

## **List of circumstances for evaluating a deficiency in the reliability of entities regulated by the ISA**

### **Background**

Israel Securities Authority (“ISA”) regulates the activities of various financial market actors (“the Regulated Entities”). The ISA oversees the fitness of the Regulated Entities’ operations in order to protect the interests of investors and their funds. Regulated Entities include mutual funds, portfolio managers, investment advisers, and others.

As part of its regulatory activities, the ISA examines the fitness and reliability of a large portion of the Regulated Entities and others that seek operating permits from the ISA (licenses, registration, permits; all hereinafter, “permits”) by examining whether the applicant or the active party itself fulfills the requirements, or by evaluating whether other parties related to it fulfill them – for example, control permit holders, the applicants’ officers, etc.

The legislator instructed the Authority to evaluate the reliability of a portion of Regulated Entities; the legislator has in effect established a high entry bar, and standards of activity and integrity that are designed to ensure the protection of the public’s money.

As will be shown below, the ISA is likely to be asked to evaluate reliability both at the stage of granting a permit and at the stage of considering its nullification by canceling or suspending an existing permit (hereafter jointly – “canceling the permit”).

The Law for Enhancing Improvement of Enforcement by Israel Security Authority (Legislative Amendments) – 2010 (hereafter – “Administrative Enforcement Law”) was published in early 2011. The main purpose of the law was to establish an administration enforcement process, to which additional amendments were added in order to improve the protection of investors, owners of units in mutual funds, and clients of those holding permits. In the framework of the Administrative Enforcement Law, the Authority was authorized to act in all matters pertaining to withholding of a permit due to discoveries of a deficiency in reliability, and order the cancellation of a permit already granted due to the discovery of such a deficiency, was clarified. Additional legislative amendments define provisions concerning the reliability of other regulated entities.

In granting a permit, the ISA has been legally authorized to consider the reliability of the applicant, without its discretion being delineated in the provisions of the law. Nevertheless, the law limits the ISA’s discretion, as described below.

The ISA has been authorized to cancel permits for a deficiency in reliability, including a deficiency in the reliability of related parties, as listed below. It is stated, however, that such a denial of a permit shall be based on a list of circumstances indicating an deficiency in reliability, and the Authority shall consider its ruling solely in the light of this list. For this purpose, the ISA has been required to determine and publish a list of the circumstances constituting prima facie

evidence of a deficiency in reliability.<sup>1</sup> The publication of this list will enhance clarity regarding the way the ISA exercises its discretion in such cases.

Reliability is examined with respect to all of the following:<sup>2</sup>

1. Fund managers, including an examination of the reliability of their officeholders, their controlling owner and the officeholders in any of them,<sup>3</sup> pursuant to Article 15(A1) of the Law of Joint Investments in Trust 5754-1994 (hereinafter, “the Joint Investments Law”);
2. Fund trustees, including the reliability of their controlling owners and officeholders in any of them, pursuant to Articles 9(A1) and 10A of the Joint Investment Law.
3. License holders,<sup>4</sup> including the reliability of the controlling owners of a corporation that holds a license and the officeholders<sup>5</sup> in a corporation holding a license or in a controlling shareholder in it – according to Article 10(1a) of the Practice of Investment Consultancy,

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<sup>1</sup> In some of the statutory provisions, this involves evidence that the authorized party is unfit to hold a license. This paper relates jointly to both of them.

<sup>2</sup> In addition to the following list, other factors for determining similar fitness arrangements proposed in the framework of legislative amendments that have not yet been completed, or which have not yet gone into effect, should be mentioned:

☐ Companies managing trading floors (and controlling shareholders in them and officeholders in them or controlling shareholders in the latter), according to the Securities Law (Amendment No. 42) – 2010 published on June 15, 2010. The law’s becoming effective is contingent on the publication of regulations stemming from it. These regulations have been tabled for approval at the Knesset Finance Committee;

☐ Trustees for bonds according to the Securities Law (Amendment No...) (Bonds) – 2011 (and controlling shareholders in them and officeholders in them or controlling shareholders in the latter). The ministerial committee for legislation approved the amendment on September 23, 2011, and the amendment is scheduled for publication as a government bill in the coming weeks;

☐ In addition, a similar arrangement has been proposed for underwriters (and controlling shareholders in them and officeholders in them or controlling shareholders in the latter), according to a proposed amendment to the Securities Regulations (Underwriting) (Amendment No...) – 2011. These regulations have been given to the Minister of Justice for required consultation. In effect, this requirement is also applied indirectly to distributors under these regulations, or at least to a large proportion of them (because the proposed amendment to the underwriting regulations proposes to change the fitness conditions for a distributor, so that the main alternative of the fitness conditions established in it, “eligible to be an underwriter,” will be changed to “he is registered as having active status in the Registry of Underwriters”).

<sup>3</sup> Under Article 1 of the Joint Investment Trusts Funds Law, an “officeholder” is defined as “a senior officeholder as defined in the Securities Law, and, for a fund manager, a member of an investments committee, as defined in Section 20(a), and, for a trustee, someone appointed as a trustee for fulfillment of the trustee’s duty and his functions, as stated in Section 78”.

<sup>4</sup> Where individual license holders are concerned, approval of a panel from the administrative enforcement committee is required (under Section 10(a1)(2) of the Consultancy Law) for canceling or suspending a license for a deficiency of fitness. The panel’s decision also relies on the provisions of this list. In order to facilitate discussion, the Authority is entitled to order that the panel also decide about cancellation or suspension of the license of an authorized corporation in whose name an individual license holder acts, in the framework of the process in Section 10(a1)(2), if it finds that the circumstances in this list prevail, according to Section 10(1a)(4), indicating a deficiency in fitness on the part of the individual, as already stated, or a deficiency in fitness of the corporation in whose name the individual acts.

<sup>5</sup> The definition of officeholder in the Consultancy Law refers to the definition of the concept in the Companies Law: officeholder – a CEO, CFO, deputy CEO, vice-president, any person serving in one of these positions, even if his title is different, and a director or manager directly subordinate to the CEO.

Investment Marketing, and Investment Portfolio Management Law – 1995 (hereafter – “the Consultancy Law”).

4. The control permit holders of a fund manager<sup>6</sup> or an officeholder in it, according to Section 23d of the Joint Investments Law.<sup>7</sup>
5. Licensed trading platform companies and their controlling owners, pursuant to Article 44(23) of the Securities Law 5728-1968 (hereinafter, “the Securities Law”).
6. Control permit holders of a licensed trading platform company as well as their officeholders, pursuant to Article 44Z of the Securities Law.
7. Rating companies, their controlling owners, and their senior executive or its controlling owner, pursuant to Article 7(A)(4) of the Law to Regulate the Activity of Credit Rating Companies 5774-2014 (hereinafter, “the Rating Law”).

Other additional laws stipulate the obligation to notify parties whose reliability is under evaluation, regarding any suspected deficiency in reliability.<sup>8</sup>

The list of circumstances (below) will be applied to each of the entities listed above.

### **General**

The evaluation under the above-mentioned laws is conducted for both a Regulated Entity itself and for other parties related to the operations of the Regulated Entity, as described above (officeholders, those taking part in investment decisions, etc.). However, in cases in which the ISA’s authorization to cancel permits is limited to the Regulated Entity,<sup>9</sup> an evaluation of the reliability of these related parties is conducted for purpose of considering the question of whether to cancel the permit of the Regulated Entity itself, not as a direct action involving the party whose reliability is being evaluated.

Obviously, the position of an individual whose reliability is being evaluated is important for an evaluation of the reliability of the Regulated Entity. The higher or more central the position involved, the more significant a deficiency in his reliability becomes significant while considering whether the Regulated Entity meets the conditions of reliability. If the cancellation of the Regulated Entity’s permit is being considered as a result of a deficiency in the reliability of an officeholder in it, the officeholder’s influence on the corporation’s activity will be evaluated, as well as the corporation’s responsibility for such action, insofar as it was performed in the officeholder’s capacity of his role in the corporation.

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<sup>6</sup> If the holder of the control permit is a corporation, the reliability of the individual who is the controlling shareholder in the holder of the control permit will also be evaluated.

<sup>7</sup> It therefore follows that the evaluation of the reliability of the controlling shareholder and an officeholder in it is likely to arise when authorization to the fund manager under Section 1 is under consideration, and when a permit to the controlling shareholder himself, as stated in this section is being consideration (and also when cancellation of these permits is under consideration).

<sup>8</sup> In this matter, see Sections 9a, 13a, 23b, and 23b1 of the Joint Investment Law, and Section 27(c) of the Consultancy Law, and Sections 44V and 44ZB of the Securities Law and Section 6 of the Rating Law.

<sup>9</sup> For example, when the fitness of an officeholder in a portfolio management company is being evaluated because the Authority has not approved the employment of some party as an officeholder in the company, a ruling that the officeholder’s reliability is deficient can, in certain cases, affect the portfolio management company’s reliability, although this does not allow direct action against the officeholder (in contrast to an examination of whether he has committed violations, for example). On the other hand, where the holder of a control permit in a fund manager is concerned, for example, an evaluation will be conducted of the relevant controlling shareholder when considering direct cancellation of the fund manager’s permit and direct cancellation of the control permit (on this matter, see Footnote 6 above).

Among all the considerations, significance will be given to the Regulated Entity's basic rights; in offsetting the extent of any negative impact on reliability, depending upon the above circumstances, meaning will be given to the harm caused to the freedom of occupation and property rights caused by cancellation of the permit, while distinguishing between the damage caused by canceling an individual's permit, compared with canceling the corporation's permit.<sup>10</sup>

In any case in which one or more of these circumstances occurs, other considerations will be taken into account, including the length of time between the acts involved and the date of the evaluation,<sup>11</sup> the conduct of the Regulated Entity during the time that has passed, and the expected impact of the act and the ISA's response to it on the capital market, and the public's trust in it, particularly in the parties managing the public's money.

**The circumstances listed here are events that by their nature constitute grounds for examining whether the circumstances under which they took place indicate the existence of a deficiency in the Regulated Entity's reliability. Indications of the existence of such circumstances alone do not necessarily lead to a determination that there is a deficiency in reliability, and certainly do not reason in an automatic determination that a deficiency in reliability justifying permit cancellation has occurred, since the circumstances listed here are merely grounds for exercising the Authority's judgment in this matter.<sup>12</sup>**

In an evaluation of reliability, the Regulated Entity has a right to a hearing, and the existence of one or more of the listed circumstances will not automatically lead to cancellation of the Regulated Entity's permit. Naturally, not all the circumstances are of equal significance; some of the circumstances included in the list are by nature more serious than others in substance and their relevance to the supervised entity's activity. It is also possible that the ISA will assess the same circumstance differently in different cases, depending on its significance in the given case. Finally, it is possible that the cumulative value of a number of circumstances or the prevalence of the circumstances among a number of parties could lead to a different result than each of those circumstances by itself.

It should be clear that a reliability evaluation is conducted in the framework of an administrative proceeding designed to protect the proper operations of the capital market and the interests of the investors in it. This procedure is not contingent on the existence of a criminal proceeding or its results (if one is taking place).

In passing, we mention here another declarative list jointly published by the three main regulators overseeing activity in the Israeli capital market: the Israel Security Authority, the Supervisor of Banks, and the Ministry of Finance Capital Markets, Insurance, and Savings Division.<sup>13</sup> This joint list is declarative, and is not explicitly required or authorized in law. The

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<sup>10</sup> And both of these in contrast to cancellation of control permits, which is not considered to constitute a violation of freedom of occupation.

<sup>11</sup> On the other hand, in circumstances in which the evaluation is prolonged, (such as when an investigation is prolonged, for example), or in circumstances in which the Authority deems it proper to wait for the results of some proceeding, the passage of time in itself will be given little value.

<sup>12</sup> A decision by the State Attorney's Office in such matters usually rests on evidence that is sufficient for administrative purposes. Subsequent acquittal of the accused for causes other than reasonable doubt is likely to lead to reconsideration of the case of the accused.

<sup>13</sup> A criminal investigation into a suspected crime may constitute sufficient evidence for a fitness evaluation. If the criminal investigation ends with the case being closed, the grounds for closing the case will also be considered.

list is published due to a belief that a certain degree of clarity is required with respect to the parameters used by the three regulators in examining the question of the fitness of the various supervised entities. Such cooperation as described above and the joint list of circumstances accompanying, is particularly important, given the fact that both the large investment houses and the banks are frequently supervised by more than one regulator, with each regulator evaluating a different activity. Finally, the statute defines reliability qualifications for almost all such entities.

At the same time, the list for the above-mentioned parties supervised by the Authority is the sole binding list.

**It is hereby clarified that use of the ISA's powers discussed in this paper are restricted to cases in which the above-mentioned evaluation reveals that conduct has deviated substantially from proper codes of conduct, or in which the conduct has a serious impact, due to the extent of the damage caused, or that it is liable to cause. This refers to cases in which this conduct gives rise to concerns about future prejudice to the investing public's interest, and consequently justifies consideration of cancellation of the permit.**

**Following is the list of circumstances that may indicate a deficiency in reliability, subject to the ISA's examination:**<sup>14</sup>

- (1) Conviction of a crime, filing of an indictment, or a criminal investigation into the commission of a crime;
- (2) Establishing that a disciplinary violation<sup>15</sup> has been committed, filing of disciplinary written arguments, or opening an investigation into the commission of such a violation;
- (3) Imposition of administration enforcement measures, including monetary sanctions, issuance of a demand for payment of a financial sanction, administrative written arguments, or initiation of an administrative hearing relating to the committing of a violation;<sup>16</sup>
- (4) An agreement concerning inherently substitute administrative arrangements replacing the filing of an indictment or the conducting of an administrative proceeding, such as payment of a fine, a consensual writ, or an agreement for a conditional halt in proceedings instituted due to the committing of a crime or violation;<sup>17</sup>
- (5) Invalidation of a permit as a result of a fitness deficiency – invalidation of a license, refusal to accept a permit, or disqualification for engaging in a profession or some occupation due

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<sup>14</sup> In any case in which the ISA determined that reliability is deficient, in view of any interim proceeding (such as the initiation of an inquiry or investigation, filing of an administrative statement of claims or indictment or such) and the proceeding was concluded without a determination of guilt, for any reasons, the decision regarding reliability shall be reconsidered (in other words, the authority authorized to decide on the issue of reliability — the ISA / the license committee/ the panel of the administrative enforcement committee — will examine whether the new information affects the previous determination).

<sup>15</sup> A disciplinary violation is a disciplinary offense under the law (under the statute or any arrangement made under the law, such as the by-laws of the TASE, disciplinary violations according to the rules of the Israeli bar (and similar offenses).

<sup>16</sup> Following Footnote 14, a determination concerning deficient reliability will generally expire upon the conclusion of an administrative enforcement procedure based on the same circumstances.

<sup>17</sup> It should be clarified that insofar as this concerns an enforcement arrangement in which the ISA entered together with a Regulated Entity, the arrangement shall not of itself constitute a circumstance for evaluating reliability. Nonetheless, the arrangement may constitute a supporting or supplementary element for the conclusions of a reliability evaluation that was conducted in light of other circumstances.

to a fitness deficiency, whether the permit was granted under law or by a professional association;

- (6) Findings in legal proceedings concerning violations of the law;
- (7) Findings in an audit and client complaints – findings in an audit conducted by the Authority, a different supervisory entity, an independent auditor, an internal auditor,<sup>18</sup> findings by an internal enforcement system, or accumulated complaints by clients – all in matters of substance and provided that they were found to be substantiated;
- (8) Dismissal following findings indicating alleged improper conduct relating to the activity supervised by the Authority;
- (9) Liquidation due to insolvency or failure to meet substantial economic obligations relating to the supervised occupation;

In this list, “crime” or “violation” refers to a crime or violation under securities laws or a economic crime or other violation whose substance, severity, and circumstances render a person unfit to possess a permit (including theft, bribery, forgery, etc.), and including a disciplinary violation, all whether in Israel or overseas.

#### **Binding publication, application, and effect**

This list is a binding list of circumstances. Nonetheless, it should be recalled that the ISA may add to or remove items from this list from time to time. Notice of the list’s publication, any amendment thereto, and its date of effect, will be published in the Official Gazette.

As determined by the clauses that were enumerated in this paper, the list comes into effect after the elapse of 30 days from the public date. It is also determined that amendments to the list do not apply to outstanding proceedings.<sup>19</sup>

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<sup>18</sup> It should be noted that such circumstance does not affect the extent of the duty to reveal information concerning an internal audit.

<sup>19</sup> Section 10(1a) of the Consultancy Law; Sections 10a(b), 15(a1), and 23d(b) of the Joint Investments Law.