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# Custody Services in the Israeli Capital Market

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## **Consultation**

Recommendations of the  
Inter-Departmental  
Committee

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August 2010

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**This is a consultation paper in which the regulators of the Israeli financial market request feedback relating to regulatory recommendations concerning custody services in Israel.**  
**COMMENTS SHOULD BE RECEIVED BY OCTOBER 3<sup>RD</sup>, 2010**  
**ISA contact details and the address for sending comments on the recommendations may be found on page 12 of this consultation paper.**

## **The Committee and its Mandate**

An inter-departmental committee comprising representatives from a number of Government departments and agencies and chaired by the Israel Securities Authority has recently completed its examination of custody services in Israel. The Inter-Departmental committee on Custody Service in the Israeli Capital Market ("the committee") published the final report of its findings in Hebrew on 3<sup>rd</sup> August, 2010.<sup>1</sup>

The most important element of the report is Annex 1 in which the committee sets out its recommendations for future regulation of custody services in Israel.

An English version of Annex 1 is attached to this consultation paper and the committee first and foremost seeks feedback on these recommendations, both on their content and also on any issues which in the opinion of readers have been omitted but should be included.

The financial crisis broke soon after the committee began its work and in many developed markets custody has been one of the areas of regulation that received special attention from regulators determined to introduce reforms and improvements in the wake of the crisis. The spectre of unstable banks caused regulators to look again at the most basic requirements for segregation of accounts. The collapse of a number of Ponzi schemes as a result of falling markets resulted in enhanced custody regulation focused on greater transparency and independent verification of client assets. The committee benefited from studying these responses to the crisis and their influence may be seen in some of the committee's recommendations.

The committee was chaired by Ms Yael Almog of the ISA, and its membership was comprised of a number of staff from each of the three Israeli financial market regulators, the Bank of Israel (Supervisor of Banks), the Capital Markets, Savings and Insurance Division of the Ministry of Finance and the Israel Securities Authority (ISA). In addition, experts from the Ministry of Justice and the Tax Authority sat on the committee and the Tel Aviv Stock Exchange (TASE) provided detailed comments to the draft final report.

This wide membership illustrates the fundamental importance of custody to the capital market. All three of the financial regulators are responsible for the supervision of entities

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<sup>1</sup> The full report in Hebrew may be found at [http://www.isa.gov.il/Download/IsaFile\\_5026.pdf](http://www.isa.gov.il/Download/IsaFile_5026.pdf)

that either provide custody services or must arrange custody of assets that they hold for investors.

The committee was established with a basic three point mandate:

1. To carry out a survey of the custody services available to Israeli investors and foreign persons investing on the Tel Aviv Stock Exchange;
2. To map any weaknesses in the current market and analyse whether regulatory intervention was required to improve the standard of custody services and investor protection;
3. To produce recommendations for improving custody regulation, if and where improvement was required.

In the course of its work, the committee met with a range of major market participants involved in the custody business on both the buy and sell sides. Generally the position taken by these entities, including the major Israeli custodians, was that some changes to regulation of custody services would benefit investors and the market.

The committee also examined custody regulation abroad. Of particular interest were the custody regime set out under the EU's Markets in Financial Instruments Directive (MiFID) and the US custody rules set out in Rule 17f promulgated under the Investment Company Act of 1940. The committee also commissioned a report by the international custodian rating agency Thomas Murray Ltd. The report reviewed major issues in the custody world today and also provided a survey of custody regulation in additional foreign developed markets.

## **Recommendations**

As the committee's work progressed it became relatively clear that more comprehensive regulation of custody services was needed in Israel. The members agreed that the approach that would best serve regulatory improvement was not for the committee itself to draft new regulation but rather to provide a framework of principles and broad rules that would shape the detailed regulation that the individual regulatory authorities would produce.

The committee felt that regulation must be matched to the specific requirements of each market sector and each type of market participant. The custody rules that are applied, for example, to mutual funds will differ in some respects from those applied to brokers. Only the three regulators are able to provide this fine tuning of regulation, each to its own area of responsibility.

Asset managers are a case in point. The wording of the committee's recommendations and in particular the definition of the term "intermediary" (see the definitions section of Annex 1) allows the individual regulators to decide whether and to what extent the recommendations should be applied directly to fund managers and/or fund trustees and also leaves open the question of what conditions shall apply when an asset manager wishes

to outsource the responsibilities of an intermediary to another financial institution such as a bank.

Therefore the committee took the approach that, where needed, it would present moderately detailed recommendations that made clear the purpose and methods of the recommended regulation but left flexibility for each regulator to implement in line with its own market requirements.

## **Core services**

The committee examined the need for changes to regulation in relation to the core custody services only.

The definition of what custody services generally include has expanded somewhat in recent years. This trend has been the result of the increasing suite of additional services offered in particular by global custodians. The purpose of the second layer of services is primarily to enhance the management of, and income earned from, securities deposited with them by their customers (e.g. more efficient management of assets and cash, risk profiling of portfolios, enhanced reporting capabilities).

These additional services do not form part of the traditional core role of custodians and do not fall within the committee's remit which focused on those issues relating to ensuring clear ownership rights and safe enjoyment of the fruits of that ownership.

The custody services considered by the committee and the kind of issues raised by each, were:

<b>Safekeeping</b>	Segregation of accounts, record keeping, reconciliations.
<b>Disclosures to clients</b>	Risk warnings, account statements, confirmations.
<b>Asset Servicing</b>	Income payments, voluntary and involuntary corporate actions, splits, purchase offers, rights issues, notices and voting.
<b>Client cash</b>	The holding of client cash.
<b>Use of client assets</b>	Securities lending, authorized use of assets.

Securities lending is a special case. Whilst perhaps not a core custody service, it is an activity which is carried out by custodians for their clients and in practice is inseparable from the custody field. More importantly, securities lending is an activity which raises clear and important regulatory concerns regarding protection of investors' ownership rights and interests. For these reasons the issue was included by the committee in its deliberations and was at the forefront of committee members' minds when formulating the recommendations dealing with unauthorized use of client assets.

## **The Tel Aviv Stock Exchange – Operational Infrastructure**

The operational infrastructure of TASE is such that only a member of the Tel Aviv Stock Exchange Clearing House ("the Clearing House") may provide custody services. The securities account at the Clearing House in which the Clearing House member holds customer securities is the account to and from which trades on TASE are settled.

Securities held by Clearing House members for their own clients and for TASE members that are not Clearing House members must be segregated at the Clearing House from the Clearing House member's own securities. The internal records of the Clearing House member (and not the records of the Clearing House itself) must record which of these securities belong to which clients.

All TASE members are subject to the Exchange Rules and Regulations. These are adopted by the TASE Board and are subject to the approval of the ISA which also oversees all TASE activity. This ISA supervision also encompasses internal TASE management and organizational matters as well as the monitoring of trading activity.

Below is a brief outline of the central elements of the operational organization of TASE.

Trades on TASE may only be executed by TASE members. There are currently 28 TASE members, of which 22 are also Clearing House members. A TASE member that is not a Clearing House member must enter into an arrangement with a Clearing House member for settlement of its trades and holding of securities at the Clearing House.

The Clearing House clears and settles all securities whilst cash clearing and settlement is carried out at the Bank of Israel via the accounts maintained for the 12 banks that are Clearing House members. Each non-bank Clearing House member must enter into an arrangement with one of the bank members for carrying out clearing and settlement of cash payments through that bank's account at the Bank of Israel.

All trades on the exchange are recorded by book entries in the accounts of the Clearing House members maintained at the Clearing House.

At the close of each business day the Clearing House reports to Clearing House members which trades were executed on their accounts that day and the quantity of each listed security they hold in their account.

The Clearing House also manages all corporate events. It distributes the cash stemming from income events, settles all rights issues to members' accounts and delivers all notices from issuers to the Clearing House members.

Most investment in TASE from outside Israel is carried out via global custodians who generally enter into sub-custody agreements with the local Clearing House members that are banks. Citibank NA is the only foreign institution that has become a Clearing House member. Various foreign institutions or their local subsidiaries have joined TASE (Deutsche Securities Israel Ltd., HSBC Bank plc, Merrill Lynch International (Remote Member) and UBS Securities Israel Ltd.)

## **Current Regulation in Israel**

Custody services in Israel are generally of a good standard. There have been no major failures in the Israeli market leading to losses to investors. A number of reasons may be cited for this positive state of affairs.

Firstly, the Rules and Regulations of the Exchange are of a high standard, providing a comprehensive framework of rules to ensure ownership rights are kept safe. The Rules and Regulations are prepared by the management of TASE and must be approved by the ISA.<sup>2</sup>

Secondly, the simple, centralised operational structure of TASE and the Clearing House provides a stable, relatively low risk environment in which to store all TASE listed securities.

Thirdly, the entry of global custodians into the local market in the mid-1990s has had a positive effect on the quality of custody services, at least in relation to those local banks acting as sub-custodians. The need to comply with the custody standards required by foreign regulation has had the effect of turning these standards into a local benchmark of good practice as well as influencing the TASE Rules and Regulations.

The main weakness in Israeli regulation at present is its status rather than its content. At the current time (with the exception of a relatively few requirements relating to safekeeping of securities that may be found in various laws and regulations) all direct custody rules are to be found in the TASE Rules and Regulations. Unlike all developed markets, there is no centralized body of custody regulation in primary or secondary legislation. This raises a number of problems.

The custody rules that do exist are created by TASE which is owned and controlled by its members, namely the financial institutions that themselves provide custody services in Israel.

Despite the fact that the TASE is run in a professional manner for the benefit of investors as well as members and the TASE Board cooperates fully at all times with the ISA, this arrangement is unsatisfactory.

Perhaps the aspect of this arrangement that is most exposed to potential conflicts of interest is in the sphere of enforcement. Enforcement of breaches of the Rules and Regulations are currently dealt with by TASE. Where breaches of Rules are discovered by TASE they are reported to the ISA along with the steps taken by TASE. Once informed of a breach the ISA may decide to take direct actions itself. However, the ISA is one step removed from the oversight process. The fact that in Israel the formulation and front line enforcement of custody regulation is in the hands of the stock exchange as opposed to the capital markets regulator, separates Israel from other developed markets.

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<sup>2</sup> The TASE Rules and Regulations may be found in English at the following address:  
<http://www.tase.co.il/TASEEng/PublicationsandEducation/TASERulesandRegulations/>

The TASE Rules and Regulation on custody rules do, in large part, match the basic requirements in developed markets though in some areas do not go beyond broad principles.

## **Custody of Israeli investments abroad**

The TASE Rules and Regulations of course relate almost exclusively to trading and custody of TASE traded securities. In relation to securities held outside Israel by TASE members for their clients, the current level of protection is less than optimal. The Exchange Rules and Regulations do contain the basic requirement that foreign securities held for clients be held abroad separately from nostro holdings, however beyond this there is little development of custody rules for foreign securities. Other general TASE requirements such as reporting standards will also apply to holdings abroad. However, the TASE Rules and Regulations were naturally created for trading of TASE securities and are not the natural place to set out rules applying to foreign securities.

The other obvious limitation in relation to foreign holdings is that the Exchange Rules and Regulations only apply to TASE members. Many other bodies, notably investment funds of various kinds must arrange custody of assets abroad. Whilst many such funds use a TASE member to arrange such foreign custody, there is no requirement to do so.

Many Israeli institutional investors use Israeli financial institutions (particularly local banks) to arrange their custody abroad for them. The Israeli banks tend in turn to use global custodians for this purpose. However, various institutions told the committee that they trade in foreign markets directly and also hold their own and their client assets with foreign brokers without making separate arrangements for custody of those assets. One of the key factors underlying the decision not to use a global custodian was cost.

The committee heard of a number of cases of problems relating to the use of brokers to hold assets (both client and nostro assets). These cases involved failure of the broker to transfer dividends to the Israeli intermediary and long delays in transferring securities to other institutions.

The value of assets held in foreign markets by Israeli investors has risen sharply in recent years. It is also important to note that whereas once, investments abroad were focused in New York, London and a handful of other developed markets, today Israeli investments are spread throughout many emerging markets. It is often far from clear what level of protection of ownership rights is provided by the local regulation and operational structure of these markets. In light of these considerations, the committee found that it was important to develop a set of recommendations dealing with the use by local intermediaries of third party custodians in foreign markets.

One of the more delicate issues tackled by the committee was the question of the liability of an intermediary for losses affecting client assets that are caused by a third party custodian. The question faced by the committee was whether the Israeli bank should be fully and

automatically liable to its client for losses caused by the global custodian selected by the intermediary. This question is of particular relevance in relation to investments in foreign securities.

Such a rule would in particular benefit Israeli retail investors who, practically speaking, are unlikely to be able to mount a serious claim against a global custodian. The committee heard that in such cases the Israeli bank would normally seek to exert pressure on the global custodian and persuade it to make good the loss to the client and in many cases this approach is successful. However, in terms of regulatory protection this is obviously not an acceptable solution.

The approach taken by the committee in its recommendations is to impose strict, automatic liability upon the Israeli intermediary but then to provide a wide safe harbor against such liability.

The recommendation broadly states that the intermediary may avoid liability for loss caused by the third party custodian provided that the loss was unforeseeable and that the intermediary had fulfilled all requirements relating to the appointment of the third party custodian, the ongoing monitoring of the services it provided and the provision of risk warnings and notices to the client.

## **Benefit to the Israeli Market**

Strong investor protection is a pre-requisite for an attractive and liquid capital market. This is particularly relevant in relation to foreign investors considering investment in Israeli securities. The attraction to the Israeli market of foreign investment requires that both foreign investors themselves and the financial institutions through which they invest are satisfied that their rights are actively protected by strong local regulation.

In this respect, the committee heard that foreign entities put great emphasis on their examination of the Israeli custody environment, including regulation, and this field has the potential to either encourage or deter foreign investment in Israel.

Global custodians are themselves subject to custody regulation in their own jurisdictions and are required to ensure that when they arrange for custody of their clients' assets in foreign markets, such as Israel, the custody of those assets will meet the standards that their home regulation requires.

It has been a complaint of global custodians that Israel does not have a clear framework of custody regulation, based in primary legislation and directly overseen by the financial regulators.

Whilst the quality of the TASE by-laws that deal with custody services together with the efforts of some Israeli custodians to provide services that meet US and European custody standards, has been successful in helping to bring foreign investors to TASE and keep them there, the absence of a comprehensive regulatory framework, administered by government

agencies, appears to be filtering out at least some investment that would otherwise reach Israel. In particular, the committee heard that some foreign investment funds (which often tend to be subject to stricter regulation) are deterred from investing on TASE for this reason.

## Conclusions

The lack of a systematic and comprehensive body of custody regulation in Israel, linked to an independent enforcement apparatus with statute based powers to investigate and impose sanctions, means that in this area of regulation Israel lags behind other developed markets.

This situation is detrimental to investor rights, weakens the Israeli capital market and even deters some foreign investment.

In light of the above considerations, it was clear to the committee that it needed to provide not just a list of areas where regulation could be improved but detailed recommendations for a comprehensive framework of regulation dealing with all aspects of custody services.

In terms of the content of such a framework, the committee benefitted from the input of various major market participants including TASE, an examination of the regulation in force in developed markets and the experience of its own members and their combined long term familiarity with the Israeli capital market.

The committee's recommendations are attached to this consultation paper. They attempt to provide the three financial market regulators with a firm basis upon which each will construct custody regulation for the market sectors and participants for which it is responsible.

The recommendations are contained in forty one rules which are divided into various headings as follows:

1. Safekeeping of client assets
2. Segregation of assets, record keeping, maintenance of accounts and reconciliations
3. Client cash
4. Client statements
5. Third party custodians
6. Transactions in client assets
7. Risk warnings, notices and client approval
8. External audit
9. Liability
10. Basic requirements for provision of services
11. Tax

## Market Feedback

The committee has produced a framework of regulation that it believes will be of benefit to all market participants from individual retail investors to the largest institutions as well as to

the stock exchange, its members and the issuers whose securities are traded there. The committee has now embarked on a process of public consultation during which it looks forward to receiving market feedback on its recommendations.

The reaction of, in particular, international custodians, intermediaries and institutional investors is of crucial importance both to the committee and to the Israeli capital market regulators that will each take the recommendations in Annex 1 and use them as the basis of their own regulation.

**The committee is interested to receive all comments. Some key points that the committee would be particularly interested to receive comments on include:**

- Appointment and ongoing monitoring of third party custodians (Rules 15 - 17)
- Level of liability of the third party custodian to the intermediary (Rule 18(ii))
- Access by the intermediary to the records of third party custodians (Rules 24 - 25)
- The creation of interests in favour of third parties over client assets (Rules 23 and 26)
- Holding of assets in jurisdictions where there is little or no custody regulation (Rule 27)
- Enhanced risk warnings for clients that are not qualified investors (Rule 34)
- Liability of custodians and intermediaries (Rule 37)

**Please send feedback by October 3<sup>rd</sup> 2010.**

Following this consultation, the ISA, the Capital Markets Division and the Bank of Israel will each be in a strong position to draft new custody regulation that will reinforce the position of the Israeli market as one of the world's newest developed markets and ensure that investors' most basic rights are fully and effectively regulated and supervised.

**Written comments**

Please send written comments by email or post, to be received by **October 3<sup>rd</sup> 2010**, to:

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**All responses received may be made available to the public by the committee unless the respondent specifically informs the committee that its comments are not for publication.**

## Annex 1

### Regulatory Recommendations of the Interdepartmental committee on Custody Services in the Israeli Capital Market

This Annex to the main report sets out the committee's recommendations for regulation of custody services in the Israeli Capital Market.

#### Definitions

<b>"client assets"</b>	Financial instruments owned, managed or administered by a client of a custodian or an intermediary. <sup>3</sup>
<b>"client cash"</b>	Cash owned, managed or administered by a client of a custodian or an intermediary;
<b>"custodian"</b>	An entity which provides safekeeping of client assets within its own systems and records by virtue of its membership of a central securities depository; <sup>4</sup>
<b>"intermediary"</b>	An entity that selects a third party custodian and places client assets with such third party custodian; <sup>5</sup>

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<sup>3</sup> The client may be the direct owner of the client assets or alternatively it may be a fund, a portfolio manager, an intermediary, a global custodian or another type of service provider. Therefore the formula "owned, managed or administered" is used both here and in the definition of client cash.

<sup>4</sup> The key point here is that a custodian is able to directly provide safekeeping services without the need to place the client assets with a third party custodian. In the Israeli market members of the TASE Clearing House are the only entities that comply with this definition. For the purposes of this document, the TASE Clearing House is not deemed to be a custodian, an intermediary or a third party custodian and these recommendations are not intended to apply to it.

<sup>5</sup> The term intermediary may, depending on the circumstances, refer to a broker which having received a purchase order selects the custodian that will hold the purchased client assets or it may be an entity that whilst being a custodian does not itself intend to hold the specific purchased client assets but rather selects a third party custodian to do so. A common example of the latter is when an Israeli custodian or broker receives an order to purchase non-Israeli securities for its client and arranges custody in the foreign jurisdiction.

The term intermediary therefore covers any entity which is responsible for arranging custody of client assets with a third party custodian. As the definition indicates, in order for the definition to apply, two acts are required – (i) selection of the third party custodian and (ii) placement of the client assets with it. In cases where an entity is instructed by the client to place client assets with a specific third party custodian (i.e. the client makes its own selection) then not all these Rules on custody would apply to the intermediary in relation to any client assets to which such an instruction applies.

<b>"third party custodian"</b>	An entity with whom an intermediary places client assets for safekeeping, whether such entity is a custodian or an intermediary; <sup>6</sup>
<b>"financial instrument"</b>	Securities as defined in section 1 of the Securities Law 1968 and also units of a closed ended fund as defined in the Joint Investment Trust Law 1994 and also any other contract or arrangement, whether or not admitted to trading and whether or not settled physically or in cash, which involves the payment of money by one party to another and which is designed to create a benefit or financial return for either party or to protect either party against a financial risk, including by way of reference to an underlying asset, interest rate, exchange rate, index or commodity.
<b>"a client that is not a qualified investor"</b>	A client that is not a "qualified investor" as that term is defined in the Regulation of Investment Advice and Investment Portfolio Management Law, 1995.

### **Safeguarding of client assets**

1. When providing, or arranging for, safekeeping of client assets and/or client cash a custodian or intermediary shall act to ensure that the client assets and client cash are adequately safeguarded. In addition, the custodian or intermediary shall safeguard the rights stemming from ownership of the client assets and/or client cash including the right to receive dividends, interest payments, notices and various rights due to the client as a result of its ownership of the client assets.
2. A custodian or intermediary when providing or arranging for custody services will ensure that it has in place an organizational structure and operating systems that prevent as far as possible any loss or damage caused to client assets, the ownership rights stemming from them and client cash.
3. A custodian or intermediary may only provide safekeeping and related services to clients with whom it has executed a written contract setting out the the legal relationship between the parties including the respective rights, obligations and liabilities of each party in accordance with the rules set out in this Annex.

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<sup>6</sup> The third party custodian may itself be either (i) a custodian that will itself provide the custody services or (ii) an intermediary that will place the client assets with a different entity. The most common example of when the third party custodian is an intermediary will be when it is a global custodian that holds client assets with a sub-custodian in a foreign jurisdiction.

**Segregation of assets, record keeping, maintenance of accounts and reconciliations**

4. The custodian or intermediary shall not, in its own books, co-mingle
  - (i) the assets of one client with those of another; or
  - (ii) client assets with those of the custodian or intermediary.
  
5. A custodian or intermediary must maintain records and accounts that effectively segregate client assets and enable it to identify without delay the client for whom each client asset is held.
  
6. A custodian must conduct regular reconciliations between its own records and accounts and those maintained by a clearing house or other entity with which client assets are held. An intermediary, including a custodian when acting as an intermediary, must conduct regular reconciliations between its own records and accounts and those maintained by a third party custodian with which client assets are held.
  
7. A custodian or intermediary must maintain and implement internal procedures designed to ensure high standards of record keeping and administration in relation to client assets and client cash so as to reduce as far as possible the potential for any loss or damage to clients as a result of any failure or negligence.

**Client cash**

8. Promptly upon receipt of client cash, a custodian or an intermediary shall ensure it is deposited with either a bank (as defined in the Bank Licensing Law 1981) or, in the event that the client cash is held in connection with a transaction in securities outside Israel, a licensed bank in a jurisdiction outside Israel.
  
9. When a custodian or an intermediary deposits client cash with a bank in accordance with the foregoing it shall ensure that client funds are held in a separate account to cash belonging to the custodian or intermediary. A custodian or intermediary will take all steps necessary to ensure that both the bank with which client cash is deposited and any third party (including creditors of the custodian or the intermediary) shall not treat, or be able to treat, the client cash as belonging to the custodian or the intermediary. Wherever operationally possible, a custodian or an intermediary will ensure that accounts in which client cash is deposited are designated in the books of the third party bank as "*[custodian or intermediary]* for clients" or equivalent designation.

10. In order to fulfill its obligation to safeguard clients' rights in relation to client cash, a custodian or an intermediary will apply high standards and strict internal procedures in the selection, appointment and periodic review of any bank with whom it deposits and holds client cash. In choosing which bank in a foreign jurisdiction to use for this purpose the intermediary will take account of the financial strength of the foreign bank.
11. A custodian or an intermediary shall keep a written record of
- (i) the grounds upon which it selected each such bank; and
  - (ii) the results of the periodic review of each such bank.

### **Client statements**

12. A custodian and an intermediary shall provide a periodic statement to each client listing the assets and cash for which it provides or has arranged custody, giving details of all purchases and sales of client assets during the period since the last such statement.
13. In cases where a custodian or intermediary has entered into or arranged transactions utilising client assets it shall provide the client with paper copies of each of the following:
- (i) a confirmation in relation to each such transaction setting out its terms which shall be delivered to the client promptly upon the execution of the transaction;
  - (ii) periodic statements of all such transactions, including the details of the transaction and the fee or other payments received by the client in relation to each such transaction.
14. Where the information contained in the confirmations and statements described above are available to the client over the internet, the client may waive its right to receive paper copies.

### **Third party custodians**

15. An intermediary, including a custodian when acting as an intermediary, shall apply high standards and strict internal procedures in the selection, appointment and periodic review of any third party custodian with whom it deposits client assets. When implementing this requirement, the intermediary shall prepare procedures for assessing the following matters and shall document the implementation of those procedures in the decision making process leading to choice of a third party custodian:

- (i) the ability of the third party custodian to provide a level of service that permits the intermediary to comply with its regulatory obligations under these rules; and
  - (ii) the financial strength of the third party custodian, such as capital levels, credit ratings, insurance, guarantees and other such indicators.
16. An intermediary, including a custodian when acting as an intermediary, shall carry out periodic reviews of the third party custodian with whom the intermediary has deposited client assets, in the course of which the intermediary shall monitor the ongoing adherence by the third party custodian to the above mentioned standards required of it by the intermediary.
17. An Intermediary, including a custodian when acting as an intermediary, shall keep a written record of:
- (i) the examination of the third party custodian that it carried out prior to entering into an agreement; and
  - (ii) the results of the periodic review of each third party custodian.
18. An intermediary, including a custodian when acting as an intermediary, shall execute a written contract or agreement with each third party custodian. Such contract or agreement shall contain, inter alia:
- (i) provisions designed to ensure that the intermediary is able to comply with its obligations under these Rules.
  - (ii) provisions dealing with the liability of the third party custodian to the intermediary for losses caused in relation to client assets by the acts or omissions of the third party custodian.
19. An intermediary, including a custodian when acting as an intermediary, shall ensure that client assets held with a third party custodian are effectively segregated from assets belonging to the intermediary and the third party custodian.
20. An intermediary, including a custodian when acting as an intermediary, shall take all steps required to ensure that all client assets held with a third party custodian are deposited in an account in the name of the intermediary or held in a similar manner by the third party custodian such that the intermediary's rights in relation to the client assets are clearly documented.
21. An intermediary, including a custodian when acting as an intermediary, shall take all steps required to ensure that all dividends, interest payments, notices and rights due in

respect of client assets held by a third party custodian for the intermediary, are received by the intermediary's clients.

22. An intermediary, including a custodian when acting as an intermediary, shall take all steps required to ensure that the accounts maintained by a third party custodian in which client assets are held are given account names that record in a clear way that they are client accounts, for example "*[name of intermediary]* for clients" or equivalent designation.
23. An intermediary, including a custodian when acting as an intermediary, shall ensure that client assets held with a third party custodian are at all times freely transferable upon receipt by the third party custodian of intermediary instructions, subject only to receipt by the third party custodian of any fees due to it in relation to the said client assets.
24. An intermediary, including a custodian when acting as an intermediary, shall ensure that it is entitled to receive upon request, copies of the records maintained by the third party custodian relating to client assets.
25. An intermediary, including a custodian when acting as an intermediary, shall receive from the third party custodian periodic reports documenting all transactions in client assets and account statements documenting balances of assets and cash belonging to its clients.
26. Neither a custodian nor an intermediary shall grant or create over client assets any right of set off, lien or security interest, except a contractual right of lien granted by an intermediary, including a custodian when acting as an intermediary, in favor of a third party custodian in relation to safe keeping or administrative charges due to such third party custodian in connection with client assets placed with it by such intermediary.
27. Whenever possible, an intermediary, including a custodian acting as an intermediary, shall only deposit and hold client assets with third party custodians that are subject to regulation governing custody services. If the market in which certain client assets are traded is not subject to custody regulation the intermediary shall provide a special risk warning to the client as described below.
28. In the event that the intermediary, including a custodian when acting as an intermediary, becomes aware that the third party custodian is failing to comply with its obligations to the intermediary and as a result the intermediary is prevented from complying with these rules, it shall withdraw all client assets from the third party custodian as soon as reasonably practical.

### **Transactions in client assets**

29. Client assets shall not be utilized in transactions of any kind (including where the client receives a fee or other payment for such use of its assets) without the prior written agreement of the client.
30. The agreement referred to above shall set out at least the following matters:
- (i) the parameters and terms that will apply to all such transactions;
  - (ii) clear, full and accurate information on the obligations and responsibilities of the custodian or intermediary with respect to the use of client assets, including the terms for their restitution;
  - (iii) an explanation of the risks involved in the transactions and the clients declaration that it understands such risks; and
  - (iv) details of any fees or other payments due to clients in respect of the transactions.
31. In relation to the use of client assets in transactions, a custodian or intermediary shall:
- (i) ensure that its operational controls and internal procedures are sufficient to ensure that only those assets belonging to clients that have completed an agreement as described above are used in such transactions;
  - (ii) maintain accurate and clear records of any such transactions.
  - (iii) ensure that where client assets are held by the custodian or intermediary in an omnibus account maintained by a third party custodian, any additional measures required to comply with parts (i) and (ii) of this Rule are in place.

### **Risk warnings, notices and client consent**

32. Prior to placing the assets of a client that is not a qualified investor with any third party custodian, an intermediary, including a custodian when acting as an intermediary, will inform the client that is not a qualified investor that its assets will be held with a third party custodian and will explain the risks associated therewith including risks relating to:
- (i) acts and omissions of the third party custodian;
  - (ii) the insolvency of the third party custodian; and
  - (iii) the use of an omnibus account to hold client assets with the third party provider.
33. An intermediary, including a custodian when acting as an intermediary, shall provide a risk warning to its client on the first date that it becomes aware that it is not possible to

execute an instruction of the client other than by placing client's assets with a third party custodian,

- (i) in a jurisdictions in which custody services are not regulated, or
- (ii) that is operationally unable to segregate the client assets from those of the intermediary or the third party custodian.

The requirement to provide the said risk warning shall apply only in relation to the first instruction given by the client in relation to the said jurisdiction or third party custodian.

34. If the client referred to above is a client that is not a qualified investor, then the intermediary, including a custodian when acting as an intermediary, shall act as follow:

- (i) provide details of the risks involved in executing the instruction in the circumstances described above;
- (ii) In relation to the holding of assets in a foreign jurisdiction, the intermediary shall warn the client that the applicable law in the foreign jurisdiction may differ from local arrangements and may not provide the same level of protection of ownership rights;
- (iii) A client that is not a qualified investor shall confirm in writing that he/she/it has received and understood the risk warning and that notwithstanding this, wishes to proceed with the transaction(s).

35. An intermediary, including a custodian when acting as an intermediary, shall inform the client of any lien, right of set-off or other security interest that any third party custodian claims to hold over assets of that client.

#### **External audit**

36. An independent external accountant shall, at least once each year, examine the standard of compliance by the custodian or intermediary with the regulation applicable to the custody services that it provides and shall prepare a report of the examination and its findings. Such report shall include an analysis and assessment of the effectiveness of the controls and procedures put in place by the custodian or intermediary in order to comply with these rules.

#### **Liability**

37. A custodian shall be liable for the loss of client assets and for any damage or loss caused to a client as the result of failings in the safekeeping of those assets. An intermediary, including a custodian when acting as an intermediary, shall be liable for losses or damage caused to client assets that are deposited with a third party custodian, *unless*

- (i) the loss or damage was caused in circumstances that could not be foreseen in advance or prevented; and
- (ii) the intermediary can demonstrate that it complied with the regulatory obligations placed upon it in relation to the choice of, and agreement with, the third party custodian and the ongoing monitoring of the third party custodian; and
- (iii) the intermediary can demonstrate that it complied with the regulatory obligations to provide risk warnings and notices to the customer.

**Basic requirements for provision of services**

38. Permission to act as a custodian shall be granted by the relevant Israeli regulator subject to, at least, the following basic requirements:<sup>7</sup>

- (i) The applicant is a company (or another form of corporation deemed appropriate by the regulator) which is either incorporated in Israel or registered in Israel as a foreign corporation;
- (ii) The applicant complies with minimum capital requirements;
- (iii) The applicant has taken out professional indemnity insurance or received bank guarantees or placed on deposit cash or securities, in an amount to be prescribed;
- (iv) The internal organization and functioning of the applicant complies with suitable corporate governance requirements;
- (v) The applicant's sole activity is as a financial services provider;
- (vi) The applicant maintains systems and procedures, including in relation to technology and manpower, to permit it to effectively and safely supply its services;
- (vii) The owners and management of the applicant are considered suitable, trustworthy and sufficiently experienced and/or qualified;

39. Following the granting of permission, the above requirements must be complied with on an ongoing basis. Failure by a custodian to so comply will be grounds for withdrawal of its permission by the relevant Israeli regulator.

**Tax**

40. Israeli tax law shall continue to apply to custodians, intermediaries and third party custodians in relation to foreign residents that make use of a custodian, intermediary or third party custodian for the purpose of investing within Israel, both in relation to the

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<sup>7</sup> The Israeli regulators responsible for implementation of this Rule may develop additional requirements to augment these basic standards.

requirement to pay tax (or an exemption) and in relation to withholding of tax at source for income earned or produced in Israel. This shall apply whether the investment was executed through accounts in the name of the foreign resident client or whether executed through an omnibus account. The reporting, identification and responsibility towards the Israeli tax authorities in relation to investment of foreign resident that were executed through omnibus accounts shall be governed by the relevant instructions issued by the Israel Tax Authority.

41. Israeli tax law shall continue to apply to custodians, intermediaries and third party custodians in relation to Israeli residents that make use of a custodian, intermediary or third party custodian for the purpose of investing within Israel and/or outside Israel, both in relation to a tax liability (or exemption) and in relation to withholding of tax at source on income stemming from these investments.