



## ISA Adopts Final Version of the Goshen Report

December 17, 2006

The Goshen Committee recommendations focus on improvement of director independence, particularly regarding approval of related party transactions, improvement in the workings of auditing/balance committees, pertaining to approval of company's financial statements, improvement of corporate disclosure and accountability and establishment of a Court for Securities and Corporate Offences.

Last week the ISA had decided to adopt the Goshen Committee recommendations, which was appointed about two years ago by the chairman of the ISA, Mr. Moshe Terry, to address the proper structure and content of an Israeli corporate governance code. The committee was appointed as part of ISA strategy to fortify corporate control mechanisms in Israel's securities market. Corporate governance codes consist of principles and rules which define good practice for public companies to follow regarding control and supervision. Good corporate governance is expected to lower the risk that investments will be misappropriated and serves as an important mechanism of prevention and control of corporate conduct and disclosure.

The members of the Committee, other than its chairman, Prof. Goshen include: former tax commissioner; Att.; Moshe Gavish, Itzhak Devash, businessman; Doron Debbi CPA (Isr.), managing partner in the Somekh Chaikin Accountants; Ronit Harel, Senior Vice President of the Tel Aviv Stock Exchange; Att. Dr. Yair Friedman, partner in the Sharir, Shiv, Friedman & Co. law firm; Prof. Ephraim Zedaka, Tel Aviv University; Yossi Rosen, President & CEO, Israel Corporation, Ltd.; Att. Amir Scharf, Secretary and Legal Counsel, El Al Airlines; Ram Gev, CPA (Isr.), Corporate Finance Department, Israel Securities Authority; and Att. Yoram Naveh, Deputy Director Corporate Finance Department, Israel Securities Authority. Observers to the Committee's proceedings included Moti Spiegel, CPA (Isr.), Deputy Supervisor of Banks; Att. Orly Doron, Securities Violations, T.A. District Attorney's Office -- Economic and Tax Division; Air Inbar, CPA (Isr.), Vice President, Institute of Certified Public Accountants in Israel; and Att. Nathan Shilo, legal counsel to the association of Public Companies in Israel.

Draft proposals were submitted to the ISA and published for public comments in January 2006. On December 12 committee's final conclusions were submitted to the chairman, Mr. Moshe Terry.

The Goshen Committee recommendations focus on improvement of director independence, particularly regarding approval of related party transactions, improvement in the workings of auditing/balance committees, pertaining to approval of company's financial statements, improvement of corporate disclosure and accountability and establishment of a Court for Securities and Corporate Offences. Committee's recommendations took into consideration individual characteristics of the Israeli economy and its capital market, while also referring to corporate governance codes adopted in different countries.

Given the process of globalization and the growing competition between financial markets, and as Israel is considered an emerging market, the Committee places great importance in setting proper corporate governance standards and rules that align themselves with standards adopted in leading western economies.

The Committee believes that the best way to implement these principles is through the imposition of disclosure requirements on public companies. At the same time, the Committee does not believe that requiring companies to explain why they did not adopt certain principles or rules will be particularly effective. Based on the nature of the disclosure and experience in other countries, these explanations, particularly when they are legally mandated do not contribute material information to the investor. At times, these explanations can serve as a smoke screen that to a certain extent undermine the intent of disclosure requirement.

Companies can voluntarily elaborate its decision not to adopt a given corporate governance principle. The Committee believes that the corporate governance code it recommends sets an appropriate threshold which should be adopted by the market. The disclosure requirements highlight the conduct corporations choose to undertake, with the expectation that the capital market will process and uses this information as part of the decision-making process regarding investments in various companies and securities pricing.

Throughout the course of the Committee's deliberations it heard the views of parties active in the capital market in various capacities. Representatives from underwriting firms, institutional investors, public companies and the Ministry of Justice were invited to voice their opinions. Additional position papers were received in response to a call for public comments issued by the Committee. The Committee formulated its recommendations after extensive deliberation.

Key recommendations include:

### 1. Independence of the Board of Directors

In the Committee's opinion, board of director independence is one of the cardinal principles of good corporate governance. In various countries that have adopted similar codes, various arrangements have been devised conforming to the characteristics of the capital market and cost/benefit considerations. The Committee believes that the issue of board independence necessitates a balance between objectivity, professionalism and risk-taking in corporate management. This balance is required because the board of directors plays a dual function which may collide at times: formulation of the company's business policy; supervision of corporate management. While the first task requires a deep understanding of business and a close fiduciary relationship with corporate management, which facilitates the directors' ability to advise and help mold corporate strategy, the second task requires objectivity and an arms-length relation with management. Balancing directors' independence depends on market characteristics in a given country; hence various countries have found various balances pertaining to directors' independence. After examining accepted practices abroad and the characteristics of Israel's capital market, it recommended that 30 days

after the second general meeting of a company, after 1/1/2007, every public company shall have independent directors (as henceforth defined) on its board, in addition to external directors (as defined under the Companies Law), so that an overall number of independent and external directors shall be as follows:

1. In a company that doesn't have a "group of controlling shareholders", as defined under the Companies Law - at least half of all directors;
2. In a company that does have a "group of controlling shareholders" – at least one third of all directors.

"Independent Directors" shall be designated as such following the examination carried out by the committee, that examined connections between said directors and the company, its controlling shareholder and senior corporate officers, and had substantiated its decision, regarding independence of said directors, by referring to their connections with the company and other circumstances relevant to the issue. The aforesaid examination and adjudication of the auditing committee shall be carried at least once a year. An independent director has to inform the auditing committee regarding changes in his position, where it is relevant to his independence.

## 2. Composition and Role of the Internal Audit Committee

To compliment board of director independence the Committee recommends consolidating the independence of the internal audit committee of public companies. The Committee states that "in light of the auditing committee's importance, and as a complimentary step insuring directors' independence, great significance is attached to the independence of the auditing committee's members and their financial qualifications". Hence, the Committee recommends that a majority of members of the audit committee be independent directors (including external directors) and the chairman of the committee will also be an external director. The Committee stipulates the duties of the audit committee in process of approving financial statements and recommends that audit committee hold preliminary discussions on the company's financial statements and that its recommendations be brought before the board of directors. The board of directors is obligated to discuss the Committee's recommendations prior to approving the financial statements.

## 3. Approval of Transactions with Related Parties

In Israel's capital market, where most public companies are held by controlling shareholders, the central concern of misappropriation is in related party transactions, harboring conflicts of interest. Hence, the main protection extended to minority shareholders is - demand for a majority quorum, of shareholders bearing no interest in the transaction, for approval of corporate transactions with controlling shareholders in which conflicts of interest exists. The Committee recommends that until a specialized court for corporate and securities law is established, approval of corporate transactions with controlling shareholders in which conflicts of interest exist will require a majority of the quorum of shareholders bearing no interest in the transaction, as opposed to the one third threshold effective to date.

The Committee believes that once the court is established, public companies will be able to approve related party transactions with a simple majority (without qualification of a majority of disinterested shareholders). However, in cases in which a shareholder disputes the fairness of the transaction in court, the burden of proof will fall on the company. The costs of a trial will be paid by the company.

## 4. Establishment of a Court Specializing in Corporate and Securities Law

The Goshen Committee recommends establishing a court specializing in corporate and securities law. The Committee believes that the existence of a dedicated court will prevent exploitation and discrimination of minority shareholders and will constitute a key factor in enhancing the quality of public company management, developing the capital market and improving the economy. Empirical research demonstrates a clear correlation between the quality of investor protection, financial development and economic growth. Moreover, in the absence of a court empowered to prevent minority shareholder discrimination, the development of a market characterized by diffused ownership will not come to pass. Controlling shareholders will simply not have an incentive to sell control in the market, as long as they are able to "appropriate" benefits from the company at the minority shareholders' expense. Only when the ability for misappropriation is restrained by a court, controlling shareholders will reach the conclusion that the dispersion of risk favors diffuse ownership or that the proceeds received from selling shares to the public justify the relinquishment of control.