INSTITUTIONAL INVESTORS AS CORPORATE MONITORS IN ISRAEL

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Introduction

Ever since 1932, when Adolph Berle and Gardiner Means described the central problem of corporate law as the separation of the ownership of a company from its control, scholars in the fields of law and economics

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have been searching for a solution.\textsuperscript{1} It is difficult for a company that wishes to grow to remain under family ownership. Few financiers are capable of raising by themselves large enough sums of money to fund the capital requirements of such a company, and, in any event, it is not worthwhile for them to invest all of their money in one company and to be exposed to the risk that the company may fail. A company that wishes to grow must therefore raise funds from a number of investors, and, if large sums of money are involved, from numerous investors.

Under such circumstances, it is not practical for every contributor to the company’s treasury to participate in its management, as in an Athenian democracy. The need to make immediate managerial decisions which accompanies the day to day running of the company requires that the wheel be placed in the hands of one investor, or in the hands of a group of investors, who agree among themselves on the proper way to steer it. It is preferable to hand over the control of the company to the investor, or group of investors, who invested the largest amounts of money in the company, and who therefore will exert themselves more than others in leading it to success. However, the separation of the control of the company from its ownership provides an opportunity to those who control the company to use it to their own benefit. Although they are supposed to represent the entire company, including all of its shareholders, there is a constant concern that, in the absence of monitoring, they will essentially represent themselves.

In theory, voting rights, which are usually given to shareholders in regard to making structural changes and manning key positions in the company, are supposed to serve as a monitoring instrument over the controlling shareholders. However, in practice, the masses of atomistic shareholders do not monitor the controlling shareholders. First, the larger the controlling block of the company, the less the chance that an opposing block will form and overcome it, and when the controlling block is made up of half of the company’s capital it overcomes all opposition. Second, even when the formation of a block opposing the controlling shareholders is possible, it is not practical. The limited voting power of each individual shareholder and the meager part of the company each holds makes their involvement in monitoring the controlling shareholders rewardless. Not only is the profit that can be gained by a rise in the value of their shares less than the cost of their involvement, but in any event

their involvement lacks any influence and it is better for them to save themselves the effort.\(^2\)

Shareholder apathy, which is the result of holding a small number of shares, can however be avoided. If a group of shareholders is large enough to influence the company and profit from this at the same time, it can be expected to show greater interest in the affairs of the company; and if such a group undertakes the task of monitoring, the other shareholders will also benefit.\(^3\) Such is the case with institutional investors. Since the extent of their investments in companies is much greater than that of individual investors, they should be less apathetic towards these companies and monitor the controlling shareholders in their place.

In light of the accelerated growth of institutional investment in the capital market during the last fifty years, and first signs of institutional-investor interest in corporate governance, this forecast seemed closer than ever. The possibility that institutional investors would become the watchdogs of public companies became a subject of great interest in the legal and economic circles of western countries.\(^4\)

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\(^2\) The first problem is that of "rational apathy", and the second is that of "free riding". Together they are known as "collective action problems". See R.C. Clark, Corporate Law (Little, Brown & Co., Boston, 1986) 389-394.

\(^3\) This idea was first proposed by Professor Conard. See A.F. Conard, "Beyond Managerialism: Investor Capitalism?", (1988) 22 U. Mich. J. L. Reform 117. Other solutions to agency problems include boards, in house comptrollers, audit committees, and inter-company competition in various markets, such as the product market, the capital market, the market for corporate control, and the labor market. The literature that deals with the shortcomings of these solutions is vast. For an overview of the main arguments, see G.W. Dent, "Toward Unifying Ownership and Control in the Public Corporation", (1989) Wisc. L. R. 881. It seems that there is no single panacea for agency problems, but rather the answer lies in combining all the solutions together. Apparently, institutional monitoring will also not be a perfect response to agency problems, although it will contribute to their control.

It is undeniable that institutional investors in western markets have awakened and begun following with greater interest the actions of the managers of companies whose stock they hold. Their interest has not only taken the form of tracking these actions, but also of asking questions and giving advice to company managers in areas that until now had been their exclusive dominion. They have begun appearing at stockholder meetings, participating, raising issues, voting, and even soliciting votes against management proposals. They have formed umbrella organizations for theoretical research and inter-institutional coordination, filed class action law suits and lobbied for changes in securities regulation that have facilitated their action on the capital market.5

Nevertheless, it seems that the excitement over this new and promising trend was premature. The ink had barely dried on articles forecasting greatness for the monitoring of companies by institutional investors, when it became clear that there were still a number of obstacles to be overcome before the end of agency problems could be proclaimed. Although


See Garten, ibid., at 643-648; Rock, ibid., at 449-450, 479-492; Black & Coffee, ibid., at 2017-2024, 2028-2055; Black, Shareholder Passivity Reexamined, ibid., at 570-575.
in light of the extent of institutional holdings it could have been expected that institutional investors would be deeply involved in corporate governance, their actual involvement was far more modest, almost disappointingly so, due mainly to profitability considerations.6

This article examines the feasibility of institutional monitoring of companies in Israel. Against the background of only partial success of institutional monitoring abroad, it is perhaps surprising that the young Israeli market, in which institutional investment is smaller than in other countries, is better suited to institutional monitoring of companies. The Israeli stock exchange is still very concentrated. In such a market, the agency problem exists in a different form than in a diffuse market. The typical agency problem in Israel does not involve conflicts of interest between the controlling shareholders and the company, but rather between the controlling shareholders and the non-controlling shareholders. There is no need for the controlling shareholders to be given incentives to improve a company’s performance — their being holders of the majority of the company’s shares makes them the principal benefactors of any improvement. Instead, what is needed is to prevent the controlling shareholders from taking for themselves more than their due share of the profits. In other words, the monitoring necessary for today’s Israeli capital market is not of the effectiveness of management but rather of the fair distribution of profits.

Fortunately, such monitoring is not only more suitable for the Israeli market, but it is also more profitable from the perspective of institutional investors. The increased voting power that Israeli law bestows upon non-controlling shareholders regarding the approval of related-party transactions, makes narrow-scoped monitoring possible. The cost of such monitoring is low and its application is not dependent on the support of the majority of the shareholders, but rather on the support of two-thirds, or even less, of the non-controlling shareholders. In a market where a small number of institutional investors hold two-thirds of the shares that are not held by related parties, this kind of monitoring is practical and its beginnings can already be seen. New Israeli legislation, which requires institutional investors to participate and to vote in general meetings of portfolio companies, may even speed up the process

6 See Rock, ibid., at 451, 481-489; Coffee, Half-Time Report, supra n. 4, at 843-846; Fisch, supra n. 4, at 1029.
and accustom the institutional investors to their new role as the watchdogs of public companies. This rationale is the key to the proper interpretation of the new legislation: the extent of the duty to vote must be determined by the character of the conflicts of interest that afflict company management. The typical conflicts of interest that are characteristic of companies in the Israeli market today are, as has been stated, related to the distribution of profits between controlling and non-controlling shareholders. On this must the institutional duty to vote be focused.

Narrow-scoped monitoring does not have to be the end of the story. It is suitable for most of the companies in the Israeli market, which today are controlled by means of large controlling blocks. However, even today there are companies in Israel with small controlling blocks, and their numbers are increasing. Wide-scoped monitoring is suitable for such companies, and perhaps with time institutional investors will arrive at this themselves, or perhaps they will be required to carry out such monitoring by law. Increased voting power, which allows them to approve or reject related-party transactions, together with the regular voting power they will acquire as a result of the dilution of controlling-shareholder holdings, can serve as a means of significant influence to this end. However, wide-scoped monitoring still is not essential in Israel, and, at the present time, it is better to maintain only narrow-scoped institutional monitoring, and to allow the various players in the market to adjust to it.

The following parts will detail what has been outlined above. Part I extends the theoretical basis of institutional monitoring as a means of constraining conflicts of interest within companies, and sets forth the characteristics of the typical conflicts of interest found in the concentrated Israeli market. Part II presents the practical side of institutional monitoring in Israel, and examines the suitability of the legislation in this area to solving the kinds of conflicts of interest that are characteristic of Israeli companies. Part III deals with possible future expansion of institutional monitoring in Israel in accordance with changes in the holdings structure in the market and changes in the nature of the conflicts of interest that would follow.
I. The Theoretical Basis of Institutional Monitoring

A. What is Wide-Scope Monitoring?

In a diffuse capital market, in which the companies are characterized by small controlling blocks, the non-controlling shareholders, as a whole, hold a majority of the shares. What is good for the non-controlling shareholders is good for the company: when the company profits they profit also, and when the company incurs losses they too lose. This alignment of interests exists both on a theoretical as well as on a practical level. It exists on a theoretical level because, as a whole, the non-controlling shareholders own almost the entire company. It exists on a practical level because, lacking any influence over the company's management, their sole interest is in the value of their shares, which reflects the company's success.

Such alignment of interests does not exist among typical controlling shareholders in a diffuse market, who hold a block of shares significantly smaller than half of a company's share capital. Whereas the benefit they derive from the company's success is partial and in accord with their portion of the shares, the benefit they derive from exploiting their position in the company is complete and they do not share it with the other shareholders. If one adds to this the fact that profits gained by making management more effective come in the future and are risky, whereas profits gained by diverting company resources to the pockets of the controlling shareholders are immediate and without risk, then it will become clear that there is a strong temptation for the controlling shareholders to neglect company affairs.

Consequently, the agency problem in a diffuse stock market takes the form of conflicts of interest between the controlling shareholders and the entire company, and therefore the non-controlling shareholders in such markets should not only monitor the integrity of the controlling shareholders, lest they will divert company resources to themselves, but also monitor their effectiveness, lest they will cause losses to the company.

The United States and England belong to this group of capital markets. In fact, institutional-investor activism in these countries is

Approximately 63% of Fortune 500 companies are controlled by less than half of their stock. See R.J. Daniels & J.G. MacIntosh, “Toward a Distinctive Canadian Corporate Law Regime”, (1991) 29 Osgoode Hall L. J. 863, at 884. For data on a similar dispersal of shares in England, see J. Scott, Capitalist Property and Financial Power: A Comparative Study of Britain, the United States and Japan (Wheatsheaf Books, Brighton, 1986) 52-54.
directed mainly toward maximizing company value. The most vigorous battle was waged by the active institutional investors in the United States — the public pension funds — against management antitakeover defensive measures. Whether this battle was intended to prevent a drop in share value following the adoption of such entrenchment measures, whether it was intended to obtain higher premiums from bidders, or whether it was intended to expose underperforming managers to replacement, the guiding principle behind it was to maximize the value of the shares held by the institutional investors. With the demise of hostile takeovers, institutional investors in the United States turned to closer monitoring of companies in additional areas, in order to improve company performance and thus to maximize share value. Monitoring management effectiveness and company profitability is also characteristic of institutional investors in England: as long as the company operates within reasonable fluctuations in share value, a passive tracking of it takes place. Institutional intervention is reserved for times of crisis in the company.

B. What is Narrow-Scoped Monitoring?

In a concentrated capital market, in which companies are characterized by large controlling blocks, the controlling shareholders hold an overwhelming majority of the shares. Here, as opposed to a diffuse market, the interests of the controlling shareholders are more closely

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10 See Black & Coffee, supra n. 4, at 2053.
aligned with the company's interests. Their large share of the company’s capital makes them central partners in both profits and losses.\textsuperscript{11} If they drive the company to losses they will suffer from this more than the non-controlling shareholders, and if they lead the company to economic prosperity they will be the first to benefit from it.\textsuperscript{12} The typical conflicts of interest in companies under such conditions are not between the controlling shareholders and the company as a whole, but rather between the controlling shareholders and the non-controlling shareholders.

Israel and Canada belong to this group of capital markets.\textsuperscript{13} As a result of the alignment of interests between the controlling shareholders and the companies in the Israeli market, it is not essential for the non-controlling shareholders to watch the steps of the controlling shareholders. Even without monitoring, the controlling shareholders will make all efforts to improve company performance, which is primarily their asset. The main concern of the non-controlling shareholders, and especially of the institutional investors, who today hold two-thirds of non-controlling shares in the Israeli stock exchange,\textsuperscript{14} is to prevent the

\textsuperscript{11} For the convergence of the interests of controlling shareholders with the interests of shareholders as a whole, as controlling-shareholder holdings increase, see M.C. Jensen & W.H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure”, (1976) 3 J. Fin. Econ. 305, at 312-313. For a compilation of empirical evidence demonstrating the relationship of company effectiveness to the size of its controlling block, see Black, \textit{Institutional Monitoring, supra} n. 4, at 917-921.

\textsuperscript{12} This is the case both in absolute terms, because they hold a majority of the shares, as well as relatively, as they are less diversified.


\textsuperscript{14} See \textit{supra} n. 13.
unfair distribution of company wealth. In other words, the institutional
investors in Israel are exempt from the need to “increase the pie” by
means of ensuring effective management of the company. The controlling
shareholders have a strong incentive to see to this themselves. All that
the institutional investors in Israel have to do is to ensure that they are
not deprived of their “share of the pie”.

This is also the tendency of institutional investors in Canada. Instead
of focusing on company transactions on the market, they are primarily
interested in company transactions with related parties. Institutional-
investor involvement in this area is so widespread that it is difficult for
a public company to announce its intention to undertake a transaction
with one of its related parties without receiving the blessing of its large
institutional investors.\textsuperscript{15} The position of the institutional investors is
given considerable weight because Canadian regulations require that
these transactions be approved by a majority of the non-controlling
shareholders.\textsuperscript{16}

C. The Profitability of Narrow-Scoped Monitoring for Institutional
Investors

The mere fact that narrow-scoped monitoring of companies is beneficial
to the Israeli economy is not enough to cause institutional investors to

\textsuperscript{15} See Daniels & Waitzer, supra n. 4, at 35.
\textsuperscript{16} See MacIntosh, supra n. 4, at 377 n. 15, 383, 428; Daniels & MacIntosh, supra n. 7,
at 897, 929-932; Ontario Stock Commission Policy Statement 9.1 — Disclosure,
Valuation, Review and Approval Requirements and Recommendations for Insider
Bids, Issuer Bids, Going Private Transactions and Related Party Transactions,
(1991) 14 O.S.C.B. 3345, §§ 20, 30-33 (related-party transactions whose value exceeds
one-quarter of the company market capitalization are subject to minority approval,
and in some cases the approval of two-thirds of the minority is required). In the
United States a different rule applies. Although shareholder approval is given some
weight, and more substantial weight is given to minority approval, the law settles
for the approval by a majority of the non-interested directors, and in any event the
principal test is that of fairness. See Clark, supra n. 2, at 166-189. See also E.P. Welch
(Little, Brown & Co., Boston, 1993) 230-241; M.L. Small, “Conflicts of Interest and
Law. 1377; J.F. Johnston & F.H. Alexander, “The Effect of Disinterested Director
Approval of Conflicts Transactions Under the ALI Corporate Governance Project —
take it upon themselves to monitor. Institutional investors are business-minded entities whose sole purpose is to make a profit. They will monitor the companies that make up their investment portfolios only if such monitoring is profitable to them.\textsuperscript{17} Fortunately, narrow-scoped monitoring is more profitable than wide-scoped monitoring, not only from the perspective of the general public but also from the perspective of the institutional investors.

First, it is easier to identify a business decision that is intended to loot the company than it is to identify a merely unsuccessful business decision. In the first instance, one is dealing with a specific transaction, usually one between the company and a related party, whose mere existence attracts attention and casts suspicion on it.\textsuperscript{18} In the second instance, one is dealing with one of many transactions, or a faulty business strategy, in which it is difficult to point out exactly where the flaws lie.\textsuperscript{19} Failures of the company which are the result of such faulty business decisions often become clear only in retrospect, whereas at the time they are made the decisions seem reasonable, or at least not groundless. Moreover, whereas monitoring management effectiveness requires both institutional initiative and institutional response to controlling-shareholder initiative, monitoring the fair distribution of profits requires only institutional response to controlling-shareholder initiative. This reduces the number of instances in which the institutional investors must consider intervening in company affairs and delineates them in advance. The relative ease with which business decisions that enrich the controlling shareholders at the company’s expense can be detected reduces the cost of their monitoring.

Second, in the event of an attempt by the controlling shareholders to loot the company, not only is it easier to diagnose the disease than in the event of ineffective management, but also the cure for the disease is more readily available. All that is required of the institutional investors


\textsuperscript{18} Nonetheless, not every related-party transaction is illegitimate: the transaction may be in accordance with market terms, and may even be better than a transaction between the company and an outsider. See Clark, supra n. 2, at 184. Obviously, when the transaction sets the terms of employment of the related party in the company, it is not preventable, and the sole question is whether the terms are not too generous towards the related party. See \textit{ibid.}, at 148.

\textsuperscript{19} See Daniels & Waitzer, supra n. 4, at 35.
is to oppose the conferring of benefits on the controlling shareholders. In contrast to monitoring management effectiveness, here the institutional investors are not required to thoroughly analyze the problems that the company faces, and to provide a solution to these problems. Thus, they are spared the trouble of conducting an in-depth study of the business condition of the company, of the business sector it belongs to, and of the entire market. They are also spared the difficulty of coordinating among themselves a uniform position as to the steps necessary to improve company performance. It is one thing to agree that there is room for improvement, but it is another thing to agree upon the necessary improvements.

Third, the benefit that non-controlling shareholders gain by preventing the transfer of wealth from them to controlling shareholders is more tangible than the benefit that they might derive from monitoring the overall quality of management. A dubious transaction that enriches the controlling shareholders does not create wealth for the company, but instead detracts from it. Opposition of the non-controlling shareholders to such a transaction therefore prevents an immediate loss to them, equal to the profit that was to be made by the controlling shareholders. On the other hand, a business error made by management rarely seems patently erroneous when made, and in any event there is no guarantee that another business decision would yield better results. In other words, monitoring fairness produces immediate and certain profit whereas monitoring effectiveness produces only uncertain future profit. Furthermore, the profit that can be expected from monitoring effective company management is shared by all shareholders, of whom the principal benefactors in a concentrated market are the controlling shareholders, who hold most of the shares. In contrast, the profit that can be expected from monitoring fair distribution of company resources will be captured completely by the non-controlling shareholders.

20 See *ibid.*., at 35-36.
21 In the United States it has been argued that the great interest that institutional investors have demonstrated in fostering the market for corporate control is an exception to their general indifference. The traditional apathy that derives from legal constraints, economic considerations, and conflicts of interest, disappears the moment that the profit from selling shares in a takeover becomes clear. See M.J. Roe, “The Modern Corporation and Private Pensions”, (1993) 41 UCLA L. R. 75, at 94-95; Rock, *supra* n. 4, at 484-486; Ferrara & Zirlin, *supra* n. 4, at 354. On the importance of profit and loss considerations among institutional investors, see *supra* n. 17.
Fourth, as opposed to monitoring the wisdom of all business decisions made by management, monitoring decisions that are unfair towards non-controlling shareholders requires less expertise.\textsuperscript{23} Whereas in the first instance considerable time and resources are required for in-depth study of the possible courses of action facing the company and for choosing the best course from among them, the second instance requires much less. Here, one is not dealing with setting a comprehensive business policy for the company, and the choice is not between numerous alternative business opportunities. Instead, one is dealing with the examination of one business decision whose faultiness is more easily detected whenever it enters the forbidden sphere of unfair self-dealing. In addition, when a transaction between a company and the controlling shareholders — which is the usual means for the company to transfer wealth to them — is on the agenda, the main question is that of the price, and not of the very existence of the transaction. The non-controlling shareholders are usually not required to question the need to undertake such a transaction. They are only required to examine the desirability of the specific transaction that is involved, and can approve it on the condition that its cost to the company, and essentially to them, will be cheaper than what was originally proposed. Institutional investors who perform this kind of monitoring are exempt from employing an army of management specialists to serve as investigators of every single company in their portfolios. Setting up a research division to track the various commercial sectors in which these companies operate is equally

\textsuperscript{23} Institutional-investor lack of expertise in managing companies has been mentioned more than once as an obstacle to institutional monitoring in the United States. Whereas company management is familiar with its day to day operation, the company is just one of many for the institutional investor. Consequently, the institutional investors have no advantage over the management, and institutional interference in company affairs is liable to cause damage. For attempts to deal with this problem, see Black, Shareholder Passivity Reexamined, supra n. 4, at 580-584; Black, Agents Watching Agents, supra n. 4, at 854; Grundfest, supra n. 4, at 926. Apparently, this problem is prominent in Israel when dealing with provident funds, who by the end of 1995 had only 11.2% of their capital invested in shares and another 9.1% in non-governmental bonds. The reminder of their investments were not in companies. See Developments in the Capital and Finance Markets: 1995 Annual Survey (Bank of Israel, Jerusalem, 1996, in Hebrew) (hereinafter: 1995 Annual Survey) 120.
unnecessary. All that is required is a basic familiarity with the market and, especially, common sense.\textsuperscript{24}

Fifth, monitoring profit distribution between controlling shareholders and non-controlling shareholders can be expected to encounter little public opposition.\textsuperscript{25} Institutional-investor intervention in corporate governance in Israel and abroad has led to vigorous criticism from among the ranks of company managers, law-makers, and the general public. This criticism is founded on two main claims: the lack of faith in the ability of institutional investors, whose expertise is in the field of investment and not in the field of management, to know how to run a company better than its management,\textsuperscript{26} and the concern that institutional investors will gain power to the point where they will have potentially hazardous control over the economy.\textsuperscript{27} As has been stated, these two claims are weakened if institutional investors leave the managing to the managers, and focus on protecting the rights of non-controlling shareholders. Exerting institutional influence over companies seems less threatening when it is used as a shield to protect non-controlling shareholders from being deprived of their rights, rather than using it as a sword to impose the will of the minority over the majority. In Western eyes, the majority rule, which in this case is the majority of shares, is viewed as natural and understandable, yet the minority's

\textsuperscript{24} Because both mutual funds and provident funds are managed mainly by banks, who themselves hold shares and are involved in the capital market as underwriters and creditors of companies, the expertise problem in any event is reduced. In addition, the funds themselves loan money to companies by acquiring their bonds. This centralization in the Israeli capital market is perhaps a source of institutional conflicts of interest, but it also allows for specialization and professionalism of the banks as institutional investment managers. On the advantages of institutional investors who are also creditors, see Black & Coffee, supra n. 4, at 2073-2074; Gilson & Kraakman, supra n. 4, at 878. On the advantages of institutional investors who are also private investors, see Black & Coffee, ibid., at 2081.

\textsuperscript{25} It is difficult to exaggerate the power of such public opposition to suppress institutional monitoring today just as it has suppressed both institutional activism and hostile takeovers in the past. See M.J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (Princeton University Press, Princeton, 1994).

\textsuperscript{26} See, e.g., L. Lowenstein, “More Like Whom?”, (1993) 18 J. Corp. L. 697, at 705.

standing up for its rights also is viewed as natural as long as it does not go beyond this. Not only is there economic sense in handing the management of a company over to the majority shareholders and putting the monitoring of orderly management in the hands of the minority shareholders, but there is also a basis for believing that such role allocation will be acceptable to the players in the market: the institutional investors, the managers, the law-makers, and the general public.

II. Institutional Monitoring in Israel: From Theory to Practice

A. Legislative History

In 1991, Part D1, which deals with the liability of company officers, was added to the Companies Ordinance (New Version), 1983. Section 96-36, which was then added, subjects certain related-party transactions to the approval of at least one-third of the votes of shareholders who are not interested parties and who are present at the general meeting. The transactions covered by section 96-36 are those between an officer who holds one-quarter or more of the means of control in a publicly traded company and the company itself, that involve the conditions of his employment, extraordinary transactions between the company and the officer, and extraordinary transactions between the company and another person in which the officer has an interest.\(^{28}\) In 1994, the Securities Regulations (Limitations on Conflicts of Interest Between a Listed Company and a Controlholder) were promulgated, and provided, in regulation 12, that similar approval would be required also for extraordinary transactions between a publicly traded company and a non-officer controlholder, or extraordinary transactions between the

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\(^{28}\) See section 96-36 of the Companies Ordinance (New Version), 1983 (D.M.I. 716) (hereinafter: the Companies Ordinance) which was added in the Law for Amending the Companies Ordinance (No. 4) (Officer Liability), 1991 (S.H. 132). Section 96-36(c) of the Companies Ordinance extends the rule also to the situation where a majority of the directors who hold one-quarter or more of the means of control in the company have an interest in a transaction. The term “extraordinary transaction” is defined in section 96-24 of the Companies Ordinance as “a transaction not in the company's regular course of business, or not in market terms, or a transaction that may significantly affect the company's profitability, property, or commitments”.

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company and another person in which the controlholder has an interest.\textsuperscript{29} As a result of this law and these regulations, the controlling shareholders in publicly traded companies became dependent on the support of the non-controlling shareholders in order to undertake transactions with the company which are to their advantage.\textsuperscript{30} Since the many small shareholders who hold their shares through depository companies never participate in general meetings, the decision to approve or reject a proposal is for all intents and purposes placed in the hands of the institutional investors. All the institutional investors have to do to prevent a certain transaction is to send a representative to the general meeting to vote against it. Since those who would not oppose the transaction do not trouble themselves to come to the meeting, theoretically, one opponent is enough to block approval of the transaction.

However, the extra voting power that was given to institutional investors remained unused.\textsuperscript{31} Consequently, the Mutual Investments in

\textsuperscript{29} See regulation 12 of the Securities Regulations (Limitations on Conflicts of Interest Between a Listed Company and a Controlholder), 1994 (\textit{K.T.} 905) (hereinafter: the Conflicts of Interest Regulations). Sections 232, 284-291 of the Companies Bill, 1995 (\textit{H.H.} 2) (hereinafter: the Companies Bill) combine the provisions of the Conflicts of Interest Regulations and Part D1 of the Companies Ordinance. Section 231 of the proposed bill extends the application of this arrangement to extraordinary transactions between the company and any of its shareholders, when a majority of the members of the audit committee have an interest in the transaction. Section 233 of the proposed bill adds several problematic exemptions to the requirement for the approval of one-third of the minority shareholders, which might open up a loophole for getting around this requirement. In this paper, the existing provisions are considered.

\textsuperscript{30} The foundation for a more stringent regime was set in \textit{Clal Industries Ltd. v. Leumi Pia, Mutual Fund Management Company Ltd.}, (1993) 47(ii) P.D. 329 (hereinafter: the \textit{Clal Industries} case). In this case, the Supreme Court held that the enrichment of one group of shareholders at the expense of another group is subject to approval by the majority of the prejudiced shareholders. Although the court set this rule in the context of the compensation of preferred shareholders within the framework of company recapitalization, it also ruled that the distinction between groups of shareholders within the company is not made according to the class of shares they hold but rather according to their adverse interests. Consequently, future case law may develop the rule set in the \textit{Clal Industries} case, and apply it to additional instances of conflicts of interest between shareholders, even if they hold the same class of shares.

Trust Law of 1994 was enacted, and provided that mutual fund managers are required to participate and vote in general meetings of their portfolio companies whenever a proposal which can advance or harm the interests of the fund unit owners is brought up for approval at the meeting. In addition, the law also provides that a transaction with a related party is considered potentially harmful to the interests of the unit owners. Since practically all proposals may harm or advance the interests of the unit owners, the result of the law seems to be that all mutual fund managers are required to participate in all general meetings of all companies in which the fund has any holdings whatsoever. In any event, since violating the duty to be present and vote is a criminal offense in which there is a presumption of negligence and is punishable by a heavy fine, mutual fund managers are not willing to take any chances and send representatives to practically all general meetings. In addition to the Mutual Investments in Trust Law, the Provident Funds Bill prepared by the Ministry of Finance provides that an analogous duty will apply to managers of provident funds as well. As an interim arrangement, the Ministry of Finance instructed provident fund managers to act in accordance with this duty as part of the fiduciary duties they owe to their clients.

32 See section 77 of the Mutual Investments in Trust Law, 1994 (S.H. 308) (hereinafter: the Mutual Investments in Trust Law). According to this section, mutual fund managers are required to present a report to the Securities Authority and to the Registrar of Companies. The information to be included in this report was determined in regulation 27 of the Mutual Investments in Trust Regulations (Immediate Reports, Monthly Reports, Unit Holding Reports, and Reports on the Voting in General Meetings), 1994 (K.T. 304).

33 See section 123(4) of the Mutual Investments in Trust Law.

34 See section 43 of the Provident Funds Bill, 1996 (H.H. 360) (hereinafter: the Provident Funds Bill).

35 This directive was issued in Provident Fund Bulletin, No. 265, Oct. 10, 1994. The directive also requires provident fund managers to vote whenever the fund holds five percent of a certain security (this, however, has been left out of the Provident Funds Bill). According to the directive issued in Provident Fund Bulletin No. 274, May 2, 1996, provident fund managers are required to report to the Capital Market, Insurance, and Savings Department of the Ministry of Finance on their voting at general meetings.
B. The Profitability of Monitoring for Institutional Investors in Israel

The United States discovered institutional investors at the end of the 1980’s, when their holdings went beyond fifty percent of all the shares on the American stock market, and the takeover mania that had swept the market for a decade had died down. However, both the expectations and the concerns regarding institutional investors were exaggerated, since their activism proved to be limited in comparison to what could have been expected in light of their control over the capital market.\(^{36}\) It became clear that even though they increased the level of concentration in the capital market, they did not increase it enough to overcome the apathy typical of non-controlling shareholders. Although the world of Berle and Means has changed, it is still recognizable. American institutional investors widely diversify their portfolios,\(^{37}\) and invest a considerable part of them according to stock indices.\(^{38}\) In addition to this, the limited number of shares held by each institutional investor in every company is divided among a number of investment managers who compete among themselves, thus creating dispersion on top of dispersion.\(^{39}\) In order to perform institutional monitoring, cooperation among a large number of investment managers is required, yet such cooperation is rare.\(^{40}\) Normally, the extent of a single institutional investor’s investment in one company does not justify monitoring it from his perspective, and the extent of the investment of every investment manager it employs justifies such monitoring even less so.\(^{41}\) Since

\(^{36}\) See supra n. 6.

\(^{37}\) See Coffee, Liquidity Versus Control, supra n. 4, at 1314-1315; Rock, supra n. 4, at 473; Garten, supra n. 4, at 623; Black, Agents Watching Agents, supra n. 4, at 886.


\(^{39}\) See Coffee, Half-Time Report, supra n. 4, at 867.

\(^{40}\) See ibid.

\(^{41}\) See Rock, supra n. 4, at 473; Coffee, Liquidity Versus Control, supra n. 4, at 1326-1327.
investment managers' compensation is only a fraction of the value of the portfolio they manage, and the investments they manage are at most a fraction of a company's share capital, there is no economic incentive for them to commit resources to monitoring: in any event they bear all the costs and practically do not benefit from the profits, and their performance is examined in comparison to the performance of other investment managers who invest in the same companies and share the same profits. Consequently, everyone of them prefers to sit idly by and let others do the monitoring. Instead of increasing the profits, they compete among themselves by decreasing the costs of managing the portfolio. In effect, institutional investors, and even more so institutional investment managers in the United States, exhibit rational apathy similar to that of private investors.

The reluctance of investment managers to bear the costs of monitoring from which others will also benefit would be less if they held a larger stake in the company than the average stake held by their competitors. Their profit from monitoring would then be greater than that of other investment managers, who take advantage of their labors. However, overweights certain stock in their investment portfolios would come at the expense of less liquidity and increased exposure to company-specific risks, and would undermine the economic rationale of having an indexed portfolio. In contrast, the profit gained from selling bad stock, is profit that investment managers do not share with anybody.

In Israel things are different. Despite the fact that the holdings of institutional investors are smaller than those of their American

42 See Coffee, Half-Time Report, supra n. 4, at 863-864; Pozen, supra n. 17, at 144. Cf. Stepak, supra n. 31, at 85-88. In the United States, this is in part the result of legal provisions that limit incentive compensation. See Coffee, Half-Time Report, ibid., at 865-866; Coffee, Liquidity Versus Control, ibid., at 1326-1327. Still, the English experience indicates that even in the absence of legal constraints, incentive compensation is a parity as a result of market forces. See Black & Coffee, supra n. 4, at 2058.

43 See Rock, supra n. 4, at 473; Fisch, supra n. 4, at 1019-1025. For a different perspective, see Black, Agents Watching Agents, supra n. 4, at 876-881.


45 See Black & Coffee, supra n. 4, at 2070; Fisch, supra n. 4, at 1024-1025.
counterparts, in Israel they are more concentrated. First, institutional portfolios in Israel are less diversified than institutional portfolios in the United States, since the number of shares to choose from is significantly smaller and because Israeli institutions concentrate their investments in only some of the shares traded on the stock exchange. Second, the Israeli institutions themselves are limited in number. In Israel, a small group of banks command all sectors of institutional investment: the three largest banks manage three-quarters of the assets of the provident and mutual funds. They have little difficulty coordinating their positions and voting together against a questionable transaction between a company and a related party. This situation is different than that in countries where there is a wide range of independent institutional investors who require the mediation of coordinating organizations in order to form an influential opposition, and who face strict legal constraints.

Moreover, indexed investment is not widespread in Israel, and the institutional investors differ from one another in choosing which shares to invest in. Every investment manager manages a portfolio which is characteristic to him, and overweights his favorite stocks. There certainly could be a situation where an institutional investor would be willing to commit resources to monitoring a certain company whose stock is of considerable importance in his portfolio, knowing that he would profit from its improvement more than other institutional investors.

Another reason for the applicability of institutional monitoring in Israel is not related to the concentration of institutional investment, but rather to the fact that narrow-scoped monitoring is called for. Unlike wide-scoped monitoring, narrow-scoped monitoring is profitable independent of the size of the institutional investment in the company. Since the cost of narrow-scoped monitoring is insignificant and its benefit is tangible, institutional rational apathy is avoided to a great extent. Furthermore, due to the profitability of narrow-scoped monitoring,
it is worthwhile for institutional investors to monitor, even when their holdings are not long range. Since the benefit derived from opposing the depletion of company resources by controlling shareholders is immediate, and since the cost of opposition is low, narrow-scoped monitoring becomes profitable even for institutional investors who have rapid turnovers in their portfolios. Consequently, even in the limited framework of institutional holdings in Israel, it is worthwhile for institutional investors to perform narrow-scoped monitoring of companies.  

C. The Rationale of Legislation that Requires Institutional Investors to Monitor

Compelling an institutional investor to participate and vote in general meetings is not enough to compel him to care. The American experience shows that a legal obligation per se does not create true institutional-investor involvement in corporate governance, but rather an economic incentive is required. In order for institutional investors to fully acquaint themselves with a company and the proposals on its agenda, and to vote intelligently, this must be profitable for them. If it is not profitable, their vote will merely be window dressing. This insight is demonstrated in pension-fund behavior in the United States, that is only marginally motivated by the legal duty to vote. Whereas public pension funds, which are not required to monitor companies, are the pioneers of


51 See Coffee, Liquidity Versus Control, supra n. 4, at 1353. An additional cost considered by institutional investors is the loss of access to soft information about a company as a result of confrontation with controlling shareholders. See Conard, supra n. 3, at 146, 149-150; Coffee, Liquidity Versus Control, ibid., at 1323-1324; Black, Shareholder Passivity Reexamined, supra n. 4, at 602.
institutional monitoring, it is private pension funds, which are subordinate to the directive of the Department of Labor to exercise their voting rights to the benefit of their clients, that consistently support company management. The loyalty to company managers, the employers of these fund managers, is apparently stronger than any other loyalty.

In Israel, as has been stated, the conditions are more suitable for institutional monitoring than in the United States. First, the kind of monitoring which is needed in Israel today is of a more limited scope than that which is needed in the United States. Second, the increased voting power that non-controlling shareholders have regarding the approval of related-party transactions facilitates such monitoring. Third, institutional investment in Israel is more concentrated than in the United States. The economic incentive for the institutional investors in Israel to monitor companies exists even without their being required to do so. This can be seen in the narrow-scoped institutional monitoring that had begun to take shape even before institutional investors were required to perform it. If such is the case, is there any point in having legislation that compels institutional investors to participate in general meetings?

I believe that there is. First, the concentration of shares in the hands of institutional investors in Israel is a new development which has emerged in the last few years as a consequence of the reforms in the


53 See Coffee, Liquidity Versus Control, supra n. 4, at 1353; Rock, ibid., at 476-478. For a more positive tone, see Black, Shareholder Passivity Reexamined, supra n. 4, at 597-598. The source of this directive is a letter from 1988 known as “the Avon Letter”. See Grundfest, supra n. 4, at 921. The directive was updated in greater detail by the American Department of Labor in 1994. See Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 C.F.R. § 2509.94-2 (1994).

capital market,\textsuperscript{55} and hence institutional investors are still captives of the traditional avoidance of intervention, and the selling of bad stock.\textsuperscript{56} Imposing a duty to vote in the company can overcome the inertia that preserves traditional modes of institutional behavior and speed up the adjustment of institutional investors to the role of corporate monitors.

Second, apart from the function of the legislation to change traditional modes of behavior and accustom institutional investors to continuous involvement in corporate governance, it has an additional role: to reduce collective action costs, which are a major impediment to the institutional monitoring of companies.\textsuperscript{57} Since an institutional investment manager does not himself hold enough shares to influence company management, the coordinated action of a number of such investment managers is required. However, since it is not possible to compel every one of them to bear the costs of monitoring, including the costs of obtaining information about a company, they tend to dodge responsibility by relying on monitoring performed by others. An answer to the collective action problem can be found by either making the monitoring more profitable for the individual investment manager or by compelling all investment managers to bear the costs of monitoring.

The first step is accomplished by legislation that confers on non-controlling shareholders increased voting power regarding the approval

\textsuperscript{55} Between 1985-1994, the institutional-investor portion of the stock market, which consists mostly of mutual fund and provident fund investments, increased from 10% to 20%. See Hauser & Shohet, supra n. 31, at 4 (regarding 1985 data); Bank of Israel: 1995 Report (Bank of Israel, Jerusalem, 1996, in Hebrew) (hereinafter: 1995 Report) 293-294 (regarding 1994 data). The year of 1995, however, was marked by a dramatic drop in institutional share holding. By the end of 1995, provident funds held 10% of the shares on the market, and mutual funds held 6.5%. See 1995 Report, ibid. This was the result of the withdrawal of investor money in light of poor fund performance, the uncovering of several corruption scandals, and the growing importance of saving accounts and pension funds as alternative channels for investment in 1994. See 1995 Annual Survey, supra n. 23, at 67-75.


\textsuperscript{57} See Black, Shareholder Passivity Reexamined, supra n. 4, at 590; Grundfest, ibid., at 909. Even in Israel, where three banks command three-quarters of all institutional investments (15% of the shares overall), free riding and rational apathy may undermine monitoring.
of related-party transactions. This way, the cost of monitoring is reduced while, at the same time, profitability is increased. The second step is accomplished by legislation that mandates the institutional investors, who are a majority of the non-controlling shareholders, to monitor the controlling shareholders. This way, institutional investment managers are prevented from relying on the monitoring performed by others. Since they are obligated to vote, and because the manner of their voting is reported to the authorities and to the public, it is worthwhile for them to obtain the information necessary for effective monitoring, and to vote intelligently.

D. Legislation and Proper Interpretation: Narrow-Scoped Monitoring

Mandatory legislation that intervenes in the market mechanism is economically justifiable only when there is a market failure that impedes achieving the best result by market forces alone. Collective action problems are a typical example of market failure and justify legislative intervention. However, reforming legislation must not exceed the bounds of reforming the market failure for which it was introduced. Over intervention in the market mechanism can be counterproductive. The agency problem in Israeli companies takes the form of the exploitation of company resources by the controlling shareholders, while at the same time market failure that originates from share dispersal reduces institutional-investor willingness to commit resources to resist this unfair self-dealing. Legislation that compels institutional investors to vote and to report the way they voted can mend the market failure and be economically justifiable. However, legislation that would drag institutional investors into also monitoring the wisdom of business decisions taken by controlling shareholders, would be excessive and would not be beneficial to the Israeli economy.

58 See supra nn. 18-24 and the accompanying text.
59 Cf. Black, Shareholder Passivity Reexamined, supra n. 4, at 590.
61 Therefore, imposing a duty to vote on institutional investors is justified independent of the size of their holdings. Such detachment forces every institutional investor to monitor the company notwithstanding his chances to influence it and to benefit from this, and thus is essential for preventing rational apathy and free riding.
Section 77 of the Mutual Investments in Trust Law and section 43 of the Provident Funds Bill require institutional investment managers to participate in general meetings and to vote whenever a proposal that is brought up for approval can harm or advance the interests of their clients. At first glance, this seems to cover every possible situation. It is difficult to imagine a proposal brought up for approval at a general meeting that would not have some effect on the holders of the company’s issued securities and hence on the clients of institutional investors who hold them. Yet, an examination of these sections, in light of the economic justification for their enactment, leads to a different interpretation. According to this interpretation, the duty to participate and vote applies only when conflicts of interest among the controlling shareholders are apparent. In other situations, there is no reason for

62 Apart from related-party transactions, the following decisions are also subject to approval at general meetings: changes in company bylaws (section 15 of the Companies Ordinance); changes in the articles of incorporation (section 25 of the Companies Ordinance); privatization of the company (section 42 of the Companies Ordinance); setting director compensation (section 85 of the Companies Ordinance); transfer of office from one director to another (section 94 of the Companies Ordinance); making director and executive liability unlimited (section 96 of the Companies Ordinance); recapitalization (sections 144, 151 of the Companies Ordinance); compromise or arrangement of a company in liquidation (section 233 of the Companies Ordinance); liquidation (sections 257, 319 of the Companies Ordinance); allocation of securities to an interested party or to a person who will become an interested party after allocation (regulations 7, 9 of the Securities Regulations (Allocation of Securities in a Registered Company that were not Offered to the Public), 1992 (K.T. 984)); appointment of directors (section 84 of the second supplement to the Companies Ordinance); making changes in the number of directors, and setting the order by which they will leave office (section 86 of the second supplement to the Companies Ordinance). Compare this with the list in section 80 of the Companies Bill (making structural changes; deciding on the distribution of profit; setting the number of directors and the terms of their employment, appointing and dismissing them; appointing and dismissing an accountant, setting the terms of accountant employment; changing company bylaws; approving transactions in which company officers have a personal interest, and substituting for the board and the chief executive officer). Section 229 of the proposed bill imposes a duty on shareholders to refrain from exploiting their power at the general meeting, and in this context details three situations which are susceptible to conflicts of interest between groups of shareholders: amendments to the bylaws, including changes in the rights that accompany shares, approval of dividend distribution, and approval of structural changes, including acquisition of the company.

63 Cf. Conard, supra n. 3, at 135-136.
the institutional investors to acquire business information that the controlling shareholders already have: in the absence of concern over conflicts of interest among the controlling shareholders, it is perfectly safe to rely on their discretion, and to monitor them as well would undermine the advantage of putting them in charge of the company in the first place.

To begin with, I shall examine the first instance where institutional voting is required: when a proposal brought up for approval at the general meeting is potentially harmful to the clients of the institutional investor. According to the interpretation set forth above, the harm in question is not incidental, but rather derives from conflicts of interest among the controlling shareholders.\(^{64}\) As was discussed in the beginning of this article, the typical conflicts of interest among controlling shareholders in Israeli companies are related to the unfair distribution of company resources between shareholders, and are expressed mainly in related-party transactions. In this context, institutional-investor voice is important, and often has decisive influence in light of the privileged majority regime provided for in section 96-36 of the Companies Ordinance and regulation 12 of the Conflicts of Interest Regulations.\(^{65}\) In contrast, conflicts of interest that hinder the effective operation of the company are not common among controlling shareholders in Israeli companies.

\(^{64}\) This interpretation is also supported by the illustration given in sections 43 and 77, according to which potential harm also includes a related-party transaction.

\(^{65}\) The situations covered by section 96-36 and regulation 12 are prominent examples of conflicts of interest common in the Israeli corporate arena today, yet they do not exhaust the possible situations where this kind of conflicts of interest may arise and necessitate institutional monitoring today. Section 96-36 and regulation 12 apply to extraordinary transactions with certain related parties. They do not apply to ordinary transactions nor to other related parties. The analogous provisions in the Companies Bill apply to all shareholders, but are limited to extraordinary transactions only, and in addition introduce a number of new exemptions (see supra n. 29). Apart from these provisions, the Companies Bill includes provisions that assign the decision-making power to the majority of the non-controlling shareholders in the following situations: changes in company bylaws that prejudice a certain class of shareholders (section 25) (a similar rule can already be derived from the Clal Industries case, supra n. 30); a merger with a company that holds shares in the targeted company (sections 367-369, 390); and an acquisition by such a company (sections 380, 391). In these scenarios, the potential for abuse of corporate control to the detriment of non-controlling shareholders is great, and therefore the requirement for approval by one-third of the non-controlling shareholders has been supplanted by a requirement for approval by a majority of the non-controlling shareholders.
They usually hold a majority of a company's shares, and are inherently interested in its success. While institutional investment managers are required to be on guard for proposals that directly transfer wealth from the minority to the majority, they are not required to serve as "super managers" who examine the desirability of every business decision that company management makes, and which affects their interests as well. Institutional voting on such regular business issues is required only in companies that are controlled by a minority of their shares, and there are not many such companies in Israel.

The second instance where institutional voting is required is when a proposal that can advance the interests of the clients of the institutional investors is brought up for approval at the general meeting. According to the proposed interpretation, the institutional investors must focus their attention on conflicts of interest among the controlling shareholders here as well. In Israel, most proposals are initiated by the controlling shareholders. Yet, a proposal introduced by controlling shareholders that can advance the interests of the clients of the institutional investors is obviously not afflicted with conflicts of interest, and therefore there is no purpose in obligating institutional investors to participate in the voting, knowing that their participation is not essential for the approval of the proposal. It is possible that a certain institutional investor would like to express its faith and full support of company management, and would also like to show the entire public how much it is involved. There is nothing wrong with that. However, there is something wrong, at least from an economic perspective, in compelling institutional investors to vote in such a situation. The duty to vote should only apply in those situations where the proposal is initiated by a non-controlling shareholder in response to the conflicts of interest of the controlling shareholders. Indeed, such a proposal is one which can advance the interests of the clients of the institutional investors. At the present time however, the possibility that a non-controlling shareholder will make a proposal is only hypothetical. This is both because there is no mechanism for voting by proxy in Israel that can serve the non-controlling shareholders, because the controlling shareholders hold most of the shares on the market and consequently a proposal on behalf of the non-controlling

66 A proposal to set up a comprehensive proxy voting mechanism can be found in subchapter IX of chapter B of the Companies Bill. The explanatory notes to the proposal detail the lacuna in the existing law that the proposal is intended to fill.
shareholders is destined for failure, and because the non-controlling shareholders are much too apathetic to initiate such proposals. Therefore, the duty to vote in favor of a proposal that can advance the interests of the clients of institutional investors is dormant today.\textsuperscript{67}

Limiting the duty to vote to proposals that are afflicted with conflicts of interests raises the question of who will determine when a proposal falls into this category. The answer is that the institutional investment managers will decide, and their decision will be subject to judicial review.\textsuperscript{68} Although this arrangement creates a certain lack of clarity as to the extent of the duty to vote, this lack of clarity will be cleared up in the future with the development of case law. In any event, it is inescapable when dealing with a duty to vote, which is inherently discretionary. Indeed, the broad language of the law that requires institutional investment managers to vote whenever a proposal which can prejudice or advance the interests of their clients is brought up for approval, already requires the institutional investors to decide in every case whether such a condition is met, with the knowledge that their decision will be subject to judicial review. The proposed conflicts-of-interest test better defines a proposal that may prejudice or benefit institutional-investor clients, thus helping the institutional investment managers to know what is required of them, and helping the court to decide if they complied with this requirement.

E. The Fear of Institutional Conflicts of Interest

The purpose of institutional monitoring is to oversee the controlling shareholders, who hold only part of the shares, but who are supposed to act as agents of the non-controlling shareholders as well. However, agency problems occur whenever one person is responsible for the affairs of another. Institutional investors are also agents — the agents

\textsuperscript{67} Nevertheless, the provision that requires institutional voting whenever a proposal which can advance the interests of institutional-investor clients is brought up for a vote at the general meeting will be applicable in the future, when controlling-shareholder holdings will decrease, and non-controlling-shareholder involvement in corporate governance will increase. Only then will it be wise to require institutional investors to initiate proposals themselves.

\textsuperscript{68} See section 123(4) of the Mutual Investments in Trust Law and sections 78(b)(5), 87(2) of the Provident Funds Bill.
of the majority of non-controlling shareholders. In contrast to the controlling shareholders, they have no shares nor position in the company except for the shares they hold for their clients. Therefore, they are supposed to be better agents. Nevertheless, being agents they cannot escape the tendency to let their personal interest become intertwined with their considerations, and even outweigh the interest of their principals.

The personal interest of most institutional investors in Israel is their affiliation with banks, who themselves are affiliated with companies as shareholders, creditors, and underwriters. In the United States, it has been argued that strong company managers suppress institutional monitoring.\(^69\) In Israel, the concern is that institutional investors who are affiliated with strong banks may consider, within the framework of the monitoring of companies, not only what is good for the companies, but essentially what is good for the banks. These conflicts of interest may result in deficient monitoring, which may occur when institutional investors are guided by investment considerations that do not necessarily emphasize company profitability but rather emphasize company affiliation with the bank that controls the institutional investor in question. They may invest in failing companies only because they are affiliated with them, and, for the same reason, they may show extra forgiveness to companies that fail after they have invested in them.\(^70\) Conflicts of interest may, on the other hand, result in excessive monitoring, which may be performed by institutional investors who take advantage of their power as shareholders in order to benefit themselves. Instead of acting for the sake of shareholders as a whole, they may

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influence the companies to channel profitable transactions to their affiliated banks, on the one hand, and to avoid competition with them, on the other hand.\footnote{See Coffee, \textit{Liquidity Versus Control}, \textit{ibid.}; Black, \textit{Agents Watching Agents}, \textit{supra} n. 4, at 855. For similar occurrences in Japanese banking, see Coffee, \textit{Liquidity Versus Control}, \textit{ibid.}, at 1297, 1301.}

In other words, introducing institutional investors does not solve all agency problems, but instead replaces one agent with another. The calculation is rather a simple one: if the institutional investors act for the good of the company, they will capture only a relative portion of the profit in accordance with the size of their share block, whereas the remainder of the profit will be divided among the other shareholders. In stark contrast, if the institutional investors act for their own good, which is not necessarily the good of all the shareholders, they will sweep all the profit into their own pockets.\footnote{For a detailed analysis of large non-controlling shareholders' conflicts of interest, see E.B. Rock, "Controlling the Dark Side of Relational Investing", (1994) Cardozo L. R. 987.}

Of course, this danger need not materialize. It can be presumed that institutional investors will usually act with integrity and will preserve the so-called "Chinese Walls" between themselves and their affiliated banks.\footnote{See directive 322 of the Directives on Proper Banking Management issued by the Commissioner of Banks in accordance with his power under section 8-1(A) of the Banking Ordinance, 1941 (P.G., 1st supp., 85) (hereinafter: the Banking Ordinance).} However, integrity alone is not enough, and it has been said that Chinese walls have as many holes as Swiss cheese, and regularly collapse during Chinese meals. The truth is, that even Chinese walls that are strictly guarded can, at most, prevent the passage of information and directives from banks to their affiliated funds. They do not prevent the tendency of fund managers to identify with the bank that employs them, knowing that the bank has interests in the companies.\footnote{See L.A. Bebchuk, L. Kaplow & J.M. Fried, "Concentration in the Israeli Economy and Bank Investment in Commercial Companies", in \textit{The Brodet Commission Report}, \textit{supra} n. 70, at 19-20.}

What is needed is a structural safeguard against institutional conflicts of interest that, on the one hand, does not rely on pure luck and, on the other hand, does not rely on stricter legal scrutiny of the institutional investors. The promise of the institutional investors is in their ability to monitor companies better than outsiders, while being driven by economic incentives. If institutional investors must themselves be the subject of
expensive and not necessarily effective legal monitoring, then their service is of no use.

An argument often raised by supporters of institutional monitoring in the United States is that the need to form coalitions of several institutional investors in order to gain influence constitutes just such a structural safeguard. Instead of carrying out external scrutiny of the integrity of the institutional investors, the institutions will scrutinize themselves.\footnote{The argument is that in light of the dispersal of institutional investment in the United States, institutional-investor impact on companies is dependent on cooperation between institutions, and only an institution who plays by the rules will obtain such cooperation. In terms of game theory, the voting at general meetings constitutes a repeated game, in which players stigmatize cheaters, thus creating an incentive not to cheat. See Black, \textit{Agents Watching Agents, supra} n. 4, at 857-859, 861, 866-867; Coffee, \textit{Half-Time Report, supra} n. 4, at 872-873; Gordon, \textit{supra} n. 4, at 170-171. For illustration of the fact that the success of an institutional investor in obtaining the support of his colleagues is dependent on his reputation, see Paefgen, \textit{supra} n. 4, at 331-344. Cf. E. Kandel \& E.P. Lazear, \textit{“Peer Pressure and Partnerships”}, (1992) 100 J. Pol. Econ. 801, at 805. Other responses to the concern over institutional conflicts of interest which have been proposed in the United States are less convincing. One argument is that it will be difficult for institutional investors to reap private profits for themselves. (See Black, \textit{Agents Watching Agents, ibid.}, at 859-861.) However, experience proves otherwise, especially in the centralized economy of Israel. Another argument is that the private profit made by institutional investors from companies may be outweighed by the benefit that the companies will derive from the institutional involvement. (See Black, \textit{Agents Watching Agents, ibid.}, at 861; Fisch, \textit{supra} n. 4, at 1045.) However, this argument is also unsatisfactory, not only because not enough data on the desirability of institutional monitoring has accumulated (see Fisch, \textit{ibid.}, at 1045-1047), but also because under-the-table private gains are not limited. Cf. Clark, \textit{supra} n. 2, at 154-157.}

It is debatable whether such reciprocal monitoring is effective in the concentrated capital market of Israel. In the United States, institutional investors usually hold less than two percent of the stock of a single company, and even this two percent is made up of the holdings of several investment managers.\footnote{See Coffee, \textit{Half-Time Report, ibid.}, at 855, 867.} In order to carry out wide-scooped monitoring — i.e., to present a real threat to the controlling shareholders — cooperation among a significant number of rival institutional investment managers is required. In contrast to this, a majority of the institutional investors in Israel are affiliated with one of three banks.\footnote{See \textit{supra} n. 48.} In order to carry out
narrow-scoped monitoring of the companies — i.e., to mobilize two-thirds or even less of the non-controlling shareholders to vote — cooperation among only a few people will suffice.

Nonetheless, several alternative mechanisms exist in Israel that, when combined, provide at least a partial answer to the concern over institutional-investor conflicts of interest. The underlying principle common to all these mechanisms is in making public the actions of institutional investors. The duty to report immediately, which is incidental to the institutional duty to vote, reveals the vote to the authorities, and by means of agile journalists and embarrassing headlines, to the entire public. The institutional investors are then subject to various sanctions, including withdrawal of client savings, class action lawsuits, publicized investigations, criminal proceedings, and constraining legislation. All of these, together with the vigorous

78 Section 96-36 of the Companies Ordinance and regulation 12 of the Conflicts of Interest Regulations stipulate that extraordinary transactions with certain related parties, as well as the terms of employment in the company of these related parties, are subject to approval by one-third of the non-controlling shareholders. The rule in the Clal Industries case (supra n. 30), and a number of sections of the Companies Bill (supra n. 65) stipulate that certain other actions that prejudice the non-controlling shareholders are subject to approval by the majority of the non-controlling shareholders.


80 On the possibility of institutional-investor clients suing institutional investment managers for violating fiduciary duties owed to them in exercising voting rights, see O'Neill v. Davis, 721 F. Supp. 1013 (N.D. Ill. 1989); Newton v. Van Otterloo, 756 F. Supp. 1121 (N.D. Ind. 1991). Section 74 of the Mutual Investments in Trust Law, section 41-5 of the Income Tax Regulations (Rules for Approval and Management of Provident Funds), 1964 (K.T. 1302) (hereinafter: the Income Tax Regulations (Rules for Approval and Management of Provident Funds), and section 3 of the Provident Funds Bill impose on mutual fund and provident fund managers fiduciary duties to their clients. Section 83 of the Mutual Investments in Trust Law provides unit owners in a mutual fund a cause of action to sue for damages they incurred as a result of a violation of these duties. The Provident Funds Bill does not include an analogous provision, but investors in a provident fund can, in similar circumstances, file a regular damages law suit. Both the Mutual Investments in Trust Law and the Provident Funds Bill grant the authorities responsible for their implementation — the Head of the Securities Authority, and the Commissioner of the Capital Market, Insurance, and Savings of the Ministry of Finance — broad administrative and legal authority to deal with violations of this duty. However, it is not easy to prove violation of fiduciary duties and damages therefrom in court. See Conard, supra n. 3, at 150-152; Bebchuk, Kaplow & Fried, supra n. 74, at 19.
and vocal actions of company managers against institutional investors who invade their territory, and with the addition of restrictions that the law imposes on institutional investors, can deter institutional investors from abusing their power. Although each one of these safeguards is not in and of itself enough, together they cultivate an internal institutional culture of self-restraint, whose importance should not be underestimated.

Furthermore, institutional investors want long-term survival. From their point of view, harming a portfolio company in order to reap quick profits means cutting off the branch they are sitting on. As a matter of fact, in practice, institutional investors are only slightly involved in corporate governance, and according to some scholars they are still not involved enough. England is an instructive example, which demonstrates the great self-restraint of institutional investors even in the absence of legal restraints on them. In Israel, the concern that institutional investors will seek short-term profits for themselves is even less, since the Israeli stock market is small, and the diversification possibilities are limited to begin with. If one adds to this the fact that institutional investors concentrate their investment in only some of the shares traded on the market, then it becomes clear that company welfare is more important to them than it is to their counterparts in the United States and England, and it makes no sense for them knowingly to spoil the little that there is. Indeed, in the Israeli context, where legislation to compel institutional investors to monitor companies is required, the concern over abuse of institutional power seems a remote possibility.

Finally, one should bear in mind that the issue of institutional conflicts of interest is not raised here as an academic exercise, but in

81 Such restrictions are found in abundance in the Mutual Investments in Trust Law and its regulations, in the Income Tax Regulations (Rules for Approval and Management of Provident Funds), in the Provident Funds Bill, in the Banking (Licensing) Law, 1981 (35 L.S.I. 277), in the Banking Ordinance, and in the Directives on Proper Banking Management issued by the Commissioner of Banks according to this law. The newly-enacted Banking (Licensing) Law (Amendment No. 11), 1996 (S.H. 318), is of considerable importance, in as much as it restricts bank share holding, thus attenuating potential conflicts of interest of bank-affiliated mutual or provident funds.

82 See Black & Coffee, supra n. 4.

83 In economic terms it can be stated, that institutional investment concentration in Israel, in comparison to institutional investment dispersal in the United States, intensifies risk aversion among Israeli institutional investors.
order to fashion a suitable legal policy regarding the institutional monitoring of companies. Even if all that has been said up until this point is insufficient to relieve the concern over institutional conflicts of interest, the question of what are the implications on the optimal legal regime still remains. Whatever the concern over institutional conflicts of interest may be, it does not derive from the duty to vote that is imposed on the institutional investors. On the contrary, the voting obligation is capable of moderating the conflicts of interest, which are predetermined by the affiliation of most institutional investors with banks. If the concern is over the reluctance of institutional investors to monitor companies that are affiliated with the same banks, the voting obligation can be helpful; if the concern is that institutional investors will exploit their influence over companies for the benefit of these same banks, the concern exists both with and without the voting obligation, and therefore the obligation can cause no harm.

III. A Future Outlook: Wide-Snoped Institutional Monitoring in Israel

A. The Political Model for Wide-Snoped Monitoring

Within the framework of scholarly discourse on institutional monitoring in the post-takeover era, it has been proposed that the emerging corporate governance structure be viewed as conforming to a political model.84 The basis of the political model is institutional-investor use of various means of pressure that are at the institutions’ disposal, in order to influence companies. Institutional investors can accept, or threaten to accept, a hostile takeover bid; they can boycott or threaten to boycott a second securities offering to the public carried out by the

84 See J. Pound, “The Rise of the Political Model of Corporate Governance and Corporate Control”, (1993) 68 N.Y.U. L. R. 1003. Professor Pound demonstrates how the political model reflects Corporate America today. In fact, the English perspective described in an article by Professors Black and Coffee also parallels the political model: a quiet dialogue between company management and small ad hoc coalitions of institutional investors, which is conducted under the continuous threat of launching an overt battle for corporate control against rebellious management. See Black & Coffee, supra n. 4, at 2053-2055.
company in order to raise capital, and they can also oppose management proposals, make their own proposals, and vote against management's slate for the board — all by joining institutional forces and by including the media in the battle. The results are impressive. By demonstrating their full power in a few instances, institutional investors create an atmosphere receptive for solving most disputes between them and the companies by direct and discrete dialogue, and through compromise.

The political game in the corporate world resembles the parliamentary political game. Institutional-investor strength is not necessarily manifested in an absolute ability to defeat the managers in a battle for corporate control, but in a relative ability to influence the managers through negotiations, the applying of pressure on them, the making of any dispute with them public, and even in a sort of no-confidence vote by opposing management proposals at general meetings. Institutional-investor opposition to management business policy which amasses headlines in the media signals to the market that “something is rotten in the State of Denmark” and may block business and financing opportunities of the company. Company management is well aware of this, and tries to avoid direct confrontation with the institutional investors.

In fact, the political model modifies the definition of corporate control from an absolute to a relative concept. According to the traditional definition, corporate control means having complete power to manage the company as one sees fit, while being limited only by legal constraints. A definition that is in line with the political model describes control as a quantitative concept: the transition from the status of non-controlling shareholder to the status of controlling shareholder is still very meaningful, yet the overwhelming power of the controlling shareholders is set-off by the more modest power of the non-controlling shareholders. The stronger the non-controlling shareholders are — and this is dependent on both their determination as well as their coordination in every issue — the more limited the power of the controlling shareholders. The dominance of the controlling shareholders is not total, just as the submissiveness of the non-controlling shareholders is not complete.

85 This is an important source of institutional-investor power in England. See Black & Coffee, ibid., at 2034-2037.
86 See Pound, supra n. 84, at 1052-1053. For an elaborate discussion of this strategy, see Grundfest, supra n. 4.
B. Implementation of the Political Model in Israel

In future, such corporate politics may evolve in Israel as well. Among other things, this will depend on the extent of the funds handled by institutional investors (which affects their financial strength), the stability of the stock exchange (which is a prerequisite for increasing the extent of their investment in it), and on the availability of alternatives to investment in shares, such as state bonds issued exclusively for institutional investors (which reduces their interest in the stock exchange). Foreign institutional investors may also increase their holdings in the Israeli market, and import American-style activism into Israel. On top of this, wide-scope institutional monitoring according to the political model can be expected along with the maturing of the Israeli market, and the dilution of controlling-shareholder holdings in it. Insofar as this process progresses, so will grow the need to supervise the functioning of companies under the direction of the controlling shareholders, whose interests will no longer be aligned with company interests. At the same time, the power of institutional investors to perform the necessary supervision will grow: at the point where controlling shareholders will hold a minority of the shares, institutional investors will be able to repel proposals made by the controlling shareholders, and have their own proposals accepted in their place; they will be able to publicize their dissatisfaction with company performance, and will be able to negotiate with management in private; they will also be able, in extreme circumstances, to cause the dismissal of the board and management, and to crown a new board and management in their place.

In addition to the regular voting power that will pass from the diluted controlling shareholders over to the institutional investors, the institutional investors will be able to utilize their already increased voting power regarding the approval of related-party transactions. This

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87 It should not be expected that foreign institutional investors will be pioneers in this area, both due to their more meager holdings in the Israeli stock exchange and their not being rooted in the Israeli market. Nonetheless, they may support initiatives of local institutional investors, and may even urge them to take such initiatives. Compare this to the behavior of American institutional investors in France: J.A. Fanto, "The Transformation of French Corporate Governance and United States Institutional Investors", (1995) 21 Brook. J. Int'l L. 1.
de facto veto power enables institutional investors to make it harder for the controlling shareholders to benefit from their investment, thus reinforcing institutional means of disciplining underperforming companies. In addition to the increased voting power in accordance with section 96-36 of the Companies Ordinance and regulation 12 of the Conflicts of Interest Regulations, increased voting power is already vested in institutional investors in accordance with the rule in the Clal Industries case, supra n. 30, and this can also act as a lever to performing wide-scoped institutional monitoring. The Companies Bill, if enacted, will provide non-controlling shareholders with increased voting power in a number of additional scenarios that give rise to concerns over transfer of wealth from the non-controlling to the controlling shareholders. See supra n. 65.

89 On the deterrent effect of targeting poorly performing companies for institutional activism, see Nesbitt, supra n. 8, at 75; Black, Agents Watching Agents, supra n. 4, at 839; Black, Shareholder Passivity Reexamined, supra n. 4, at 581-582.

90 See supra n. 23.
institutional investors. In each case the institutional investors will have to choose the more appropriate strategy, in accordance with the circumstances. It is likely that they will choose to dictate to the company how to improve its performance only in situations where the necessary steps are self-evident, and would have been taken at the initiative of management had it not been for controlling-shareholder conflicts of interest. In the absence of conflicts of interest related to specific business decisions, the controlling shareholders and the managers appointed by them will have a relative advantage over the institutional investors in making business decisions, and therefore setting performance goals for the controlling shareholders will be preferable to dictating business strategy to the company.


92 The smaller the block of shares held by the controlling shareholders, the more distant their interests are from the interests of the company as a whole: they pursue company growth out of greed and passion for prestige — despite any considerations of efficiency and profitability; in order to facilitate such growth without the need for external financing, they refrain from distribution of dividends to shareholders — regardless of the fact that cash retention is often wasteful; they are also willing to do just about anything to ward off takeovers — even when they are advantageous to the company. See Dent, supra n. 3, at 889-892; Black, Agents Watching Agents, ibid., at 834-839; Black, Institutional Monitoring, supra n. 4, at 903-915. In these situations it is fairly easy to point to a certain business move that is essential, and the proper institutional action is to urge the controlling shareholders to make this move. However, in companies with small controlling blocks, controlling-shareholder conflicts of interest may not necessarily be expressed in specific business decisions but rather in overall shirking. See the discussion supra, in Part II.A. In such cases, it is hard to point to a certain business move that the company needs, and therefore the proper institutional action is to urge the controlling shareholders to improve company performance.
As has been stated, this type of monitoring is different than wide-scoped monitoring, not only in terms of its objectives, but also in terms of who initiates it. Use of the veto power by non-controlling shareholders in order to prevent controlling shareholders from looting a company (narrow-scoped monitoring) is a response to a proposal made by the controlling shareholders. In contrast, use of the veto power in order to force controlling shareholders to improve company performance (wide-scoped monitoring) is initiated by non-controlling shareholders, who are primarily represented by institutional investors. The voting obligation in section 77 of the Mutual Investments in Trust Law and in section 43 of the Provident Funds Bill is suitable for the narrow-scoped monitoring, which is needed at the present time. However, this obligation will be too limited if at some point in the future wide-scoped monitoring will be necessary. In order to carry out such monitoring, it will not be enough to respond to proposals initiated by the controlling shareholders, but instead it will be necessary to initiate institutional proposals, and at the same time to back up those proposals with the threat of opposing the company bestowing any benefits on the controlling shareholders. The duty to show institutional initiative in monitoring companies does not derive from the literal meaning of sections 43 and 77. Still, it will always be possible to go beyond the literal meaning of these sections, and to interpret them according to their purpose, whereby when company performance is treading water, the bestowing of benefits on the controlling shareholders is harmful to the interests of the institutional-investor clients, even if it does not amount to looting the company. In such a situation, the fiduciary duties owed by institutional investment managers to their clients will require them to condition their support of the controlling shareholders on controlling-shareholder acceptance of institutional demands intended to improve company performance.

Perhaps the institutional investors in Israel will discover wide-scoped monitoring of companies by themselves, and perhaps they will not.93 When will it be appropriate to demand such deep involvement in corporate governance of them? First, not before the lessons to be learned from narrow-scoped institutional monitoring in Israel become clear, and

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93 The first signs of wide-scoped monitoring can also be found in Israel today. Institutional investors still do not dictate business policy to controlling shareholders, but they do take company performance into consideration when requested to approve benefits for controlling shareholders. Cf. J.E. Heard, "Executive Compensation: Perspective of the Institutional Investor" (1995) 63 U. Cin. L. R. 749.
especially not before the institutional investors prove that their involvement is productive and not destructive. Second, not before the institutional investors become rooted in the securities market and gain experience and knowledge from implementing narrow-scoped monitoring. Only when these two conditions are met, will it be possible to turn to the third condition, that is when controlling-shareholder investment has been diluted to the point where controlling shareholders can no longer be trusted to see to company profitability and management effectiveness at their own initiative. Such a stage, wherein the capital market structure in Israel will approach that of the world’s developed capital markets, is not to be expected in the near future. Meanwhile, it is recommended to confine institutional monitoring to the narrow scope outlined here.

Conclusion

In comparison to what is common in other countries, institutional investors in Israel hold only a small percentage of corporate securities. However, they are more concentrated, and have decisive voting power when dealing with the approval of transactions between companies and related parties that are liable to be afflicted with conflicts of interest. In light of the concentration of the Israeli market, this is the common type of conflicts of interest, and is the focus of institutional monitoring, that I call “narrow-scoped monitoring”. Narrow-scoped monitoring is however only the beginning. It is limited in comparison to “wide-scoped monitoring”, which monitors management effectiveness. Its promise is more modest than that of wide-scoped monitoring, but its inherent danger regarding conflicts of interest and the tyranny of the institutional investors is less.

The changes that are taking place in economic markets in general, and in the Israeli market in particular, are gradual and long-term. Institutional monitoring of companies is still a new concept, and not enough data on its advantages and disadvantages has been accumulated. The Israeli securities market is still young, and the road ahead is still long. On the one hand, it is only natural that its maturing will be accompanied by a dilution of controlling-shareholder investment and a concentration of institutional holdings.94 Such a trend would increase

94 This process has already begun. See Avramov & Raz (1994), supra n. 13, at 3.
the need for wide-scoped institutional monitoring, and at the same time would expand the means at the disposal of institutions to carry out such monitoring. On the other hand, the halting of reforms in the capital market is liable to delay this process and may even undo it.95 In the meantime, it is best to develop the concept of narrow-scoped monitoring and to learn its lessons, in anticipation of the day when implementation of wide-scoped monitoring would be required.

The Mutual Investments in Trust Law, which forces mutual fund managers into the general meeting room, was enacted at the end of 1994, but only during 1995 were regulations promulgated that require mutual fund managers to continuously report on their voting. The Provident Funds Law has as yet not been enacted, and only during 1996 was a directive issued that requires provident fund managers to report on the voting, demanded of them in an earlier directive. The duty to issue voting reports is vital: not only does it ensure compliance with the duty to vote, but it also publicizes the voting and encourages proper institutional monitoring. Today, only a few months after reports on the voting by mutual funds began appearing, and in the absence of similar reports on the voting of provident funds, it is still too early to reach conclusions on the implementation of narrow-scoped monitoring in Israel. However, the day is not far off when sufficient data will be available in order to reach such conclusions. The framework outlined here suggests guidelines by which institutional-investor functioning could then be examined.96

96 After this article was sent to press, a symposium on corporate governance was published in (1995-96) 26 Can. Bus. L.J. In two articles in this volume, R.J. Daniels and P. Halpern, “Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy” on p. 11, and R.K. Morck, “On the Economics of Concentrated Ownership” on p. 63, the authors argue that large controlling blocks do not necessarily guarantee high company performance. Cf. supra n. 11. However, the argument that I make in this article is anchored on the different types of controlling-shareholder conflicts of interest dominant in different holding structures, rather than on their overall effect on company value.