attorney at Law
Ram Gev, CPA

Re: Committee for Examination of Corporate Governance Code in Israel.

You are here by appointed to serve as members of the committee for the examination of character and structure appropriate for the Corporate Governance in Israel. The Committee recommendations are intended to assist me and the ISA to evaluate the appropriate way of action pertaining this important issue.

The committee has no judicial authority. We are talking about a professional team whose function is to assist me and the Israel Securities Authority to define a stand pertaining this issue, as part of the ISA's functions under the Securities Law.

While the recommendations themselves carry a great deal of weight, the ISA will consider the extent to which they will be adopted upon receiving them.

The CG Code – is a collection of regulations and principals defining the mode of management appropriate for public companies in regard to various aspects of Best Practice. As background information, I would like to point out that similar codes were adopted on world markets during the last few years – particularly by the OECD, which had adopted the CG Code in 1999, with the intent to set forth principals for appropriate management of corporations in all member states. Countries such as the US, the UK, Holland, Germany, Australia, Turkey and others had adopted the CG Code in line with the OECD ruling and according to the laws of the country.

Therefore, the Committee is required to recommend a structure (including a number of possible versions) of a CG Code appropriate for the Israeli capital market by taking into consideration the codes that were adopted worldwide and particularly the code adopted by the OECD, as well as to refer to the following topics:

1. Special characteristics of the Israeli capital market
2. Relevant law regulations in Israel Securities Authority

3. Implementation of the code

Professor Zohar Goshen shall act as the Chairman of the Committee.
Attorney at Law, Yoram Nave, shall act as Committee's Secretary.

The ISA will provide all managerial resources necessary for the functioning of the Committee and Ms. Sara Batito shall provide administrative assistance.

The Committee can approach any one, it sees fit, for opinion or information gathering.

The Committee is requested to submit its recommendations by April 1, 2005.

I thank you for your willingness to participate in this Committee and wish you success in your work.

Truly yours
Moshe Tery

Appendix B: Committee recommendations to be adopted by public companies and reporting corporations

1. The work and composition of the Board of Directors

1.1 Board's Independence

a. Beginning on 1.1.07 one third of directors sitting of the Board of a public company have to be external directors and under no circumstances shall their number be less then two

b. Office holders subordinate to company's CEO shall not hold the office of a director.

1.2 Meetings of the Board of Directors

a. Once a year the Board shall discuss and stipulate minimal frequency of meetings for the upcoming year.

b. The Board of Directors shall discuss and regulate the following issues:

- ✓ Formulating the policy of a corporation, including its subsidiaries, pertaining exposure to various risks (credit risks, market risks, managerial risks, operational risks, liquidity risks, judicial risks, etc.), existence of supervisory tools for risk evaluation, specification of policy pertaining risk exposure and permissible limits of exposure.
- ✓ Authorization of the annual business plan and the means to supervise its implementation.
- ✓ Authorization of the overall budget of a corporation and a current follow-up over its factual implementation.
- ✓ Performance and realization of investments over a certain amount, which will be stipulated by the Board.
- ✓ Any other issue of material importance to the activities of a corporation or to the supervision over its management.

c. Periodically, a company has to conduct Board meetings at which the management (including the CEO and directors which act as members of the management; although the Committee does not recommend such doubling of functions) is not present; they are to be carried out according to a predetermined and acknowledged annual schedule.

1.3 Separation of duties between CEO and Chairman of the Board

a. Different individuals have to serve as a CEO and a Chairman of the Board of Directors. The separation of authority, between the CEO and the Chairman of the Board, has to be defined, documented in writing and approved by the Board of Directors.

b. The Chairman of the Board shall not hold another office in a corporation and shall not engage in its current management, including his participation as a member in meetings of the management.

c. The Chairman of the Board shall abstain from giving orders to managers subordinated to the CEO.

1.4 Qualifications and eligibility of Directors

a. Each one of the Directors (including external directors) shall state that he possesses the skills and time required to carry out his duties appropriately and that he has the required accounting and financial skills where he is about to be appointed as an aforesaid eligible candidate (whether under company regulations pertaining accounting and financial skills or under this Committee's recommendations as stipulated under section 2.4, henceforth).

b. The Chairman of the Board shall ensure that all Directors (including external Directors) have signed the relevant declaration s.

c. Prior to Director's appointment (or reappointment) company shareholders have to be provided with information pertaining the aforesaid director's Curriculum Vitae, qualifications, other occupations and offices held by him, along with any other information relevant to their making an informed decision.

d. Reappointments of all Directors (which are not external directors) have to be confirmed at every annual general meeting of the shareholders. Periodic rotation of the Board members has to ensure.

e. The Chairman of the Board shall insure that members of the Board will receive all the information, essential for performing their duties on time, and that it should be precise and clear.

f. The Chairman of the Board shall insure that Directors have an opportunity to update their knowledgeability and their familiarity with the business of a corporation, according to the requirements of their office.

g. The Chairman of the Board shall insure that proper communications exist between the Board of Directors and the shareholders (in an egalitarian way provided for under the law), and between internal and external auditors and the auditing committee (or balance committee – where created).

h. The Chairman of the Board shall be responsible and inspire, by virtue of his authority implement the CG regulations within the company and to update the Board on all subjects related to Corporate Governance.

1.5 Recompense of Directors and other corporate officers

When authorizing directors' recompense, the auditing committee shall refer to the means used to ensure that the recompense mechanism does in fact promote attainment of company goals. For example, it will be appropriate to refer to a suitable "freeze period" related to shares allocated to directors and other office

holders, to recompense on basis of performance, etc. (Where recompense of office holders, who are not directors, is discussed – the Board of Directors will be in charge of the subject)

2. Composition and workings of the Auditing Committee

2.1 Independence of the Auditing Committee

- **a.** Most members of the auditing committee will act as external directors
- **b.** An external director shall be appointed Chairman of the committee
- **c.** Majority presence of external directors, among the participants, will constitute the quorum for committee discussions
- **d.** Majority of the committee members must be proficient in financing and accounting, as detailed under section 2.4, and at least one of them has to act as an external director
- **e.** The members of the auditing committee are prohibited to actively participate in the compilation of company financial reports.
- **f.** Committee's recommendations will be presented to the Board of Directors, and the Board is obligated to discuss them prior to the authorization of company's financial reports. The aforesaid recommendations have to be submitted to the Board within a reasonable period of time - preceding the authorization of company's financial reports.
- **g.** Where the auditing committee discusses company financial reports, the Chairman of the Board has a right to be present as an observer.
- **h.** The auditor of a company has to be invited to all the meetings of the directors' auditing committee where company financial reports are discussed.
- **i.** The auditing committee shall express its opinion pertaining the volume of work and the fee of the auditor, relative to the work required from him.
- **j.** Internal editor shall be notified regarding the aforesaid meetings and shall be authorized to participate in them.

2.2 Functions of the auditing committee during its preliminary work pertaining authorization of financial reports

2.2.1 To assist the Board of Directors in their supervision of financial reports' correctness, as well as any notice or official reporting related to the company's financial state and activities, by reviewing material estimates and evaluations prepared pertaining the aforesaid reports.

2.2.2 To assist the Board of Directors in reviewing internal auditing reports pertaining financial reporting, the system of internal supervision and risk management in the company.

To assist the Board of Directors to oversee the impartiality of the company's internal auditor (in cases where a balance committee has been created, this issue will remain the auditing committee's responsibility).

2.2.3 To present the Board of Directors with recommendations regarding the appointment of an auditor, his professional fee and the terms of a professional engagement agreement signed with him, prior to their authorization by the general meeting.

2.2.4 To oversee and examine auditor's independence, his objectivity and the impartiality of the audit itself, within the framework of the law and professional rules of conduct – in order to present its recommendations, pertaining the aforesaid issue, to the Board of Directors.

2.2.5 To develop and apply, within the framework of the law, appointment policy pertaining accompanying services provided by the auditor, professional and ethical rules of conduct; as well as to report to the Board of directors on all failures and make recommendations for their improvement.

2.3 Meetings of the auditing committee (or a balance committee where created)

2.3.1 The Auditing Committee shall convene according to company needs and its duty requirements, but no less then once every three months, the meetings should be held on dates correlated to reporting and auditing. The Chairman of the committee, and to a lesser extent the members of the committee, has to sustain a current connection with key figures related to corporate governance including the Chairman of the Board of Directors, Director of Finance, Legal Counsel, Company Secretary, auditor and internal auditor.

2.3.2 The committee will be allocated enough time to hold in depth and thorough discussions. The committee will report to the Board on ongoing basis pertaining its decisions and recommendations, while allowing the committee enough time to work out its recommendations according to needs.

2.3.3 The committee must hold at least one annual meeting with internal and external auditors, without the presence of management (CEO included), in order to discuss issues related to functions of the committee and other issues related to the auditing.

2.3.4 The chairman of the committee will ensure that sufficient sources are available to the committee in order to carry out its functions, and that required documents and information are provided to the committee within a time period required for their proper examination.

2.4 Qualifications, proficiency and training of committee members

2.4.1 Committee members with financial and accounting skills have to be highly trained and possess a thorough understanding of business and accounting issues, financial reports and internal auditing to the extent that will permit them a profound understanding of financial reports and provide them with ability to raise questions pertaining company's financial reporting (please note, proficiency stipulated under this paragraph differs from the one required under the Regulations of the Companies Law, pertaining accounting and financial proficiency, by not being limited to the company's particular field of business activity).

In evaluating director's proficiency - education, professional experience and knowledge - all have to be taken into consideration as well as his familiarity with the following issues:

- ✓ Knowledge of accounting and auditing issues that typical to the company's business activities or familiarity with other companies of similar size and complexity.
- ✓ Knowledge of the duties and responsibilities of the auditor.
- ✓ Knowledge of preparation and authorization process of financial reports
- ✓ Familiarity with mechanism of internal auditing within other companies of similar size and complexity.

2.4.2 The company has to organize professional training programs for new members of the auditing committee that will deal, among other things, with committee's responsibilities, the framework of its activities, time required from its members to carry out their duties and an overview on the company's business activities that include identification of risks and main financial characteristics. The program may also include acquaintances with some of the company's employees.

2.4.3 The company has to ensure constant periodic professional training of committee members. The training will relate to reporting requirements pertaining the company under the law, comprehension of principals of accounting reporting and corporate

law, as well as to new developments in these areas (it is possible that the training will relate to such subjects as – comprehension of financial reports, accepted accounting rules and accepted rules of practice, a legal framework of companies' business activities, the role of internal and external auditing and risk management).

The training plan can be carried out in a number of ways, including professional training courses; company ran internal seminars and briefings by external experts.

2.5 Interrelation of the auditing committee with the Board of Directors pertaining preliminary work on authorization of financial reports.

2.5.1 The role of the auditing committee (in addition to the provisions of the law) as well as it reporting duties will be defined by the Board of Directors.

2.5.2 The auditing committee has to examine, annually, its authority and the effectiveness of its activities and to advise the Board regarding the required changes.

2.5.3 The Board of Directors has to examine, annually, the effectiveness of the auditing committee. In case there are differences of opinion between the Board and the committee, an appropriate period of time has to be given to the dispute's resolution. Where such resolution was not achieved the committee has a right to report on the issue to shareholders as part of its periodic activities report.

2.6 Emphasis the committee must place on financial reports

2.6.1 The committee has to assist the Board of Directors to examine all material issues contained in financial reports, estimates and conclusions that have been reached during the preparation of the aforesaid reports, as well as internal and other official reports.

2.6.2 The management is responsible for the preparation, completion and accuracy of financial reports as well as for disclosures mandatory for other company reports, all according to the rules pertaining financial reports and other regulations of the law. As aforesaid, the committee members are not entitled to actively participate in the drafting of company's financial reports. However, the committee has to discuss the accounting policy that has been implemented, with all the changes it entailed, as well as all estimates and estimations that were carried out. The management has to inform the committee about the system used to register irregular transactions, in cases where there are a number of

alternatives for handling such transactions in terms of accounting reporting. Also, by taking into consideration the auditor's professional opinion, the committee has to examine whether the company had exercised a suitable accounting policy and used suitable estimates and estimations.

2.6.3 The auditing committee is responsible for reviewing the completeness of disclosure contained in company's financial reports and for deciding whether, under the existing circumstances, sufficient disclosure has been made. The committee has to report on every case it sees as problematic, in terms of financial reporting, to the Board of Directors.

2.6.4 The committee has to review all accompanying information included in financial reports, including information pertaining financial and operational situation, as well as information related to corporate governance in connection with auditing and risk management.
Similarly, when the Board's authorization is required to provide financial information, the committee must review the information prior to its release, where possible.

2.7 Emphasis the committee must place on internal auditing and risk management.

2.7.1 The auditing committee has to assist the Board of Directors to review and examine internal auditing reports pertaining financial reporting, as well as the whole mechanism of internal auditing and risk management where they are not under the control of the Board.

For the purpose of this section internal auditing will relate to financial reporting and existing operational procedures within a company; the aforesaid auditing is meant to ensure that information disclosed in company's financial reports is published in accordance with the law as well as registered, documented, processed and reported on the date and in a way stipulated by the law.

More over the auditing and operational procedures, related to disclosure, include control and procedures created to ensure that information which has to be disclosed in company reports is collected and reported to the management, including company's senior executive officers and those in charge of financial issues, in a manner which will allow them to make timely decisions regarding the required disclosures.

2.7.2 The company management is responsible for identification, evaluation, management and supervision of risks; it is also responsible for development, operation and supervision over the mechanism of internal auditing and reporting of the aforesaid activities to the Board of Directors. Except for cases where all of the aforesaid is done by the Board of Directors; in this case the auditing committee has to receive reports from the management regarding the effectiveness of the created mechanism and the results of reviews carried out by the internal and external auditors.

2.8 Protection of "whistle blowers"

The auditing committee has to examine and adopt regularization according to which company employees will be able to, safely, raise reservations and complaints pertaining possible failures in financial reports or other issues. The auditing committee has to ensure that there is regulation in place which allows to check and investigate these matters as well as to treat them. The existence of these arrangements will be periodically brought to the attention of the employees.

2.9 Emphasis the committee must place on the process of internal auditing

2.9.1 The auditing committee has to review and authorize every reference related to risk management and internal supervision, found in the periodic reports, unless the issue is under the responsibility of the Board of Directors.

2.9.2 The auditing committee has to examine the effectiveness of the internal auditor. The committee has to ensure that the internal auditor has at his disposal all necessary tools, sources and access to information - relevant to his work and required for the proper execution of his professional duties.

The auditing committee has to examine the existence of checks designed to identify and authorize transactions of principal shareholders, according to the law and company regulations. The operational responsibility for this task is part of the internal auditor's duties.

3. Authorization of transactions with principal shareholders prior to the establishment of the Companies and Securities Court

a. Authorization of irregular transactions (as defined under the Companies Law) in which principal shareholders have

personal interests, particularly compensation of principal shareholders and their relations in any way (including by means of share allocations, etc.), will require authorization of a general meeting of company shareholders. The majority vote count in the general meeting will include **majority** of all votes of participating shareholders which do not have personal interest in the authorization of the transaction, while abstainers are not taken into account (henceforth – "special majority").

b. It is proposed to examine the possibility for the Minister of Justice to stipulate provisions , under section 275(b) of the Companies Law, for a principal shareholder which had committed oneself for a predetermined period of time to getting a special majority authorization for every transaction that requires such authorization according to section 275 of the Companies Law – for the majority vote rate stated under section 275(a)(3)(b) to stand at 2% of all voting rights in the company, for the aforesaid period.

4. Directors' Declaration

The CEO and a senior office holder, in the area of financing, will sign a declaration enclosed as Appendix C, personally and individually, and the company will add it as an integral part to its periodic and quarterly financial reports.

Appendix C: Directors' Declaration

Declaration*

I (the signatory) hereby state:

1. I have examined the report of the Board of Directors, the section pertaining description of the corporation's business and annual/interim financial reports of (name of company)…….(henceforth "the company") for the year/quarter 200…… (henceforth combined "reports").

2. In my opinion, the reports do not contain any misleading presentation of material facts and do not lack any presentation of material facts, required in order for presentations included in them (in light of the circumstances under which they have been included) – not to be misleading.

3. In my opinion, financial reports and other financial information included in the reports, faithfully represent, on all material counts, the financial situation, results of actions, fluctuations in capital equity and cash flow of the company for the period relevant to the aforesaid reports.

4. I, in common with others in the company who are required to sign this declaration, hereby state that we have disclosed to the company's auditor, to the Board of Directors and to the company's auditing committee** of the Board, on the basis of our most current assessment pertaining internal auditing of financial reports:

a. all material deficiencies and weaknesses pertaining the functioning of internal auditing of financial reports, which might have a reasonably adverse affect on the company's ability to register, process, sum up or report financial information; hence
b. we have evaluated the effectiveness of the auditing and procedures pertaining the disclosure required in the aforesaid reports, and found it to be appropriate.

5. I, in common with others in the company who are required to sign this declaration, hereby state that:

* The company should include in its annual/interim reports individual declarations of the CEO and Deputy CEO for Financing, the company's accountant or of a person acting in this capacity. The required declaration, to be included in the company's annual report, must be in a precise format shown below. Any amendment of the declaration requires prior authorization by the ISA.

** Where a balance committee exists the wording should be: "we have disclosed the company's auditor, to the Board of Directors and to the auditing and balance committees of the company…"

a. We have stipulated regulations pertaining disclosure required in the reports, or validated their existence and execution, which are meant to ensure that material information regarding the company, including its consolidated corporations, is brought to our attention by others in the company and the aforesaid corporations*, particularly during the preparation of the aforesaid reports;
b. We have evaluated the effectiveness of the audit and the regulations pertaining required disclosures in the reports, and had found them adequate.

Nothing in the aforesaid comes to decrease my responsibility, under the law, or acquit from responsibility any other person.

* A company that does not have consolidated corporations, in section 4 in place of: " including its consolidated corporations, is brought to our attention by others in the company and the aforesaid corporations.." shall come "is brought to our attention by others in the company".

Appendix D: Summary of feedbacks received from the public

COMMITTEE FOR THE EXAMINATION OF CORPORATE GOVERNANCE

Summary of the main points

Feedback A

- ✓ States that the composition of the Committee is not balanced, and that "the real problems encountered in the field" did not get an appropriate attention during this Committee's discussions. We request to add these representatives to the panel.
- ✓ States that there is a backlash between the Committee recommendations and the requirements of the law, and that this Committee "can not replace the Ministry of Justice in preparation of the new Companies Law".
- ✓ Request for public discussion of Committee's recommendations
- ✓ The Committee adopts regulations formulated in a foreign judicial environment, which are not necessarily similar to Israel, and selectively adopts foreign regulations.

Feedback B

- ✓ Generally states that the Companies Law is sufficient for safeguarding the investors' interests, in regard to both two external directors and controlling shareholders' transactions.
- ✓ The proposal to obligate all Israeli companies to sustain majority of independent directors on their Boards, is too stringent and has a number of drawbacks. It expropriates control from the hands of controlling shareholders that have economic property rights which should not be expropriated. The recommendations also hurt the rights of minority shareholders, which invested their money on assumption of trust in controlling shareholder and his ability to lead a company to success.
- ✓ In recommendations presented by the Committee the definition of "nonaffiliated" is wider then American – where there is talk of affiliation with a company and not with a controlling shareholder.
- ✓ There is no place to append additional responsibility, such as the duty to ensure that directors are qualified and eligible for their positions, to the responsibilities of the Chairman of the Board.
- ✓ There is no balance between the right of a controlling shareholder to manage a company and a preservation of a professional and balanced board of directors that will act in the interests of the company.
- ✓ Tenure limitation of a nonaffiliated director and limitations on a number of companies where he can serve as a director – are too stringent and have to be remitted.
- ✓ Rotation of members within an auditing committee will hurt the quality of its work since a member's learning period is rather long.
- ✓ There is no sagacity in the recommendation to run a periodic learning program - on principals of the accounting reporting, companies law, etc. - for members of

the auditing committee; it must be left to them to decide on the nature and character of the program.

- ✓ The requirement to review accompanying information included in financial reports, by the members of the auditing committee, is not practical.
- ✓ The requirement to review the information, including financial information, prior to the publication of the reports is not realistic.

Feedback C

- ✓ The stipulation that unaffiliated director will be disqualified as such, in case his tenure lasts for more then 6 years in not appropriate. I do recognize the need to invigorate the management and the Board of Directors, but there is nothing like experience to prevent financial failure of a company. I am of opinion that the Board of Directors has a right to decide whether to choose experience over rotation and when the time is right to invigorate its ranks. See TEVA as an example.
- ✓ I propose to distinguish between companies where directors or their representatives are controlling shareholders and companies managed along the lines of TEVA. Meaning – to stipulate the percentage limit of control that when crossed will have an effect on the composition of the Board, and various other limitations on tenure of unaffiliated directors.

Feedback D

- ✓ We are of opinion that the recommendations regarding the auditing committee are too wide-ranging, in terms of demands placed on its members. It will be difficult to find directors prepared to serve on the auditing committee under these regulations. The main problem is in the depth of their involvement in the preparation of financial reports and the examination of internal auditing, risk management and supervision over the effectiveness of an internal auditor.
- ✓ The requirement for ongoing communications between the members of the auditing committee and ongoing communications with a financial manager of a company, who is subordinate to the company's CEO, might be problematic and go beyond the supervisory authority of the Board.
- ✓ Qualification requirements and the understanding of accounting and supervisory issues, characteristic to the field of the company's business activity, limits too much the field of potential candidates that might comply with the aforesaid requirements. The requirement for ongoing learning should not become a qualification requirement but should be presented as an option to the Board of Directors.
- ✓ We propose to reconsider the option given to the members of the auditing committee to report their disagreements with the Board of Directors to shareholders by means of a periodic report. This option turns the members of the auditing committee into a Super-Board.
- ✓ Obligations cast upon the members of the auditing committee, in the chapter pertaining financial reporting, are too far reaching and contradict the requirement

not to become involved in the preparation of financial reports, since at the same time there is also a requirement to examine the estimations, discretion and the choice of an appropriate accounting policy.

- ✓ Also, the implications of a requirement to review the work and effectiveness of the internal auditor are not clear.
- ✓ The requirement for majority of directors to be nonaffiliated is not realistic.
- ✓ The section that requires institutional bodies to describe the process of decision making pertaining voting procedures in affiliated companies is problematic. If the intent is to publish protocols of discussions, then institutional investors will hold vacant discussions for protocol purposes, which will hurt the quality of their decisions on the subject. We also propose that in case a mechanism for publishing position papers is founded, extension of immunity against claims to investors publishing such papers - should be considered.

Feedback E

The article written by Professor Eden in August 2004 has been received. According to it two dimensions have to be defined for grasping corporate governance: the dimension of compliance and reporting as well as responsibility for stipulating appropriate business strategy, which will lead to high performance and creation of benefits for shareholders. Proper supervision is an essential condition in itself, but it is not sufficient for achieving business success. What is required is a balance between responsibilities for the existence of an appropriate supervision and the responsibility for high business performance.

Feedback F

- ✓ Over regulation of public companies already has an adverse effect on the balance between the needs of investors and the analysts' requirements on the one hand, and the burden of reporting and responsibility applicable to the companies and their corporate officers on the other.
- ✓ The Committee's recommendations pertaining directors being nonaffiliated with the company or its controlling shareholders are a serious infringement on the property rights of company shareholders. This requirement is more stringent then the one practiced in the US. We hereby propose to stipulate that the number of nonaffiliated directors shall be related to the percentage of public holdings in the company, and in any event not fewer then two.
- ✓ The reference to section 240 of the Companies Law for the definition of "nonaffiliated" is far too stringent, and provides for tenure of Israeli residents only. The adoption of this recommendation might force dually registered Israeli companies to become entirely American ones.
- ✓ The Committee's recommendations will burden the Chairman of the Board with too great a responsibility (to validate eligibility and to brief the Board of Directors). Since the post of director is a position of trust, director's written declaration pertaining his eligibility and qualifications – is sufficient, there is no need to burden the Chairman with additional obligations.

- ✓ There must be a separation and distinction between the requirement applicable to large companies and the requirement applicable to small and medium ones.
- ✓ We welcome the recommendation to establish a specialized court.
- ✓ Definition of issues that will come under the authority of the Board of Directors is a manifest involvement in the working proceedings of the Board.
- ✓ The issue of risk management in the company is very complex and it is neither feasible nor logical to require the members of the auditing committee to be familiar with all its aspects.
- ✓ We are of opinion that amendment 3 to the Companies law provides a sufficient answer to the separation of duties between CEO and the Chairman of the Board.
- ✓ From the ethical standpoint it is not appropriate for one group of directors to critic the work of the other group of directors.

Feedback G

- ✓ In the overall review of the legislation and rulings pertaining directors' responsibility it is stated that without stipulating basic requirements regarding directors' personal qualifications, particularly regarding their education, relevant business proficiency and experience – there is no particular meaning to the obligation for caution since, judging subjectively, it works for the benefit of a director which lacks the required education. Hence a personal interest of a shareholder is hurt by the fact that appropriate candidates abstain from directorship due to a large exposure to claims, while those close who lack the appropriate education and experience - but are close to the power center – those who get the office as a "gift" will gladly accept it, with disregard to the results of erroneous decision making and damage to shareholders.

Feedback H

- ✓ I propose to provide for a position of an internal legal adviser in a public company, and to obligate every public company to appoint an internal legal adviser who will also be a member of the company's management. In my opinion the position of the internal legal adviser in a public company, in contrast to a position of an external adviser, is essential in every aspect related to the auditing of a corporation regarding reporting requirements according to the Securities Law and Companies Law, as well by virtue of him being exposed to full information as a member of management and due to his ability to act and react in real time. An internal legal adviser is also an appropriate address for "whistle blowers", who perceive him as more independent and objective.

Feedback I

- ✓ Prose to explore the possibility to legislate the issue of "societal report" that will reflex various aspects of human resources of the company and will detail the terms of temporary (non-unionized) employees.