

CAPITAL MARKET ACTIVITY OF THE BANKING SYSTEM

Introduction

1. This regulation sets several minimum requirements for the management and control system in banking corporations and in controlled corporations engaged in investment and investment counseling, in particular with regard to preventing conflicts of interest.
(A banking corporation's dealings in securities on its customers' behalf are discussed in [Regulation no. 461.](#))

Preventing conflicts of interest - general

2. (a) The involvement of banking corporations in capital market activities and investment in financial assets, whether for themselves or for their customers, embodies potential conflicts of interest. The existence of a mechanism for preventing conflicts of interest is important both in order to prevent abuse of the power and knowledge in the hands of the banking corporation and in order to prevent the banking corporation being harmed if exploitation is perpetrated by its employees or if individual or class action suits are brought against it, thereby increasing public confidence in the banking system as an honest broker in the capital market.
- (b) In order to prevent exploitation of those conflicts of interest, the banking corporation must establish an organizational structure with "Chinese walls" in occupations which involve capital market activities. A structure of this kind should prevent information known to an individual or a group involved in one or another of the transactions of the banking corporation and/or a related company from reaching another individual or group involved in other transactions of the banking corporation and/or a related company. Furthermore, the "Chinese walls" should prevent a situation arising in which decisions of the banking corporation and/or a related company are made on the basis of non-business considerations.

Definitions (6/98)

3. **“Insider”** -
- (a) Someone who is a party at interest, a director, or an employee of the banking corporation, or of a corporation controlling it, or of a corporation controlled by either of them;
 - (b) Despite the aforesaid in section (a), a person shall not be considered an insider merely because he serves as a director or employee of a corporation that engages in investments or of another corporation controlled by it that engages in the same area of investments;
- “Party at interest”** - Someone who holds more than 5% of a certain kind of means of control of a banking corporation or of its holding corporation;
- “Underwriter”** - As defined in section 1 of the Securities (Underwriting) Regulations, 5753–1993;
- “Investment counseling”** - Advising others regarding the profitability of investing, holding, buying or selling financial assets;
- “Inside information”** - As defined in chapter 8,1 of the Securities Law, 5728–1968;
- “Portfolio manager”** - As defined in the Regulation of Investment Counseling and Portfolio Management Law, 5755–1995 (henceforth, the Counseling Law);
- “Securities”** - As defined in section 1 of the Securities Law, 5728–1968, including units in a fund, securities issued by the State or under a special law, and securities issued outside Israel;

“Management of investment portfolios” -	As defined in the Counseling Law (henceforth, portfolio management);
“Financial asset” -	Securities, a deposit in Israeli or foreign currency, investment in a provident fund, options, futures contracts, including in assets and commodities, or the right to any of these;
“Provident fund” -	As defined in section 47(a)(2) of the Income Tax Ordinance;
“Fund” -	As defined in the Joint Investment Trust Law, 5754–1994 (henceforth, the Funds Law);
“Corporation engaging in investment” -	A corporation whose principal business is in one or more areas of investment;
“Controlled corporation engaging in investment” -	A corporation that engages in investment and is controlled by a banking corporation;
“Areas of investment” -	One of the following: <ul style="list-style-type: none">- Underwriting;- Portfolio management;- Provident fund management;- Fund management;- Investment counseling.

The framework for certain investment activities (6/98)

4. (a) A banking corporation shall not manage a provident fund by itself;
- (b) A controlled corporation that engages in investment shall not deal with more than one area of investment;
- (c) Despite the foregoing:
 - (1) Revoked;
 - (2) A bank that managed a provident fund before this regulation went into effect, and which was authorized to do so by the Supervisor of Banks, may continue to manage that provident fund;
 - (3) A corporation for portfolio management may also engage in investment counseling;
- (d) A controlled corporation that engages in investments shall not extend credit; this regulation shall not apply to credit extended from the funds of a provident fund.

Preventing conflicts of interest in a corporation engaged in investments (6/98) (12/98) (1/01)

5. A banking corporation that controls a corporation that engages in investments shall take steps to prevent conflicts of interest, acting *inter alia* as follows:
 - (a) The composition of the board of directors of a controlled corporation that engages in investments shall be constituted in accordance with one of the following:
 - Insiders shall not be a majority of the directors, or
 - If the chairman of the board of directors is neither an insider, a director, nor an employee of the corporation or of a corporation controlled by it, insiders may be in a majority of one person.
 - (b) The directors of a controlled corporation that engages in investments who also serve as directors of another corporation that engages in investments shall not constitute more than one third of their total number; for this purpose, “another corporation that engages in investments” - excluding corporations that are involved in the same area of investments and are controlled by the same banking corporation.
 - (c) A director of a controlled corporation that engages in investments shall not serve simultaneously as a director of more than two other corporations that engage in

investments, except for corporations that engage in the same area of investments and are controlled by the same banking corporation.

- (d) A majority of the directors of a controlled corporation that engages in investments shall constitute a legal quorum for a meeting of the board of directors, provided that the directors participating in the meeting and serving on the board of directors of more than one corporation engaging in investments do not exceed a third of the number of participants; for this purpose, corporations engaging in the same area of investments and controlled by the same banking corporation shall be considered as one corporation.
- (e)
 - (1) The investments committee of a controlled corporation that engages in investments shall be appointed by the board of directors, a majority of its members shall be directors in that controlled corporation, and it shall determine the investments policy and policy regarding voting at the meetings of the corporations whose securities are held by that corporation. Neither insiders nor employees of the corporation or the corporation controlled by it shall be the majority at any meeting of the investments committee.
 - (2) The members of the investments committee who are not directors of the controlled corporation engaging in investments shall not be insiders and shall be subject respectively to the restrictions and qualifying requirements that apply to an outside director, as specified in sections 240 (a)-(c) and (e) of the Companies Law 5759–1999.
 - (3) If the investments committee has issued instructions regarding investments, the judgement in the framework of those instructions shall be made by a person who is not an insider, as stated in section (h).
- (f) A member of the investments committee of a controlled corporation that engages in investment shall not be a member of the investments committee of another corporation engaging in the same area of investments.
- (g) A member of the investments committee of a controlled corporation that engages in investments shall not, by virtue of his position in either another corporation that

engages in investments or in a banking corporation, have direct access to information regarding certain securities that is not in the public domain.

- (h) The employees and directors of a controlled corporation that engages in investments who have the judgement to make decisions regarding investments shall not be insiders. For this purpose, an employee of a banking corporation, an employee on loan, or an employee who is on unpaid leave shall not be considered an employee of the banking corporation.
- (i) The banking corporation shall not instruct or guide the controlled corporations that engage in investments about buying or selling any financial asset, voting on securities, or realizing rights associated with securities; however, there is no objection to passing on to those corporations a professional economic analysis of a certain corporation based on information that is in the public domain, provided that the unit or the related corporation passing on the analyses engage in such analyses as part of its ordinary business. There is also no objection to receiving a general analysis of trends or general opinions regarding investments that are not connected with investment in a particular corporation.
- (j) Paragraphs (a) through (f) shall not apply to a manager of a fund, who is subject to the provisions of the Funds Law.
- (k) This section shall not apply to a corporation whose sole business is assessing the value of companies.
- (l) Paragraph (a) shall not apply to a corporation for portfolio management or counseling, which is subject to the provisions of section 9(d) of the Counseling Law.

Control in a corporation engaged in investments (6/98) (12/98) (1/01)

6. The board of directors of a corporation engaged in the management of portfolios, provident funds, or underwriting shall appoint an audit committee as stated in section 25 (a)-(f) of [Regulation no. 301](#), and the tasks of the committee shall be as stated in section 26 of [Regulation no. 301](#). For the purposes of this section, a director who is not an insider shall be considered to be an outside director, provided the chairman of the board

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of directors and the general manager of the controlled corporation that engages in investments shall not serve on the audit committee.

7. The board of directors of a corporation engaged in the management of portfolios, provident funds, or underwriting shall appoint an internal auditor to the corporation as proposed by the audit committee. The internal auditor of the banking corporation that controls the corporation may be appointed to the said position of internal auditor.
8. The management of a controlled corporation that engages in investments shall determine an internal control system intended to ensure *inter alia* the following:
 - (a) Implementation of the corporation's policy and the guidelines of its management (including the investments committee), and the coordination of activity with customers' instructions.
 - (b) Separation of functions between persons making investment decisions for related bodies (e.g., portfolio management for related provident funds) and persons making investment decisions for other customers;
 - (c) Revoked;
 - (d) Periodical review of the performance of investments, comparing performances in the various areas;
 - (e) Definition of irregular activities and positions, determining a mechanism for monitoring and identifying such activities and positions, including analyzing securities transactions outside the stock exchange on the basis of the long-term behavior of the price of the security;
 - (f) Reporting to the authorities, as required by law.
9. The management of a controlled corporation engaged in the management of portfolios, provident funds, or funds, shall determine detailed procedures in the following respects:
 - (a) A system for splitting up transactions implemented in a centralized way for several customers;
 - (b) Transactions executed outside the stock exchange;
 - (c) Participating in issues;

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- (d) Corrections of errors.

Preventing conflicts of interest in counseling on securities investments (6/98) 12/98)

10. If a banking corporation has chosen to engage directly in counseling its clients about investing in securities (henceforth in this section “counseling”), it should separate its counseling activities from its other activities, in order to avoid the aforesaid conflicts of interest, by maintaining “Chinese walls”. The separation shall be established in written procedures that refer *inter alia* to the following subjects:

(a) **Organizational separation**

The banking corporation shall establish an organizational separation at the headquarters level between its activities in a counseling capacity and its other activities. This separation shall be expressed in a way that the counseling will be organized within the framework of a separate headquarters within the banking corporation, such as a branch, department, etc. (henceforth, the counseling unit), where all the employees and managers of the counseling unit shall be engaged at a given time in that area only.

The manager of the counseling unit will be subordinate in the managerial hierarchy to a member of the management of the banking corporation who is not responsible for the area of the credit or investments of the banking corporation (nostro).

(b) **Professional separation**

An employee who will coordinate, analyze, or transfer information, and will make recommendations to investment consultants regarding specific investments in various fields on the basis of economic analyses, shall deal solely with the analysis and transfer of data. The data, analyses, information, and recommendations that are conveyed to the investment consultants shall not be based on inside information.

(c) **Business separation**

The banking corporation shall act to prevent the transfer of inside information about the investment between its various units and its employees engaged in counseling, both in the counseling unit and in the branches. The separation shall include *inter alia* the following topics:

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- (1) The banking corporation shall not transfer to persons engaged in counseling information known to it through its other activities and which is not common knowledge or is based on data that are not in the public domain.
- (2) A person engaged in counseling shall not have access to data accumulated in other sections of the banking corporation, especially to data about the credit and investments of the banking corporation's customers and of the banking corporation itself. Notwithstanding, an investment consultant who has received a customer's written consent, may have access to the aforesaid data regarding that customer and concerning that counseling provided the customer is not a company whose securities are traded on the stock exchange.

Providing services for the good of the customer (6/98)

11. (a) Within the framework of the obligation of trust imposed on a banking corporation and a controlled corporation that engages in investments, they must act for the good of their customers, and not prefer their own personal interests or those of another over the good of their customers, or prefer the good of one customer over that of another.
- (b) In view of the aforesaid in subsection (a), a banking corporation and a controlled corporation that engages in investments shall not reward their employees by means of individual incentives to obtain investments in their own financial assets or those of their related companies, but it may reward employees of a branch for the branch's performance.
- (c) A banking corporation shall not charge a corporation that is controlled by it and engages in investments in the area of the management of funds or provident funds a commission for a securities transaction undertaken on behalf of the fund or provident fund that exceeds the accepted commission taken by the banking corporation for a transaction of that kind and extent.

Control of investment counseling

12. (a) The management of a banking corporation or controlled corporation engaged in investments counseling shall monitor the actual counseling given to its customers, at the level of both the customer and the individual consultant or branch.
- (b) The monitoring and analysis of the counseling trend according to an individual consultant or branch may be implemented by means of software that identifies and coordinates the transactions undertaken based on the counseling of each consultant or group of consultants of any branch. The monitoring may reveal biased counseling, concentration on certain investments when it is unreasonable to assume that different customers have the same needs, long-term holdings of investments intended for short-term, etc.

Rotation of office-holders (6/98)

13. (a) The management of a banking corporation or controlled corporation that engages in investments must establish and implement a policy assuring the rotation of office-holders in the field of investments.
- (b) Despite the aforesaid in subsection (a), the duty to establish a policy with respect to rotation does not refer to the occupations of consultants within the banking corporation, of portfolio managers, or of consultants in a corporation that engages in portfolio management or investments counseling.

Individual restrictions (6/98) 12/98)

13a. A banking corporation shall take steps to ensure that:

- (a) The individual restrictions on securities transactions by an employee who is a member of the stock exchange, as stated in section 52i. of the Securities Law, 5728–1968, shall also apply respectively to a director or an employee of a bank who is not a member of a stock exchange, and to a corporation controlled by either of them.
- (b) The individual restrictions on a director, member of the investments committee, and employee of a fund manager, as stated in section 21 of the Joint Investment Trusts

Law, 5754–1994 and in the joint investment trusts regulations (individual restrictions on a director, member of the investments committee, and employee of a fund manager), 5755–1995, shall apply respectively also to a director, member of the investments committee, and employee of another controlled corporation engaged in the management of provident funds.

(c) The aforesaid in this section shall not contradict the provisions of any law.

Documentation

14. All the discussions held and all the decisions reached in the professional forums that discuss investments and in the bodies approving these investments shall be documented in writing.

Exemptions (6/98)

15. A banking corporation or a corporation controlled by it that engages in the aforesaid areas of investments and which, because of its size, cannot implement the provisions specified above, may make an alternative proposal to the Supervisor of Banks that will express the aforesaid provisions. In such a case the Supervisor may approve the alternative proposal or parts of it, or may add restrictions to it.

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