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October 9, 2011

Mr. Haim Shani  
Chairman, Committee on Enhancing Competitiveness  
Ministry of Finance, Government of Israel  
One Kaplan Street  
Jerusalem, Israel  
By E-Mail

Dear Mr. Shani,

This report (the "Interim Expert Report") provides a summary of the analysis conducted and the conclusions reached in the course of my work for the Committee on Enhancing Competitiveness (the "Committee").

I was engaged to serve as the Committee's outside expert advisor with respect to its examination of the structure of business groups and the links between financial and non-financial firms within the Israeli economy, and to prepare a written report providing my analysis and recommendations with respect to these issues.

In the course of my engagement, I have had numerous conversations with yourself and other members of the committee, and have participated in more than ten meetings of the Committee, its subcommittee, and its staff. I have provided outside expert opinions on various measures that were already under consideration by the Committee, and have developed additional policy measures for consideration by the Committee.

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\* William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance, Harvard Law School. I also serve as a Research Associate of the National Bureau of Economic Research and Fellow of the European Corporate Governance Institute. Biographical information and links to my work are available at <http://www.law.harvard.edu/faculty/Bebchuk>. I have written this Interim Expert Report in my individual capacity, and the opinions I have expressed herein should not be attributed to any of the institutions with which I am affiliated.

Below I outline the conclusions that I have reached and previously provided to the Committee orally, as well as the issues that will be analyzed in the final report (the “Final Expert Report”) that I am in the process of preparing for inclusion in the Committee’s final report. In this Interim Expert Report I do not attempt to discuss all of the measures on which I provided the Committee with an outside expert opinion or that I have developed for consideration by the Committee, but rather focus on those measures on which the Committee will be seeking public comment. A more comprehensive account of the conclusions discussed below, and the analysis underlying those conclusions, will be provided in the Final Expert Report.

## I. PROBLEMS AND CONCERNS

The Israeli economy is characterized by the significant presence of large business groups and a high degree of concentration in the economy. The pyramidal structure of some of these groups enables their controllers to control assets to a much greater extent than the controller’s own capital would otherwise allow, thereby facilitating the existence of large business groups. Drawing on research in economics and finance, the Final Expert Report will analyze the problems and concerns produced by pyramidal structures in the Israeli economy.<sup>1</sup>

The use of a pyramidal structure enables an individual or a family to maintain control of an entity while owning only a minority, and sometimes a small minority, of the equity capital (termed “cash flow rights” in the literature) of that entity. The combination of a lock on control and ownership of a small fraction of cash flow rights can be expected to produce significant distortions in the controller’s decision-making, producing “agency costs” that adversely affect the interests of public investors in the group. A controller that owns a small percentage of cash flow rights can expect to bear only a small fraction of the effects of decisions on the group’s equity capital. Consequently, the controller may favor a course of action that would serve the controller’s private interests even if such course of action would adversely affect the value of the equity capital of the group. Moreover, the controller’s lock on control eliminates any viable threat of a control contests that might otherwise discourage substantial agency problems.

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<sup>1</sup> My analysis of this subject will supplement the learned and extensive discussion of existing evidence and academic learning contained in the Committee’s forthcoming interim report.

Pyramidal groups therefore raise serious concerns about agency problems, even from a “static” perspective – that is, taking as given and fixed the scale of assets under the pyramid’s control. However, as I stressed to the Committee, it is also important to pay close attention to the effects of “dynamic” distortions in choices made over time with respect to the size and scope of pyramidal groups. When the set of assets under the control of a pyramidal group expands, the controller will benefit from a larger level of private benefits of control, but will bear only a fraction of the effects of the expansion on the value of cash flow rights. As a result, the controllers of corporate pyramids have an excessive incentive to expand (for instance, by adding additional layers lower in the pyramid ladder) or to avoid contracting the pyramid’s scope (for instance, by spinning off or selling one of the group’s firms and distributing the firm’s value to its shareholders). This distortion can be expected to be especially severe when the controller’s fraction of cash flow rights is small.

In addition to the significant presence of pyramidal structures, the Israeli economy is also characterized by links among financial and non-financial firms. Some significant financial firms, which engage in banking or in asset management, are controlled by substantial non-financial groups. The Final Expert Report will analyze the potential problems and concerns produced by such links. The control of financial firms by major non-financial groups raises concerns that capital may flow to major business groups in excessive amounts or on excessively favorable terms. Furthermore, such control raises concerns that a financial firm controlled by such a group may avoid effectively exercising rights that it has as a holder of the group’s equity or debt securities. Indeed, the concerns raised by the control of financial firms by non-financial conglomerates are quite similar to the concerns that underlay the 1995 recommendations of the Brodet Committee (subsequently reflected in implementing legislation) to prohibit the control of non-financial groups by banks.<sup>2</sup>

In addition to analyzing the adverse effects that existing structures in the Israeli economy have on the efficient operation of pyramidal non-financial groups and financial firms controlled by non-financial groups, the Final Expert Report will also consider the adverse effects of such structures on the broader Israeli economy. The significant presence of pyramidal groups, and the links between financial and non-

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<sup>2</sup> In the interests of full disclosure I note that, together with my colleagues Jesse Fried and Louis Kaplow, I prepared an expert report for the Brodet Committee on which the Brodet Committee relied in making the above recommendation.

financial firms, can be expected to have adverse effects on the allocation of capital in the economy, as well as on the level of competition in various economic markets.

Furthermore, the significant presence of large pyramidal groups in the Israeli economy creates significant systemic risks. Some of the pyramidal groups are highly leveraged, and both the ratings and market pricing of their bonds reflect a significant perceived likelihood of financial distress or even insolvency. While the choice of the appropriate level of debt in private firms is generally best left to private choices in the marketplace, the substantial level of debt in Israel's large business groups deserves the attention of policymakers. While the insolvency or financial distress of a small firm largely affects only the shareholders and creditors of that firm, the insolvency or financial distress of one of Israel's large business groups can be expected to have significant spill-over effects across the economy.

Furthermore, while such effects would be expected to arise even if the large Israeli group were largely funded with capital from abroad, the economy-wide effects of financial distress in one or more of Israel's pyramidal groups can be expected to be substantially magnified by the substantial investments that Israel's pension funds make in the securities of large business groups. Because of these investment practices, financial distress or insolvency in one or more of Israel's large groups would also result in a significant negative shock in the value of the population's retirement savings.

## II. POLICY CONCLUSIONS

### A. *Strengthening Board Independence*

#### 1. *Outside Directors*

In discussions with the Committee, I expressed support for the Committee's conclusion<sup>3</sup> in favor of strengthening the independence of outside directors in "wedge companies" – that is, companies in a pyramidal structure in which the controller holds less cash flow rights than voting rights.<sup>4</sup> Under the arrangement chosen by the Committee, public investors of wedge companies will be able to determine the identity

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<sup>3</sup> I understand that all the conclusions reached by the Committee are interim conclusions subject to revision after the receipt of public comments.

<sup>4</sup> For a more precise and complete definition of wedge companies, see the Committee's forthcoming interim report.

of outside directors comprising one-third of the board. In my opinion, adopting this arrangement would be beneficial.

Under existing rules, public investors merely have a veto right over the controller's choice of outside directors. Allowing the controller to select the outside directors, however, is not an effective mechanism for ensuring that outside directors carry out their important role in limiting choices that would benefit the controller but not the shareholders in general. The 2008 report of the Hamdani committee recommended providing public investors with the power to choose outside directors,<sup>5</sup> and subsequent legislation requires companies either to comply with such an arrangement or to explain why they do not do so. While such an arrangement may well be desirable for controlled public companies in general, it is in my view especially warranted for wedge companies, where concerns about agency problems are elevated.<sup>6</sup>

## *2. The Audit Committee*

To supplement the arrangement discussed above, I advised the Committee that it would be desirable to expand the authority of the audit committee of wedge companies to include (i) approval of appointments of directors of controlled public subsidiaries made through the exercise of the company's voting power in such subsidiaries, and (ii) supervision of interested party transactions that do not require a shareholder vote but are still financially consequential. Given that wedge companies pose more significant agency concerns, such a moderate expansion of the audit committee's role would be beneficial.

Because a public company's audit committee must include a majority of directors that are not affiliated with the controller, requiring approval by this committee can be beneficial with respect to decisions that raise agency concerns. Requiring audit committee involvement in appointments of directors of controlled public subsidiaries may discourage the selection of directors who would not be best for the position, but whom the controller might prefer due to family relations or other private considerations. Similarly, when a set of interested party transactions cannot, because of practical considerations, be submitted to a vote for shareholder approval but is

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<sup>5</sup> In the interests of full disclosure, I note that I served as an adviser to the Hamdani committee and supported this recommendation.

<sup>6</sup> A related and useful recommendation of the Committee will expand the disclosure requirements in connection with the election of any directors in a public company (that is, not just wedge companies).

financially consequential in the aggregate, supervision by the audit committee may limit the extent to which such set of transactions can be used to divert value to the controller.

## *B. Shareholder Approval Rights*

### *1. Executive Compensation*

Under existing rules, public investors have to approve compensation provided to the controller (or to affiliated individuals) but not to “professional” managers. The Committee decided to recommend a different arrangement for wedge companies. Under this arrangement, the compensation of wedge companies’ top executives will require approval by such company’s public investors. In my opinion, ensuring that wedge companies’ top executives are not solely dependent on the controller for the setting of their compensation will be beneficial.

In a public company that has a majority shareholder, the controller personally bears the majority of the cost of top executives’ compensation and thus has strong incentives not to pay such executives excessively. For this reason, it is not necessary to require that public shareholders in such a company approve the compensation of a professional manager hired by the controller. In a public wedge company, however, the controller bears only a minority, and sometimes a small minority, of the cost of top executives’ compensation. Providing public investors with input on the subject is therefore sensible, and may make top executives concerned not only about how their performance is perceived by the controller, but also how such performance is perceived by public investors.<sup>7</sup>

### *2. Expansion Decisions*

To address the concern discussed above that controllers of pyramidal groups have excessive incentives to expand the size of their empire, or that such controllers might

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<sup>7</sup> While providing shareholder with a say on the subject is beneficial, it might be desirable to design special rules for cases in which the compensation of an executive hired from the outside needs to be set without the delay involved in a shareholder vote. In such cases, the audit committee could be authorized to approve initial compensation terms for an executive hired from the outside provided that it does so only to the extent that it concludes is needed to serve shareholder interests.

make expansion decisions even when doing so would be value-decreasing, I advised the Committee to expand the set of corporate transactions that require approval by the public shareholders of wedge companies. Under the proposed arrangement, major corporate decisions that would have the effect of considerably expanding the scope of the assets under the control of a wedge company, such as acquiring a controlling block in another public company or raising a substantial amount of additional capital, would require the approval of a majority of the public investors.

Under existing rules governing controlled public companies, related-party transactions with the controller or affiliated entities, which are viewed as raising significant conflict of interest concerns, already require a vote of approval by public investors.<sup>8</sup> The proposed arrangement should be viewed as a response to a recognition that, in wedge companies, there is a substantial basis for concern that the interests of the controller and the interests public investors diverge considerably with respect to expansion decisions. As is the case with any requirements for shareholder approval, the proposed arrangement can be opposed on grounds that shareholders do not have as much information as management. However, institutional investors are likely to recognize their imperfect information and defer to management views on proposed expansion decisions unless they feel sufficiently confident that the expansion is driven by the controller's private interests.<sup>9</sup>

Note that the arrangement under consideration does not assume that expansion by pyramidal groups is generally or commonly inefficient. Instead, it leaves such decisions to the marketplace, merely adding a safeguard to screen out expansions viewed by market participants as value-decreasing. To the extent that pyramidal groups

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<sup>8</sup> In connection with such approval, the Committee decided to recommend that, in cases in which a wedge company seeks approval of a transaction not preceded by a competitive process, the company be required to disclose the reasons why a competitive process was not used. Such disclosure would be useful to voting shareholders, and requiring it might also encourage the use of competitive processes.

<sup>9</sup> The proposed arrangement can also be opposed on grounds that it is impractical and costly to delay major expansion decisions until a shareholder vote is conducted. Making certain transactions conditional on receiving shareholder approval is hardly unprecedented, however. For example, under NYSE rules, shareholder approval is required in many cases prior to any issuance of common stock that would expand the number of shares outstanding by more than 20%.

will have major expansion opportunities that would be value-increasing, shareholders can be expected to approve the pursuit of such opportunities.<sup>10</sup>

### *C. Shareholder Exit Rights*

#### *1. Following Outside Offers*

In my opinion, Israeli policymakers should be concerned about the likelihood of persistence of corporate pyramids that results from the excessive incentives of the controllers of corporate pyramids against allowing the enterprises under their control to contract in size, even when doing so would be value-enhancing. This ‘persistence problem’ is best addressed by adopting a “market-based” mechanism that (i) would not require dissolving any part of a corporate pyramid, but (ii) would enable public shareholders “trapped” in a structure judged by the market to be value-destroying to escape that structure under appropriate circumstances.

The market-based mechanism that I developed for the Committee would provide public shareholders in a wedge company with “exit rights” in the event that a premium offer for all the shares of their company that they find attractive is blocked by the controller. In particular, under the proposed arrangement, exit rights for such public shareholders would be triggered if (i) an outside offer (in cash or tradable securities) is made for all of the company’s shares, conditioned on obtaining control of the company, and at a premium of 10% or more over the pre-bid price of the company’s shares, and (ii) a majority of the public shareholders of the company tender their shares in the offer, but the offer fails because the controller or entities controlled by the controller elect not to tender their shares. In such a case, the controlling entities blocking the offer from succeeding will be required to make an offer to buy out the shares of the company’s public shareholders at a price (in cash or tradable securities) equal to the per share price offered in the outside offer.

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<sup>10</sup> While the Committee has avoided taking a general and categorical position on the desirability of expansion by pyramidal groups, it adopts a decidedly negative view on expansion via the creation of a duplicate company – that is, placing most of the company assets in a subsidiary and taking that subsidiary public. Consider a wedge company, “B”, that transfers its assets into a subsidiary, “C”, and then takes C public. In this case, the public investors in both B and C will be drawing their value from the same set of assets, and the creation of such duplicate structure allows the controller to get around the one-share-one vote rule.



It should be noted that the arrangement would not force the end of a public company's life if a 10%-or-greater-premium offer for all shares is made against the objection of the controller. The controller may be able to persuade public shareholders that it will be able to deliver higher value for the company, thus inducing a majority of public shareholders to reject the outside offer, and thereby avoiding a trigger of the exit rights. Furthermore, even if exit rights are triggered and require the controller to make an offer to buy the public shareholders' shares, many public shareholders may decide not to tender but rather to remain as shareholders of the firm, thereby continuing its life as a public company. The mechanism would lead to the purchase of public shareholders' holdings only if market participants generally believe that continuing under the wedge company's current structure would be unlikely to deliver value equal to or exceeding that of the outside offer.

Note also that the introduction of this mechanism would not only produce direct benefits when the mechanism is triggered, but would also have important indirect benefits, by discouraging controllers from running wedge companies in ways that represent substantial under-performance from the perspective of public shareholders. Without such a mechanism, public shareholders might find themselves "trapped" indefinitely in a situation in which the controller extracts high levels of private benefits and public investors are forced to bear high levels of agency costs.<sup>11</sup> The introduction of the mechanism, however, will provide controllers with incentives to avoid situations of severe under-performance that might lead to the triggering of the mechanism. This indirect effect will be an important benefit of the mechanism.

## *2. Following Wedge-Creating Control Transfers*

Although Israel (similar to the United States) does not have a "mandatory bid" rule requiring that an offer be made to minority shareholders in the event that a control block is transferred, such a rule is used by many other countries, such as the member states of the European Union. Given the Committee's recognition that wedge companies tend to produce more significant distortions and agency problems than controlled companies that are not wedge companies, I developed for the Committee a "mandatory bid" mechanism tailored for the protection of public shareholders in the

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<sup>11</sup> The option of selling on the market will not provide adequate protection for public shareholders in such circumstances because the sale would occur at a discounted price, reflecting the existing high level of under-performance of the company.

event of wedge-creating transfers. Rather than applying to all control transfers, the proposed mechanism would apply only to control transfers that would result in a company becoming a wedge company.

Under the proposed rule, if the sale of a control block in a given company would result in a public company that was not a wedge company prior to the sale becoming a wedge company (for example, if a 51% control block in a stand-alone public firm were to be sold to a wedge company at the bottom of an existing pyramid), public investors in the company would have the option to have their shares acquired at the same per-share price as that paid for the control block.

The proposed rule would not apply to control transfers in a public company that was not a wedge company either before or after the transfer. The proposed rule would also not apply to control transfers that would turn a company from a company that is a wedge company into one that is not (for instance, a sale of a control block held through a corporate pyramid to a controller not operating through a pyramid). The proposed rule would be limited to the narrow-but-important case of wedge-creating control transfers. The exit right that the proposed rule would provide would protect public investors in the event that a controller effects a sale that would turn the firm into a wedge company whose structure might give rise to more severe distortions and increased agency costs.

#### *D. Caps on Voting not Backed by Cash Flow Rights*

The central problem with corporate pyramids is that they create a wedge, and in some cases an extreme wedge, between voting rights and cash flow rights. Israel has a rule preventing the creation of public companies with dual-class stock separating cash flow and voting rights. However, corporate pyramids enable controllers to get around one-share-one vote limitations and control a large set of assets with only a minority fraction of the underlying cash flow rights. The wedge between votes controlled and cash flow rights owned that results is the source of distortions and agency problems.

The arrangements discussed above take the controller's effective voting power as given and seek to limit the distortions that result. A supplemental mechanism that I developed for the Committee would directly affect the wedge between effective voting power and cash flow rights. It would impose a cap on the use of formal voting rights

when such voting rights are not backed by ownership of cash flow rights.<sup>12</sup> Under the version of the mechanism on which the Committee decided to seek public comment, the votes attached to a block of 25% or more will count beyond 25% only to the extent they are backed by cash flow rights. (Note that under the version of the mechanism being considered, a controller would be able to cast votes for shares comprising 25% of those outstanding even if the controller's cash flow rights falls substantially below 25%. A stronger version of this mechanism – which would be more effective vis-à-vis wedge companies in which the controller has only a small minority of the cash flow rights – would require that the holder of any block of 5% or more would be allowed to cast votes only up to the level backed by the blockholder's cash flow rights.)

While the mechanism under consideration would somewhat reduce the wedge between effective voting power and economic ownership, it is important to emphasize that its effects are expected to be moderate, and it is not expected to create a destabilizing control vacuum in a significant number of companies. Consider a company, "C", held in a pyramidal structure, with the controller controlling (through a company higher in the pyramidal ladder) a 70% block of the shares of C, but owning only 20% of C's cash flow rights. The considered mechanism would not reduce the controller's effective voting power to 20% for two reasons. First, the controller will be able to cast the votes of shares comprising 25% of the outstanding shares of C. Secondly, and importantly, with the votes of 45% of the outstanding shares effectively "frozen", the maximum number of shares whose votes will be cast will be 55%, and the controller will thus have effective voting power of at least 25%/55%, or 45.5%.

Indeed, an analysis of various configurations indicates that the proposed mechanism would, in many cases, leave the controller with a lock on control. In other cases, however, the mechanism would leave the controller with dominant voting power, but would take away the lock on control the controller would otherwise enjoy. In such cases, while leaving the controller at the helm, and avoiding any control vacuum, the mechanism would expose the controller to the some measure of "market discipline" by opening the possibility of a control challenge in the event that the controller's management were to result in excessively high value-diversion, or the company's under-performance were to become especially high.

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<sup>12</sup> The idea of "freezing" some voting rights when doing so is needed to avoid distortions has a number of precedents. In many countries, for example, shares of a company that are held by company subsidiaries may not be voted, and their voting power is thus "frozen", as long as they are held by company subsidiaries.

It is also important to note that the considered mechanism would not reduce the control premium that corporate pyramids (and the public investors participating in them) will be able to enjoy in the event that the controller sells a control block in a firm within the pyramid to an outside controller that is not part of a pyramid. Rather, as long as a control block is within a pyramid and subject to the distorting influence of a wedge between voting rights and cash flow rights, the mechanism would, in some cases, produce a moderate reduction in the level of such distortions.

#### *E. Facilitating Action by Institutional Investors and Private Litigants*

Building on the long-standing thinking of the Israel Securities Authority in this area, the Committee's recommendations include a series of measures intended to encourage and facilitate actions by institutional investors and private litigants seeking to protect shareholder rights and interests. These measures include enabling the shareholders of public wedge companies to vote through the internet, providing expanded financing options to private litigation seeking to protect the rights and interests of public investors, allowing institutional investors to interact and coordinate prior to shareholder meetings, requiring institutional investors to take into account the quality of corporate governance when making investment decisions, expanding the disclosure of institutional investors' voting decisions, and regulating proxy advisory firms to ensure qualifications and lack of conflicts. In my opinion, these measures would be useful complements to the investor protection measures discussed above.

The investor protection measures discussed earlier will provide shareholders with an expanded set of rights and tools. For these rights and tools to have their intended beneficial impact, however, investors need to take action to use them. As a result, there must be incentives to enforce such rights. Rights and tools need to be not just part of the rulebook but practically usable by the relevant players. Accordingly, it would be beneficial to take steps to make it more likely that, when needed, public investors' tools will be used, and public investors' rights will be enforced.

#### *F. Addressing Systemic Risk Concerns*

Based on my examination of the systemic risks concerns raised by the presence of highly leveraged pyramidal groups, I stressed to the Committee the desirability of supplementing the above measures concerning corporate pyramids with substantial steps to address these concerns. Without such supplemental measures, some of the

measures to protect the interests of public shareholders in wedge companies within pyramidal groups might have certain counterproductive consequences: they might lead controllers to switch equity securities with debt securities (for instance, by substantially increasing debt levels at the upper layers of the pyramid in order to purchase additional shares at lower layers). If controllers continue holding their large groups using other people's money, but switch from outside equity financing to outside debt financing, leverage levels would rise above their current high levels, exacerbating systemic risk concerns. In my view, addressing the systemic risk posed by Israel's large pyramidal groups deserves substantial attention from, and should be accorded high priority by, Israeli public officials.

The Committee's recommendations include a measure to amend the tax code to eliminate a current distortion that encourages the use of debt, which can be expected to provide some benefits in this regard. Furthermore, and importantly, the Committee recommends reconsidering the limitations on the size of an institutional investor's investment in the securities of a single business group or a set of such groups. In my view, it would be desirable to impose tight limits on the fraction of each retirement fund's portfolio of investments in non-financial firms that can be invested in a single large non-financial group, as well the fraction of such portfolios that can be invested in such groups in the aggregate. Such tight limits could significantly reduce the systemic risks posed by such groups by limiting the extent to which financial distress of such groups could be amplified through shocks to the Israeli public's retirement savings.

#### *G. Limits on Control of Financial Firms by Non-Financial Conglomerates*

The Committee concluded that it would be desirable to place substantial limits on the ability of large non-financial groups to control significant financial firms. In my opinion, this approach is warranted, and is superior to the alternative of addressing the concerns produced by such control through detailed regulatory interventions. Furthermore, this approach is a natural complement to the long-standing restriction on the ability of banks to control non-financial groups.<sup>13</sup>

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<sup>13</sup> Another recommendation of the Committee – prohibiting individuals closely affiliated with large non-financial groups from serving as directors of significant financial firms – is a natural and warranted element of the approach of severing the substantial existing links between large non-financial groups and significant financial firms.

While existing legislation precludes any bank from holding large blocks in any non-financial group, the Committee's proposed limitations would apply only to combinations of non-financial groups and financial firms in which both parties exceed certain high thresholds of significance. The Final Expert Report will discuss the delineation of the set of impermissible combinations and possible refinements thereto. In my opinion, the thresholds set by the Committee are conservative and moderate, and it would be desirable for subsequent legislative processes to avoid contracting the suggested set of impermissible combinations. Furthermore, the Final Expert Report will discuss the potential benefits of expanding the set of non-financial groups that are viewed as significant and the set of financial firms that are viewed as significant.

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Please feel free to append this Interim Expert Report to the interim report that the Committee will be issuing.

Sincerely,

A handwritten signature in black ink, appearing to read "Lucian Arye Bebchuk". The signature is written in a cursive, flowing style.

Professor Lucian Arye Bebchuk