The Evolution of Israel's Capital Markets

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Introduction

Israel's capital markets today reflect transition.[1] They have evolved impressively from constrictive origins, but have yet to achieve the maturity of developed capital markets. While the government has not completely embraced laissez-fairism, it has undertaken a number of significant reforms to release the markets from their historical restraints. The fact of reform is encouraging, and the reforms themselves have materially progressed the markets. Nonetheless, the attainment of fully-grown markets will require even more reforms. For maximum effect these reforms should aim to diversify capital market investors (and products) and diminish shareholding concentrations.

The understructure

Historically, the needs of the state and the absence of private capital necessitated an influx of foreign capital to finance domestic investments. In this environment, the government absorbed nearly all funds from external sources and spent heavily on nationally critical programmes, such as defence, immigrant absorption and public works. Even when private savings reached significant levels, the government maintained its central financial role. It issued state debt to domestic institutional investors, directed the borrowings to public objectives, including deficit finance, and regulated alternative forms of investment. This programme effectively replaced Israel's foreign debt with domestic obligations, but retarded the development of competitive capital.

With government domination of the capital markets, commercial banks essentially intermediated for the government, borrowing and lending on government-set terms. Because commercial banks occupied the crucial middleman role, financial institution diversification was stunted and, not surprisingly, banks eventually grew to become financial conglomerates. Directly, or via affiliates and subsidiaries, commercial banks today act as lenders, underwriters, brokers, dealers, advisers, fund managers and investment company owners. Although the trend is towards preventing commercial banks from esconcing themselves in non-financial sectors, these banks take part, directly or indirectly, in almost all aspects of the capital markets.

Commercial banks participate in the capital markets principally by acting as primary lenders. They fund themselves mainly by taking deposits and issuing equity. Mortgage banks, most of them subsidiaries of the commercial banks, operate more specifically in the medium- and long-term capital markets. They lend for home purchase and construction and capitalise themselves with multi-year deposits or funding from parent banks. Mortgage banks also receive government funding for preferential mortgage loans to underprivileged groups.

The banking crisis and capital market reform

From the mid-1970s to the early 1980s, the Tel Aviv Stock Exchange (TASE) boomed. In 1983, however, the market for non-bank shares collapsed. At first, bank shares, which dominated TASE trading, did not follow suit. This was mostly because banks propped up the prices of their shares by encouraging institutional investors under their control and their customers to buy such shares. Eventually, however, investors began to sell bank shares massively, out of concern about imminent currency devaluation.

The government feared meltdown in the capital markets and intervened. Alongside a currency devaluation, the government engineered what came to be known as the Bank Shares Arrangement, by which shares of target banks were essentially exchanged for government notes. As a result of this bail-out, the government soon found itself a major shareholder in most of Israel's primary banks. Originally, the bank shares held by the public and later acquired by the government carried minimal voting rights. The government ultimately obtained fair voting rights for the shares it came to hold, but refrained from exercising overt control over bank management.

The 1983 emergency aroused public scrutiny. In the ensuing years, the banks' dominant and suspect roles in the capital markets were spotlighted, especially by a critical public committee report published in 1986. The report emphasised

1. Unless otherwise noted, references in this article to capital markets are to public markets.

the pre-crisis practice of a number of banks to elevate artificially their share prices so as to yield a rate of return competitive with government bonds. The banks had "regulated" the market price of their shares not only by encouraging their securities customers and the investment funds they managed to purchase those shares, but by extending easy credit for the purchases.

The crisis and consequent exposure and specific recommendations by the committee galvanised the government to change the state of affairs. As a result of those events, and of the government's coincident subscription to free market concepts, the government began in 1986 a general process of reform—meant to lighten the state's heavy influence on the economy and improve standards of corporate activity. The reform applied to the capital markets was extensive and is colloquially known as "Capital Market Reform".

Capital Market Reform was both structural and regulatory. Structurally, the government retreated from dirigisme. For example, significant institutional investors were denied the inflation protected, guaranteed rate government bonds that they had previously enjoyed and were thus directed to the public markets. Additionally, the government opened the capital markets to corporate borrowing. In terms of regulation, much of the environment that had allowed pre-crisis abuses was revised. For example, the former common practice of issuing shares to the public with limited voting rights was generally prohibited, first by a TASE regulation and then, when the regulation was judicially held to be *ultra vires*, by legislation.

Within a decade, the TASE had recovered impressively from the 1983 crisis, but in 1994 it again experienced severe declines. These declines were partially linked to the willingness of some banks to lend for the purchase of securities when, on many occasions, the only collateral provided was the securities themselves. Some argue that the easy credit was once again improperly directed, this time toward the purchase of securities underwritten, or participation units in mutual funds managed, by lending bank affiliates.

Notably, the 1986 committee's recommendation to segregate securities business from commercial banking was rejected. The committee's conclusion that conflicts of interest inherent in universal banking contributed greatly to the 1983 crisis was not credibly contested, but the political preference was to avoid organic change and to address the issue administratively. This choice has been implemented by prohibiting certain transactions between related parties and by requiring procedures and structures to segregate affiliated capital market actors.

To this day, however, the ability of commercial banks to engage in both capital market and banking activities remains controversial. Authorities do restrict banking activities. For example, in 1996 the bank licensing law was amended to require commercial banks to reduce their ownership positions in economic enterprises that are not financial concerns. The process of reduction is currently ongoing and primarily affects Israel's two largest banks. It is expected to broaden equity asset distribution. Additionally, in 1995, the Supervisor of Banks reacted to potential abuse of bank customers and to conflicts of interest faced by banks when recommending financial investments and granting credit for such investments. In that year, the Supervisor promulgated a banking guideline that proscribes bank initiation of credit offers to customers for the purchase of financial assets.

Privatisation

Underscoring the "denationalisation" that infused Capital Market Reform, the government has endeavoured since 1986 to withdraw from the economy by privatising state concerns. The government's goal is to transfer control in most companies in which the state holds more than half of the voting rights or the rights to appoint more than half of the board of directors. Many consider privatisation to be fundamental to the future health of the country's economy and capital markets, but labour organisations resist it as a socio-economic threat. Whatever the perspective weighty questions overhang the process: most notably, at what pace will the government truly privatise and to what extent can domestic capital markets absorb government offerings at full value.

To date, the government has sold, in various proportions, shareholdings in a number of companies. Since 1991, the government has privatised to a significant extent bank holdings it acquired following the 1983 banking crisis, and is expected to maintain this course. Generally, privatisation sales have taken place, sometimes in stages, on the TASE, on foreign exchanges or via private placements to strategic investors. In certain critical companies, the government retains a "golden share" to preserve for itself certain overarching rights in the name of national interest.

Many protest that the government privatisation effort has focused only on relatively marginal companies and the banks acquired via the Bank Shares Arrangement. To them, the government has made little progress in selling large state-owned companies and in truly removing itself from the business of business. Additionally, some complain that the government's focus on sale price has mitigated wide disbursement of privatised assets and thus has perpetuated oligarchic control of many of those assets.

Pre-empting inflation

Another important factor in the evolution of Israel's capital markets is the country's long experience with inflation, which hit runaway proportions in the early and middle 1980s and attained an annual rate of nearly 450 per cent in 1984. A critical, and nearly unique, feature of the capital markets is that the government as debt issuer links many of its products to inflation resistant measures. Of these measures, the most common today is the official consumer price index (CPI), although the U.S. dollar too has been widely employed.

This practice, which actually preceded the hyperinflation of the 1980s by about three decades, is a product of both institutional investor demand and government sensitivity to inflation's debilitating effects on savings. Traditionally, most government debt was linked, but over the past decade many short- and some medium-term debt instruments have been issued without linkage, as the Bank of Israel now focuses on debt issues as a way to pursue monetary targets.

Linkage to protect debt investments from inflation is undeniably creative and may have been crucial to the development of the debt market. Nonetheless, when coupled with inflation's perceived effects on equity prices, it has probably impeded the development of the equity market.

The equity market

Israel's equity capital market has in many ways significantly expanded over the course of the 1990s. The number of securities traded, trading volume and participation of domestic and overseas institutional investors have all materially increased from their levels in the 1980s. As the regulator has released a number of domestic institutional investors to seek at least some of their fortunes in the public markets, their role in the equity market has grown. Accordingly, professional managers play an increasingly important role in directing the public's equity investments.

The TASE has operated since 1935 and is Israel's only stock exchange and public market for the trading of securities. Trades conducted on the TASE are based on a computerised continuous system. Index options and futures are traded on the TASE's MAOF market, which was launched in 1993. As of year-end 1998, the TASE comprised 28 members and listed the equity of 662 companies.[2] The total market value of all listed equity securities at year-end 1998 was approximately $41 billion and the annual trading volume for equity securities in 1998 was about $15 billion. By mid-year 1999, the equity market capitalisation had grown to approximately $57 billion.

Concentrated shareholdings

As robust as the TASE statistics may be, corporate ownership of TASE-traded companies is structured in a way that drastically undermines integrity in the equity market. The TASE features numerous companies with concentrated holdings by controlling shareholders and related parties. The Bank of Israel reports that the proportion of the value of interested parties'[3] holdings to total market value hit 71 per cent in 1998.

Concentrated holdings affect the equity market in a number of unfortunate ways. They cause low trade volume and inaccurate share pricing and have led to market resignation to company transactions involving interested parties. Additionally, they render the market for corporate control inactive. Since market competition for control is a key enhancer of management performance, management standards are necessarily degraded.

Compounding the matter is the long-term nature of much institutional investment and the phenomenon that relatively few TASE-traded companies are majority-owned by the public. In combination, these factors mean that the active float of many TASE-traded companies can be alarmingly small.

Public offerings

The domestic equity public offerings market has been moribund in recent years, following its peak years in 1992–1994. In 1998, Israeli companies raised only about $2 billion on the TASE, of which only slightly more than half was from equity or convertible securities issues. This compares poorly with, for example, 1993, when total equity raised on the TASE reached slightly more than $3 billion. The decline of the public offerings market is contrasted by the recent liveliness of Israel's venture capital market. In 1998, an estimated $600 million, and, in 1999, an estimated $1 billion, in private equity investments were made to finance start-up companies, a large portion of them focusing on information technology.

2. Unless otherwise noted, statistics used in this article are as of December 31, 1998.

3. Under s. 1 of the Securities Law 1968, an interested party is any person that holds 5 per cent or more of the issued share capital or voting rights of an institution; is entitled to appoint one or more members of an institution's board of directors or its general manager; or acts as a director or general manager of an institution. Additionally, any entity in which such a person holds 25 per cent or more of the issued share capital or voting rights or is entitled to nominate 25 per cent or more of the directors, is also an interested party.

The amount of public capital raised abroad by Israeli companies in 1998 was also low—approximately $300 million in equity—although the amount in 1999 was considerably higher (estimated at over $2 billion). Nevertheless, the numerous equity offerings in the 1990s for Israeli companies—typically technology-oriented—in foreign markets cannot be ignored. Over 100 Israeli companies trade abroad, mostly in New York and primarily on NASDAQ. After the United States and Canada, Israel has the greatest number of companies traded on U.S. markets.

On one level, the flight of Israeli issuers to the U.S. markets demonstrates poor faith in Israel's equity capital market. Ambitious companies with international designs see the TASE as lacking capital depth and accurate pricing power. On another level, Israeli company offerings in the United States show a readiness by Israel's technology industry to accept U.S. standards of corporate governance and transparency.

The impact of privatisation

Not surprisingly, the government's privatisation initiative has affected the domestic public equity markets. Between 1986 and year-end 1998, the government sold some or all of its equity holdings in 77 companies (counting subsidiaries of privatised parent companies) for slightly more than $7 billion, receiving $1.37 billion in 1998 alone. As of mid-year 1998, the government held ownership interests in about 95 companies, in contrast to slightly less than 120 at year-end 1996. As a result of privatisation, the government's share of total equity on the TASE has declined appreciably over the years, from about 16 per cent in 1996 to about 9 per cent at year-end 1998.

The debt market

In the main, the public debt market comprises two forms of bond: negotiable, issued by the government and by private issuers, and "earmarked", issued only by the government to certain types of institutional investors. Most negotiable debt is linked to the CPI, with the remainder linked to foreign exchange rates or not at all. Earmarked debt is non-negotiable, is linked to the CPI and pays guaranteed rates. While these guaranteed rates often yield above market returns, the subsidy inherent in earmarked bonds has declined since 1996, as market interest rates have risen.

The government debt market

The government debt market is active and developed, and negotiable government bonds account for nearly all publicly issued debt securities. As for earmarked government debt, no market exists, by definition.

Negotiable government debt includes not just CPI- and dollar-linked bonds, but unlinked products. Unlinked negotiable bonds, both floating and fixed rate, have been issued since the early 1990s and are typically of short to medium terms to maturity, up to 10 years. They comprise a significant portion of current negotiable bond government issues, but so far only a small part of the public inventory of negotiable government debt. Additionally, the Bank of Israel issues unlinked fixed rate treasury bills for monetary policy purposes. These are typically zero-coupon instruments with maturities ranging up to one year.

The corporate debt market

In contrast to the government debt market, the corporate debt market is tiny and does not serve as a significant source of capital. For example, in 1998, the amount of capital raised through a total of seven corporate debt issues on the domestic public market was less than $600 million.

In the 1980s, the government sought to ignite the corporate debt market. As part of Capital Market Reform, and in a significant departure from its then existing policies, the government opened the bond market to corporate issuers and allowed certain previously restricted domestic institutional investors to invest in corporate debt. Despite these efforts, the corporate bond market did not materially evolve. Some suggest that this oddity results from the extreme competition between banks in corporate lending, expressed in rates that barely exceed Israeli treasury bill rates, so as to obtain customer relationships for other bank business. In such a lending environment, disintermediation cannot easily provide benefit.

Asset-backed securitisations in Israel occur, but rarely. For instance, with the exception of a single mortgage-backed debt offering to the public in 1989, Israel has yet to found a secondary mortgage market. Mortgage banks facing funding shortages or capital adequacy pressures do sometimes pool and participate mortgage loans to institutional investors in the private market.

In 1992, the government decided to establish a secondary mortgage market as a way to reduce extensive government participation in housing finance, but this decision was not implemented. In 1996, a public committee was established to investigate new reforms in the capital markets, and this committee established a sub-committee to investigate establishment of a secondary mortgage market. In 1998, the sub-committee recommended removal of legal and taxation obstacles, which it believed prevented establishment of a

secondary market by private actors, but explicitly recommended that the government refrain from actively participating in the establishment of a market. This meant that the government would not sponsor a national insuring body. The Ministry of Justice is currently drafting a Secondary Mortgage Market Law.

The commercial paper market is virtually non-existent. This is despite legislative efforts to encourage it in the early 1990s. The Ministry of Finance has recently eased the former requirement for a full-blown prospectus in a commercial paper offering. According to the Ministry, the alleviation should boost this market.

Institutional investors

The principal genres of institutional investors in Israel are provident funds, pension plans, life insurance savings schemes and mutual funds. These entities, many affiliated with the commercial banks, hold about two-thirds of capital market assets and most of the government debt.[4] Except for mutual funds, these institutional investors invest mainly or wholly in government bonds and other cost-of-living-linked deposits, as opposed to domestic or foreign shares or foreign debt. A number are obligated to invest in earmarked government debt.

The regulated and conservative nature of much institutional investment means that the institutional investor community (excluding mutual funds) is not commonly affected by fluctuations in equity and debt (excluding Israeli government debt) markets in Israel or abroad. It also means that the same community does not, in the same measure, experience portfolio diversification.

An additional ramification for Israel's competitive markets of the relationship between the government as irresistible debt issuer and many institutional investors is the diversion of important players from the equity markets. By allowing—and even requiring—such players access to relatively risk-free debt investment, insufficient institutional investor attention may be paid to corporate performance and governance. This interplay probably encourages inefficiencies and neglect throughout the economy.

The players

Provident funds

The most central of Israel's institutional investors are the provident funds. A provident fund is an investment fund, often owned and operated by a commercial bank subsidiary, through which a household enjoys tax exemptions that are generally conditional on the investors maintaining their deposits with the fund for at least 15 years from the date of creation of the fund account.[5] Devised to promote long-term savings, provident funds are essentially investment funds that face limited redemption risks.

Provident funds as a class are the largest asset-holder among domestic institutional investors. As of year-end 1998, provident (and severance pay and advanced study) funds held approximately 28 per cent of domestic capital market assets, or 37 per cent if excluding earmarked debt. Since 1986, provident funds have not been issued earmarked debt, thanks to Capital Market Reform. Today provident funds may generally invest up to 50 per cent of their assets in tradable securities that are not government-issued, although they generally must invest at least 50 per cent in debt issued by the government and certain similarly secure deposits. In 1998, the maximum rate for investment in foreign securities was raised from 2 to 5 per cent of a provident fund's assets.

Despite their recently gained investment liberties, provident funds invest mostly in linked government bonds, rated bonds and linked deposits. Shares comprise only about 12 per cent of their holdings and foreign shares less than 1 per cent. Although the government no longer issues earmarked bonds to provident funds, the funds continue to hold such bonds that have been acquired earlier. Nearly all of this debt, however, will be redeemed within the next few years.

Pension plans

Many private sector employees provide for retirement through pension plans. Pension plans too have been reformed, but modestly compared to provident funds. Traditionally, pension plans provided defined benefits and, not surprisingly, the plans ran great actuarial deficits. Accordingly, the government closed pension plans established before 1995 to new participants. Nonetheless, benefits to the participants already in those plans were continued, subject to certain limitations. "New" actuarially balanced pension plans were established for new participants.

4 For the analysis of capital market assets held by investor groups, this article adopts the Bank of Israel definition of capital market assets to include earmarked debt, even though such debt is not tradable.

5. In capital market analyses, provident funds are often considered together with severance pay and advanced study funds. Severance pay funds result from savings programmes by which employers typically set aside 8.33 per cent of an employee's gross monthly salary, so as to meet the employer's legal requirement to pay a qualifying fired employee one month's gross salary for each year of work. Advanced study funds result from voluntary joint contributions by employers and employees to a five-year tax-free savings plan, withdrawals from which had historically been limited to financing postgraduate and professional studies.

In terms of assets, old plans are larger than new plans, but new plans are growing at a much faster rate than old plans. Old pension plans hold about 21 per cent of capital market assets (excluding government actuarial liability). They were, and continue to be, issued earmarked government bonds, which must comprise at least 93 per cent of their investments and which necessarily account for nearly all their holdings. In contrast, new pension plans to date account for a negligible share (less than 1 per cent) of capital market assets. The government supplies qualifying new plans with earmarked bonds for 70 per cent of the plans' monthly investments; the plans may invest nearly all of the rest in competitive domestic markets, but are constrained to invest part of that amount in negotiable government bonds or deposits.

The upshot of pension fund regulation is that even today pension fund assets continue to invest overwhelmingly in preferential government debt. Because of this, pension funds, old and new together, own less than 2 per cent of capital market assets exclusive of earmarked debt. It bears noting, however, that the impact of new pension plan investments in the capital markets exclusive of earmarked debt will presumably be felt in forthcoming years, as those plans accumulate contributions that cannot be made to old plans.

Public sector employees currently participate in a government pension plan that is unfunded. As of December 31, 1997, actuarial liabilities under the plan were approximately NIS184 billion. The government and the employees have agreed in principle that new government hires will not join the unfunded plan, but will participate in the new funded plans, to which the government will contribute on behalf of these new hires.

Insurance companies

Israel's insurance industry also grew up under state protection and, beginning in 1990, also began to be weaned off state subsidies. Typically, two kinds of savings instruments have been offered by life insurance companies, many of which are affiliated to the commercial banks: asset return policies, which have not been sold since 1991, and profit sharing policies, which invest their assets in the capital markets. Life insurance companies account for about 12 per cent of the capital market, but not quite 8 per cent of the market exclusive of earmarked debt.

"Old" life insurance policies were, and continue to be, issued earmarked bonds for nearly all of their investments. "New" policies are constrained to invest at least 50 per cent in negotiable government bonds, but no more than 15 per cent in TASE traded equity or equity-like securities. In recent years, the proportion of earmarked government bonds to total assets of life insurance plans has declined. As with new pension plan assets, the impact of new life insurance policy assets on the competitive capital markets will occur if and when those assets accumulate to a significant mass.

Mutual funds

Mutual funds are largely retail vehicles, and their investment horizons tend toward the short term. This is because mutual funds invest mainly for investment return, unlike other institutional investors, which invest primarily to cover future obligations.

Approximately 88 per cent of mutual fund assets are owned by funds managed by commercial bank subsidiaries. As of year-end 1998, there were 349 mutual funds, which had total assets amounting to slightly less than 5 per cent of the capital market, and slightly less than 7 per cent of the capital market exclusive of earmarked debt.

Mutual funds invest in the capital markets via equity or negotiable bonds, but are regulated to some extent in such areas as fund governance and asset distribution. Since 1989, mutual funds have been permitted to invest to a certain extent in securities traded abroad. By year-end 1998, shares and convertible securities accounted for slightly less than 27 per cent of mutual fund assets, class-wide. The rest of the mutual fund assets were invested in unlinked local currency assets, CPI- or foreign currency-linked assets, and assets abroad.

A continuing state role

The government's commitment to supply old and new pension plans and old life insurance policies with earmarked bonds draws assets that could otherwise be invested in competitive equity and debt issues. The absence of a large portion of institutional investor assets from the tradable securities markets deprives those markets of the depth and stability that such investors are known to bring to capital markets elsewhere. Moreover, this policy works against the government's interest in reducing the state's role in the capital markets.

The earmarked debt programme also places an unfortunate onus on capital markets. The government's non-tradable lending obligations are automatically determined by pension plan and insurance policy needs, over which the government has no control. As a result, and discounting privatisation proceeds and international borrowings, the government must adjust its borrowings via domestic tradable debt to give it the flexibility it needs to manage its deficit finance. If the government's financing needs diminish, the tradable capital markets are likely to suffer a corresponding loss of breadth and depth.

Not surprisingly, the significant "lock-up" of pension fund and life insurance policy assets stimulates calls for more deregulation. While it is practically inevitable that the "liberated" assets of new pension plans and new life insurance policies will one day exert sway in the capital markets, the wait may be long. Even if the presence of those assets were to be felt more quickly than expected, the locked-up assets will undoubtedly continue to entice capital market reformists, who would like to flush the capital markets with as much competitive investment as possible and release the government from rigid debt obligations.

The legal environment

Capital markets depend heavily on law. Israel's legal system has transmuted from Levantine beginnings through English domination to an independent Israeli character, albeit with a heavy Western bent. Colour from its exotic evolution and influence from other advanced legal systems are unavoidable, but the law is now solidly grounded on a particularly Israeli jurisprudence.

For about four hundred years, from the early sixteenth century, Palestine constituted a part of the Ottoman empire. As a result and throughout the period, Turkish law dominated the legal landscape of what eventually became Israel. When Great Britain militarily ended Ottoman control in 1917, Turkish law in Palestine (which had come to include even some French-inspired rules) was proving itself more and more inadequate for a growing and increasingly sophisticated population.

In 1922, when it received a Mandate from the League of Nations to govern Palestine, Great Britain enacted a King's Order-in-Council imposing English common law and equity in case of legal lacunae in Palestine. This led to the cloning of large chunks of English law in Palestine. Additionally, between 1922 and 1948, the year Israel attained statehood, the British enacted numerous ordinances—mandatory statutes, as it were—to regulate activities in Palestine. In the business sector, enactments such as Banking, Bankruptcy, Bills of Exchange, Companies and Income Tax Ordinances provided much-needed legal stability and, to this day, some continue to apply. Of the ordinances that have not been replaced by Israeli law, however, most have undergone significant revisions over the years of Israeli sovereignty.

Today, Israeli law demonstrates much independence from its past. Certainly, Turkish influence scarcely survives. Similarly, English common law no longer pervades: the Foundations of Law Act of 1980 annulled the last remnants of formal conjunction with English law and authorises courts to employ the "principles of freedom, justice, equity, and peace of the Jewish heritage" as precedent in cases of lacunae in traditional legal sources.

Nonetheless, Israel's strong Western orientation continues to shape its legal thinking. Legal concepts and precedents from England and the United States often influence, to one extent or another, the legislator or regulator. Similarly, in important commercial cases, courts will frequently turn to England or the United States for a comparative law analysis. Continental law, too, is not without influence: for example, Israel's requirement of good faith in contract negotiation and performance is derived, in large part, from German jurisprudence.

A new companies law

As of February 2000, Israeli corporate activity became subject to a new Companies Law 1999. The new law replaced much of the Companies Ordinance (New Version) 1983, which in its various incarnations had regulated corporate activity since even before the establishment of the State in 1948. The Companies Law revises many old corporate ways and is meant to align Israeli corporate oversight and activities with current values and practices. The new law was considered necessary because the Companies Ordinance, first enacted in 1929 (and amended a number of times thereafter), simply had not kept pace with Israeli corporate realities and vision. As a consequence, the new law codifies many rights and obligations that arose outside the literal language of the Companies Ordinance. The new law is meant to be a thoroughly modern Act that balances the interests of shareholders, officers, employees, creditors and the public.

The Companies Law is controversial. Critics complain that the new law itself is out of step with corporate and economic realities in Israel and abroad. To them, the law is unjustifiably paternalistic, to the point of damaging Israeli corporate and national interests. Among the flaws in the law that they allege are provisions that permit a piercing of the corporate veil whenever just and proper; require shareholders to act responsibly toward the company and each other; prohibit one person from acting as both a company's chairman of the board and general manager; establish wide director liability; and accord seemingly disproportionate power to creditors.

Many areas important to corporate governance and shareholder rights are addressed in relative depth. For example, the new law requires outside directors for publicly traded companies and details criteria for derivative actions by shareholders or directors against entities that improperly harm the interests of the company and for securities holders' class actions.

At this stage it is difficult to predict which provisions of the new law will materially impact on

corporate governance and minority shareholder protection. What is certain, however, is that this deep and wide-ranging legislation will remake the corporate landscape and, from a shareholder's perspective, probably improve corporate governance and fairness standards.

Conclusion

Israel's capital markets are active and the legal and regulatory supports firm. Nevertheless, important actors and products are missing and the equity market suffers from concentrated holdings and insufficient institutional investor attention. While the reforms already enacted have greatly enhanced capital market activity, they are half-baked. Undoubtedly, the incompleteness results at least from the tug-of-war between the economic benefits of full reform and the social consequences of altering institutional behaviour. Yet, the trend is toward further reform. Time will tell just how far the reforms will reach and just how many free market principles Israel will adopt.