CORPORATE PYRAMIDS IN THE ISRAELI ECONOMY:
PROBLEMS AND POLICIES

A Report Prepared for the Committee on Increasing Competitiveness in the Economy

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# Table of Contents

I. Introduction and Executive Summary ............................................................................................................. 1  
   A. The Engagement ........................................................................................................................................... 1  
   B. Executive Summary ................................................................................................................................... 2  

II. Pyramids in the Israeli Economy .......................................................................................................................... 4  

III. Pyramids and Dual-Class Stock ....................................................................................................................... 6  

IV. Agency Problems ............................................................................................................................................... 7  
   A. The Basic Problem with Pyramids ................................................................................................................ 7  
   B. Tunneling and Extraction of Private Benefits .............................................................................................. 8  
   C. Problems of Expansion and Persistence ....................................................................................................... 9  
   D. The Significance of the Gap between Cash Flow Rights and Voting Rights ......................................... 11  

V. Empirical Evidence ............................................................................................................................................. 11  
   A. Evidence from Other Countries .................................................................................................................. 11  
   B. Evidence on Private Benefit Levels in Israel .............................................................................................. 14  

VI. Potential Countervailing Benefits .................................................................................................................... 16  
   A. Contracting Benefits in Emerging Economies ............................................................................................ 16  
   B. Rent-Seeking Advantages .......................................................................................................................... 17  
   C. Evidence on Pyramids and Shareholder Value .......................................................................................... 19  

VII. Prohibiting Creation of Pyramids with Three or More Levels ........................................................................... 21  
   A. Why Structural Measures are Warranted for Israel .................................................................................... 21  
   B. Focusing on Pyramids with Three or More Levels .................................................................................... 23  

VIII. Existing Pyramids ........................................................................................................................................... 24  
   A. Transition Arrangements .............................................................................................................................. 25  
   B. Should Existing Third-Level Companies be Grandfathered? ..................................................................... 26  

IX. Corporate Governance Improvements ........................................................................................................... 27  
   A. Outside Directors Elected by the Minority Shareholders .......................................................................... 27  
   B. Audit Committee Supervision of Interested Party Transactions .............................................................. 29  

X. Conclusion ....................................................................................................................................................... 29
I. INTRODUCTION AND EXECUTIVE SUMMARY

A. The Engagement

This report describes the analysis that I have conducted and the conclusions that I have reached, with respect to the use of pyramidal holding structures by Israeli business groups, in the course of my work for the Committee on Increasing Competitiveness in the Economy (the “Committee”), appointed by the Prime Minister of Israel, the Minister of Finance, and the Governor of the Bank of Israel.1 I was engaged to serve as the outside expert for the Committee and to prepare a written report providing my analysis and recommendations.

In the course of my work for the Committee, I provided expert opinions on measures considered by the Committee, and I developed and proposed additional policy measures for consideration by the Committee. To carry out my work, I participated in meetings of the Committee during the period leading to the Interim Report that the Committee issued on October 11, 2011 (the “Interim Committee Report”),2 in hearings held by the Committee; in meetings of the Committee held to develop the Committee’s final recommendations; and in individual meetings with the Committee’s chair, individual members, and/or staff members assisting the Committee’s work. My work benefited from data and information I received from the Bank of Israel, the Israeli Securities Authority, the Israeli Ministry of Justice, and the Capital Markets, Insurance, and Savings Department of the Ministry of Finance, and I am grateful to each of these organizations and governmental units and their staffs for their assistance.

Because of the scope of the work that I have undertaken and the opinions and recommendations I have provided, I have divided my final written submission into several reports. This report focuses on pyramidal structures, one of the main subjects examined by the Committee. Two other reports focus on other issues discussed in the Committee’s final report:

1 The members of the Committee, which was headed by the former Director General of the Ministry of Finance, Mr. Chaim Shani, included Prof. Eugene Kandel, Head of the National Economic Council in the Office of the Prime Minister; Prof. Shmuel Hauser, Chairman of the Israel Securities Authority; Dr. Karnit Flug, Assistant Governor of the Bank of Israel; Mr. David Zaken, Supervisor of Banks at the Bank of Israel; Mr. Gal Hershkovitz, Budget Director; Prof. Oded Sarig, Commissioner of Capital Markets, Insurance and Savings; Adv. Avi Licht, Deputy Attorney General; Prof. David Gilo, Antitrust Commissioner; and Dr. Gitit Gur-Gershgoren, Economics Department Director in the Israel Securities Authority.

2 A description of my work for the Committee during this stage of its work is provided in the interim expert report I submitted on October 9, 2011 (hereinafter “Interim Expert Report”), which was attached as an appendix to the Interim Committee Report and is available at http://mof.gov.il/Lists/CompetitivenessCommittee/Attachments/36/2011-1111.pdf.
control of financial firms by non-financial firms, and limits on concentration of investments by Israel’s long-term savings funds. ³ I may submit later a supplementary report on measures concerning excessive leverage and bondholder protection that would be worthwhile adopting to supplement the Committee’s recommendations.

B. Executive Summary

This report focuses on the problems posed by the use of “pyramidal structures” (which I shall refer to simply as “pyramids”) in the Israeli economy, and on the structural measure of limiting the number of levels of pyramids that the Committee adopted with my support. Such a structural approach is warranted by the special circumstances of the Israeli economy and the concerns posed by its pyramids. In my view, it would be desirable to apply a two-level limitation both to new structures and to existing pyramids.

After commencing my work, I stressed to the Committee the desirability of adopting rules that would lead to changes in existing structures, rather than relying solely on arrangements for improving the governance of pyramids while taking their existence and elaborate structures as given. In my view, the Committee should be commended for its willingness to explore and ultimately adopt such a structural approach. During the stage of my work leading up to the submission of the Committee’s Interim Report, the Committee’s working premise was that pyramids with any number of levels would continue to be permitted, and given this premise I developed for the Committee arrangements that could still lead to structural changes by enabling public investors “locked” in corporate pyramids to exit under certain circumstances, constraining controllers’ ability to create additional levels down the corporate pyramid, or placing limits on controllers’ exercising voting power far in excess of their cash flow rights.⁴ Following the hearings, the Committee remained committed to a structural approach, and decided, with my support, to pursue such an approach directly through limiting the permissible number of pyramidal levels.

Part II of this Report begins with a brief description of some relevant key features of the Israeli economy: the dominant role of pyramidal structures in the Israeli economy and the elaborate and multi-leveled structure of some of these pyramids. In these respects, the use of


⁴ The arrangements that I developed for the Committee for this purpose are reviewed in the Interim Expert Report, supra note 2, Sections II.C and II.D.
pyramids in the Israeli economy is much more extensive and elaborate than what is common in other advanced economies.

Part III briefly discusses an important feature of Israeli regulation of corporate structures. Israel has long prohibited the creation of new dual-class structures that create a significant disparity between cash flow rights (i.e., contributions to equity capital) and voting power. The extensive use of pyramids, however, has enabled controllers to get around Israel’s anti-dual-class-structure rules and generate substantial separation between cash flow rights and voting power.

Part IV explains the agency problems resulting from pyramids and how these agency problems increase with greater separation between cash flow rights and voting rights. The analysis emphasizes that rules with respect to interested party transactions cannot address the full range of distortions and methods of extracting private benefits that should concern policymakers.

Part V discusses relevant empirical evidence about Israel and other countries. With respect to Israel, the analysis stresses the significance of the empirical findings that Israel stands out in its high levels of control premia, which reflect high levels of private benefits of control.

Part VI discusses potential countervailing benefits of pyramids for shareholders. The academic literature suggests that pyramids can provide significant benefits in an emerging economy, which Israel no longer is, by enabling pyramidal firms to transact with other firms in the pyramid, thereby overcome problems resulting from unreliable institutions and contracting practices. The literature also notes other benefits that can make pyramids worthwhile for shareholders, such as increased market power and improved ability to influence political decision-making. Policymakers considering the case for pyramids, however, should recognize that such benefits might well not represent social gains.

Part VII turns to policy choices and explains the case for the Committee’s recommendation to disallow the future development of pyramids with more than two levels. While such a legal limit is novel, I explain that Israel’s special circumstances warrant the adoption of significant structural measures. Furthermore, while the limitation is novel, the state of affairs it would create is one that is commonplace in other advanced economies, where pyramids higher than two levels have no practically significant presence. In my view, the limitation would be beneficial and would complement well Israel’s long-standing limitation on dual-class structures.

Part VIII discusses the treatment of existing pyramids. I explain that, in my view, an arrangement allowing existing pyramidal firms four years to comply with the new rules, and
facilitating their compliance with appropriate tax rules, would be a reasonable and proportionate way to address the legitimate interests and expectations of existing pyramids’ controllers and minority shareholders. With appropriate transition rules in place, the two-level limitation would be worth applying to existing structures, and exempting third levels of existing structures would not be beneficial. In the long-run, given the conclusion that three-level pyramids are generally socially undesirable, it would be beneficial to disallow such structures, regardless of the point in time at which they were created. Thus, existing pyramids, whose presence and elaborate structures partly motivated the Committee’s work, should ultimately be subject to the two-level limitation recommended by the Committee.

Because this report is focused on a detailed analysis of the key policy choices involved in limiting pyramidal layers, it devotes little space to the corporate governance arrangements recommended for public companies in general and second-level companies in particular. However, Part IX briefly explains the reasons for my support of two measures which I assisted the Committee in designing – bolstering the independence of boards by having some outside directors elected by minority shareholders, and strengthening the supervision of certain interested party transactions.

II. PYRAMIDS IN THE ISRAELI ECONOMY

The Interim Committee Report documents that Israeli publicly traded firms are characterized by a very high ownership concentration, with a limited number of business groups controlling a significant number of publicly traded firms and a large proportion of the Israeli economy. The Interim Committee Report identifies 24 major business groups controlling about 136 out of 596 listed companies (23%), and approximately 68% of total stock market capitalization. According to the Interim Committee Report, the 10 largest business groups’ market capitalization amounts to 41.3% of total stock market capitalization. The biggest business group holds assets equal to approximately 19.4% of GDP; the five largest business groups hold assets equal to approximately 62.8% of GDP.

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5 This calculation excludes Teva Pharmaceutical Industries Ltd, which is not affiliated with any business group, and accounted for a significant fraction of the total stock market capitalization. See the Interim Committee Report, pp. 80 and 148-149. Business groups are defined in the Interim Committee Report as three or more companies, which have at least two different areas of activities and are under the control of the same controller.
Publicly traded firms in Israel, and large business groups in particular, generally have a controlling shareholder. To control resources on a large scale, controllers of large business groups commonly use corporate pyramids with significant separation between cash flow rights and voting rights. According to the Interim Committee Report, 18% of all listed companies that have a controlling shareholder belong to pyramids, and controllers of pyramidal companies are more likely to hold only a minority of the equity capital of the company than controllers of stand-alone firms. For instance, 37% of all traded companies, and listed companies representing approximately one-third of total stock market capitalization, are controlled by business groups that hold between 25%-30% of the company’s voting rights.

It should be noted that ownership concentration in Israel is one of the highest among Western economies, as is the prevalence of pyramidal structures in Israel. The Interim Committee Report indicates that Israel ranks highly in terms of the percentage of total stock market capitalization held by the 10 largest groups. Of the countries for which data was available, only Indonesia, the Philippines and Thailand had higher concentration, and Israel has much higher ownership concentration than comparably sized economies such as Ireland, Austria, Finland, Singapore and Belgium.

Israel also stands out in terms of the complexity and ‘depth’ of its corporate pyramids. A recent study by Ronald Masulis, Peter Kien Pham and Jason Zein, using a comprehensive dataset of 45 countries around the world, assigns each country an “Average Pyramid Score” equal to the average number of levels of pyramids controlled by family business groups. In terms of this

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6 Interim Committee Report, p. 67 (as of September 2010, 86% of listed firms were controlled by a controlling shareholder or a controlling block).
7 Interim Committee Report, pp. 141-143 and 156. Konstantin Kosenko, studying business groups in Israel, provides similar evidence. According to the Kosenko study, approximately 21% of Israeli listed companies as of 2006 are organized under a pyramidal structure and roughly 80% of all group-affiliated companies belong to business pyramids. See Konstantin Kosenko “Evolution of Business Groups in Israel: Their Impact at the Level of the Firm and the Economy,” 5(2) Israel Economic Review 55, 77 (2008) (hereinafter: "Kosenko"). According to a recent study, 25.66% of all Israeli listed firms are controlled through pyramids. See also Ronald W. Masulis, Peter Kien Pham and Jason Zein "Pyramids: Empirical Evidence on the Costs and Benefits of Family Business Groups," 24 Review of Financial Studies 3556 (2011).
8 Interim Committee Report, p. 162.
9 For a bar graph vividly illustrating Israel’s high ranking in terms of the considered concentration, see Committee on Enhancing Competitiveness, Presentation Slides with Principal Recommendations, February 2012, p. 17.
10 Masulis et al., supra note 7. According to the Interim Committee Report, p. 156, there may be pyramids in Israel that reach seven levels.
Average Pyramidal Score, Israel ranks second in the world (after Colombia), and its Average Pyramidal Score is more than double the Average Pyramidal Score of most countries.

III. PYRAMIDS AND DUAL-CLASS STOCK

Corporate pyramids are closely related to dual-class stock companies. They are both mechanisms which separate cash flow rights and voting rights, and which enable a party to control corporate assets while contributing only a minority (and sometimes a small minority) of the equity capital funding these assets. Indeed, in some situations, a pyramid and a dual-class stock structure would produce an economically identical result. The similarity between dual-class shares and pyramids is worth emphasizing in light of the choice made by Israeli legislators nearly two decades ago to limit the use of dual-class structures.

Two decades ago, the use of dual-class stock structures was very common in Israel. At the end of 1989, about 40% of firms traded on the Tel Aviv Stock Exchange (the “TASE”) had dual-class shares structures.11 In January 1990, an amendment to the Israeli Securities Law came into effect, obligating public companies seeking to raise capital for the first time on the TASE to have a one-share-one-vote structure.12 Before raising equity once again on the stock market, dual-class companies whose shares had already been listed on the TASE were required either to unify their shares to a one-share-one-vote structure, or to issue only shares with the high voting rights so that the proportion of shares with lower voting rights would decline over time.

The 1990 amendment was motivated by a recognition of the problems that arise from the separation of ownership rights and control rights. The official legislative proposal stated that “(t)he situation, in which shares with preferential voting rights perpetuate the firm’s control in the hands of the holders of such shares without any proportion to their capital investment, while the general public provides most of the capital necessary for the operation of the company, does not seem appropriate.”13

The 1990 amendment had considerable success in reducing the number of dual-class equity structures in Israel. Of the 109 dual-class firms listed on the TASE as of 1989, 80 had

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12 Section 46B of the Securities Law of 1968 (Amendment 11).
13 The explanation of the legislative proposal to the amendment to the Securities Law, dated as of July 17, 1990, p. 257 (original in Hebrew).
unified their shares by 2000. Furthermore, over the subsequent decade, most of the remaining dual-class firms were delisted, merged or had their shares unified, so that dual-class shares had almost disappeared, with only seven dual-class firms remaining on the TASE as of October 2009. However, it is important to recognize that the success of the effort to eliminate dual-class stock structures did not bring an end to the problems resulting from the separation between cash flow rights and voting rights in Israeli publicly traded companies. Such separation is still in place on a significant scale through the use of corporate pyramids. Corporate pyramids enable controllers to maintain, without the use of dual-class structures, situations in which they retain control over publicly traded firms even though public investors provides most of the necessary capital.

IV. AGENCY PROBLEMS

A. The Basic Problem with Pyramids

There are two fundamental problems that result from corporate pyramids: entrenchment and low incentives. Entrenchment makes all situations worse. Entrenchment removes a disciplinary mechanism that otherwise might limit a controller's opportunity to continue underperforming (whether due to agency problems or otherwise). Entrenchment may also be a problem because it can result in the controller continuing to lead the company even when it is no longer the right person to do so.

Weak incentives for those in control are problematic, because the incentives of those in control regarding certain issues will not be well aligned with the preferences of public investors. This is especially true with respect to issues that affect the private benefits of control. Pyramids’ controllers capture the full private benefits, but they only bear a minority fraction of the negative effects on cash flow rights. This will be explained further in the next section.

It is the combination of entrenchment and low cash flow rights which produces severe problems. With low cash flow rights but no entrenchment, the extent to which a firm could underperform or run in ways departing from the interests of public investors would be limited by the market for corporate control.

Conversely, an entrenched controller with a majority of the cash flow rights would not be disciplined by the market for corporate control but would be incentivized by holding a majority of the cash flow rights affected by its decisions. In the absence of either market

discipline or financial incentives, the combination of entrenchment with low cash flow rights produces a situation where a controller might have interests that substantially diverge from those of public investors and is not prevented from pursuing these interests by the threat of removal.

**B. Tunneling and Extraction of Private Benefits**

In the previous section we saw that the combination of low incentives and entrenchment may lead to a divergence of interest and excessive agency costs, and therefore a distortion of various choices. Because a controller will take into account the effects of its decisions not only on the value of the company’s equity capital, but also on the controller’s level of private benefits, the controller may favor choices that increase the private benefits of control even if those choices are not optimal from the perspective of maximizing the value of the company’s equity capital.

It is worthwhile to explain the range of choices that may be affected. Consider a controller who, because of a corporate pyramid, has control of a company, but only has 20% of the cash flow rights of that company. The following are examples of the kinds of choices that might be distorted in such a situation.

(i) Taking of opportunities: Consider the situation where there is an opportunity that would be more valuable in the hands of the company, rather than in the hands of the controller (or in the hands of a company that is higher in the pyramid and in which the controller thus has more cash flow rights). However, the controller will have an incentive to take the opportunity, or to allocate it to a company higher in the pyramid in which the controller has more cash flow rights. For example, assume that the company has the right to an opportunity which will result in a profit of 10 to the company, but which the controller can take from the company for the controller’s own benefit, resulting in a profit of 5 to the controller. If the controller takes the opportunity, the controller will benefit 5, but will bear only 2 of the foregone benefit to the company (20% of 10), so the controller will take the opportunity. Such taking of opportunities is undesirable from the point of view of the company, and also inefficient for the overall economy. By the same logic, there is a range of other choices regarding the allocation of opportunities that are undesirable for the company but would be in the interest of the controller.

(ii) Self-dealing: A second kind of distorted choice that results from entrenchment and low incentives is self dealing, which involves a transaction between the company and an entity affiliated with the controller on terms that favor the entity and thus, in turn, the controller.

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dealing, together with taking of opportunities, is referred to in the economic literature as “tunneling.” Consider, for example, a transaction in which a company buys an asset from an entity controlled by the controller, which results in a loss of 10 to the company, but a profit of 5 to the seller. This would be in the interest of the controller, because the controller makes 5 profit but bears only 2 out of the 10 of the losses. These transactions are undesirable from the perspective of the company, and inefficient for the overall economy.

(iii) Appointment and retention of executives and directors: A third kind of distorted choice involves the appointment of executives. Suppose that the controller considers appointing a family member as an executive or a director. Suppose that choosing this person, instead of choosing the best person available outside the family, would produce a loss of 100 to the company, but the controller would derive a private benefit of 25 from having the family member serve. In this situation, the controller will appoint the family member rather than the better candidate. Furthermore, the controller might choose to retain that family member as a director or an executive even if the family member underperforms and would have been replaced but for his or her relationship with the controller.

In considering the problem of corporate pyramids it is important to keep in mind the wide range of ways in which private benefits of control can be extracted. While Israel has developed rules with respect to interested party transactions, it should be recognized that, no matter how effective these rules are, they cannot address all the ways in which private benefits are extracted, and therefore should not be a basis for concluding that agency problems have been adequately addressed. For example, such rules do not address concerns that especially profitable business opportunities will be allocated either to parts of the pyramid in which the controller owns a relatively large fraction of cash flow rights, or to private entities that are wholly owned or largely owned by the controller.

C. Problems of Expansion and Persistence

The discussion of agency problems and distortions has so far proceeded on the assumption that the company has a given amount of capital, with the relevant question being how

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17 The above discussion is not an exhaustive review of all of the ways in which the desire to obtain private benefits might lead to distorted decision-making. One other important example is the choice of assets. Suppose a company that is part of a pyramid could invest in two types of assets, but one provides the controller with a greater opportunity to extract private benefits than the other. The same logic as above indicates that even if the one asset would be more valuable for the company, the controller may have an incentive to cause the company to invest in the less valuable asset.
the company manages that capital. This section turns to another set of important problems, which arise from dynamic choices concerning whether the company and the group should expand, contract or remain the same size.

This is important because from the point of view of the minority investors in the pyramid, and of society in general, it is desirable that the pyramid tries to raise more capital only if the pyramid can deploy that capital efficiently, which is not always the case. Note that this issue is separate from the question of whether the group currently uses its existing capital efficiently – there may be a group that can effectively deploy its existing capital, but which may not have additional opportunities for profitable investments. There is another, related, set of issues that a company faces: whether to remain at its current size, or whether to contract by returning capital to its investors. Even if a pyramid has operated profitably in the past, there is always a question whether, going forward, it will be able to deploy capital more efficiently than that capital could be deployed elsewhere in the economy. From the point of view of investors, if the pyramid cannot do so, then it is desirable for it to contract.

In the context of a pyramid, controllers have a substantial structural bias in favor of expanding more than is desirable, as well as a strong structural incentive to avoid contracting, even when contraction is desirable. This results from the fact that the controller can extract private benefits from capital that is inside the pyramid, while the controller bears only a fraction of the costs of deploying the capital in the pyramid rather than elsewhere in the economy.

Consider a pyramid making a choice whether to raise additional capital at the lowest level of the pyramid for investment purposes. Assume that the controller receives private benefits of control of 10% of the company’s capital, and has cash flow rights to 20% of the capital. Suppose that the company raises capital of 100, but can only invest it in a manner that results in the capital being reduced to 90, so the company loses 10 from raising the capital. Assuming that the capital market recognizes that this will occur, the investors providing the new capital will pay only for what they expect to receive. As a result, the cost of 10 will be borne by the existing investors in the lower level subsidiary. The controller will bear 20% of the 10 cost, or 2. However, the controller will still prefer to raise the capital, because the controller’s private benefits increase by 10% of 100, or 10. This demonstrates the significance of this kind of distortion - if the controller has only 20% of the cash flow rights, even if the private benefits the controller enjoys are as low as 3% of the capital, it would be in the interest of the controller to undertake an expansion that would produce a return of -10%.

Alternatively, suppose that the company owns a block of shares in another public company that has a value of 100, and that it would be more efficient for the company to distribute those shares in kind to the company’s investors. By the same logic as above, even if
the distribution would produce a gain of 10, as long as private benefits to the controller are 3% or more, the controller would have an incentive to avoid such a contraction.

**D. The Significance of the Gap between Cash Flow Rights and Voting Rights**

The smaller the percentage of cash flow rights the controller holds, the more severe the distortions. This is why pyramids raise especially significant concerns. Take the example regarding taking of opportunities cited above and consider how the problem is worse when cash flow rights are smaller. In that example, if a controller that had 60% of the cash flow rights would take the opportunity for itself, it would internalize a large fraction of the effect on cash flow (it would bear costs of 6, and only receive private benefits of 5). However, if the controller has only 20% of the cash flow rights, it will take the opportunity for itself. Furthermore, when the controller has only 20% of the cash flow rights, it would be in its interest to expropriate an opportunity with a private benefit of 3. If the controller had only 10% of the cash flow rights, a private benefit of 1.5 would be sufficient to cause such controller to take the opportunity from the company. This demonstrates that the more severe the separation of cash flow ownership and control, the greater the severity of the distortion of choices.\(^{18}\)

Indeed, there are reasons to be concerned that a decline in a controller’s cash flow rights results in more than a proportionate increase in the resulting agency problems. When one compares two companies with separation of cash flow rights and voting rights that are identical except that the controller own 20% of cash flow rights in one but only 15% in the other, the agency costs in the latter company can be expected to be more than twice the agency costs in the former.\(^{19}\)

**V. EMPIRICAL EVIDENCE**

**A. Evidence from Other Countries**

As discussed below, there is a significant body of empirical work that documents the existence of tunneling and extraction of private benefits in pyramidal groups. Consistent with the discussion above, there is evidence that tunneling and other agency problems become more severe when the separation between control and cash flow rights increases. The evidence discussed in this Section A is based on data from various countries (other than Israel) around the

\(^{18}\) This point is demonstrated mathematically in Bebchuk, Kraakman and Triantis, supra note 15.

\(^{19}\) For an analysis demonstrating this point, see Bebchuk, Kraakman and Triantis, supra note 15.
world. In Section B, I discuss evidence suggesting that levels of private benefits are especially large in the Israeli economy compared with those in other countries.

In considering the evidence concerning agency problems in pyramids, the following are some noteworthy studies:

- Marianne Bertrand, Paras Mehta and Sendhil Mullainathan, studying Indian pyramidal groups, find evidence consistent with tunneling.\(^{20}\) They document patterns that are consistent with a controller transferring value from lower to higher tier firms in the pyramid – that is, to firms where the controller’s fraction of cash flow rights is larger.

- Stijn Claessens, Joseph Fan and Lary Lang, studying group-affiliated firms in East Asia, also find evidence consistent with tunneling.\(^{21}\) They show that whatever benefits come from group affiliation, such benefits are mainly distributed to firms at the apex of the pyramids that have higher separation between ownership and control.

- Jae-Seung Baek, Jun-Koo Kang and Inmoo Lee, studying Korean data, identify equity-linked private securities offerings (PSOs) as a mechanism for tunneling.\(^{22}\) They find that chaebol issuers involved in intragroup deals set the offering prices to benefit their controlling shareholders, and pricing decisions of PSOs are affected by the tunneling incentives of such controlling shareholders.

- Kee-Hong Bae, Jun-Koo Kang and Jin-Mo Kim, also studying Korean data, find evidence of intra-group transactions being used to pass wealth away from firms whose cash flows accrue more to public shareholders, up the pyramidal ladder toward firms whose cash flows accrue more to the controlling family.\(^{23}\) Such transactions are accompanied with stock price declines for affected companies in which the controller has relatively low cash flow rights and stock price increases for affected companies in which the controller has a relatively high cash flow rights.


• Yan-Leung Cheung, Raghavendra Rau and Aris Stouraitis, studying evidence from Hong-Kong listed companies, identify “connected transactions” as a mechanism for tunneling.\textsuperscript{24} The authors find that, on average, firms involved in “connected transactions” earn significant lower returns compared to similar arm’s-length transactions during the 12-month period following the announcement.

• Guohua Jiang, Charles Lee and Heng Yue, studying Chinese firms, find evidence of tunneling through the use of inter-corporate loans as a means to transfer significant amounts by controlling shareholders of publicly listed companies in order to siphon funds.\textsuperscript{25} The authors also find evidence that tunneling through inter-corporate loans is more severe when the controlling right is much larger than the ownership right.\textsuperscript{26}

Similarly, there is empirical evidence that controllers of corporate pyramids place family members or other affiliated individuals in executive positions in firms throughout the pyramidal groups and that they do not make the individuals’ continued service contingent on performance:

• Paolo Volpin, studying Italian corporate pyramids, finds that the probability of turnover and its sensitivity to performance are significantly lower for top executives who belong to the family of the controlling shareholder than for other executives.\textsuperscript{27}

• Yin-Hua Yeh and Tracie Woidtke, studying data from Taiwan, provide evidence on agency problems in controllers’ selection of directors.\textsuperscript{28} The authors find that the fraction of

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\item Ronald Masulis, Cong Wang and Fei Xie, studying U.S. dual-class companies, find evidence consistent with the hypothesis that tunneling is more severe when managers have greater control rights in excess of cash flow rights. Ronald W. Masulis, Cong Wang and Fei Xie, "Agency Problems at Dual-Class Companies," 64(4) Journal of Finance 1697-1727 (2009). Although not in the context of pyramids, the context of dual-class stock is economically similar, as discussed in Part III above, to that of pyramids. The authors report that, as the divergence widens at dual-class companies, corporate cash reserves are worth less to outside shareholders, CEOs receive higher levels of compensation, managers are more likely to make value-destroying acquisitions, and capital expenditures contribute less to shareholder value.
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board members affiliated with a firm's largest shareholder is higher when that shareholder has a greater divergence between voting and cash flow rights, and that controlled firms have lower value when the fraction of board members affiliated with the controlling family is higher.  

B. Evidence on Private Benefit Levels in Israel

Another way of empirically examining the existence and significance of agency problems is to investigate the private benefits enjoyed by controllers. An established way in the financial literature to assess the levels of private benefits is to study the magnitude of premiums paid when a control block changes hands. A study by Alexander Dyck and Luigi Zingales introduced this method and studied control premia in 39 countries between 1990 and 2000. For present purposes, an important finding of the Dyck-Zingales study is that Israel was among the highest private benefit countries (ranking 7th among 39 countries), with a mean of private benefit as a percentage of equity of 27% (compare to an overall sample average of 14%).

It is worth noting that, in the Dyck-Zingales study, Israel had a substantially higher level of private benefits than the great majority of countries with advanced economies and developed corporate systems – including common law countries such as the United States, the United Kingdom, Australia, Canada and New Zealand, European countries such as France, the Netherlands and Norway, and East Asian countries with advanced economies such as Japan and Hong Kong. Countries in the Dyck-Zingales study that had higher control premia than Israel were Austria (38%), the Czech Republic (58%), Italy (37%), Mexico (34%), Turkey (30%) and Brazil (65%).

Because of the importance for present purposes of the above Dyck-Zingales finding concerning the high level of private benefits of control in Israel, it is important to note that this finding was confirmed by a research examining an Israeli dataset from recent years. Such a study focusing only on control premia in Israeli companies during the period 1993-2005 was conducted by Ronen Barak and Beni Lauterbach. The study's overall sample results for private benefits from large block trades (32%) are similar to those of Dyck and Zingales. Importantly,

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29 It is also worth noting a study of firms, in which the succeeding CEO is related by blood or marriage to a departing CEO, to a founder, or to a large shareholder, underperform relative to firms that promote unrelated CEOs; see Francisco Pérez-González, "Inherited control and firm performance," 96(5) American Economic Review 1559–1588 (2006).
for the purposes of the current consideration, the Barak-Lauterbach study also found some
evidence that private benefits as proxied by control premia are larger in Israeli companies when
the wedge between the controller cash flow and voting rights increases.

Finally, a recent ISA analysis examined control premia in Israeli companies for the years
2006-2010 using the same methodology as in the Barak-Lauterbach study. This analysis found
the average control premia in Israel during this five-year period to be in the range of 19%-30%,
depending on whether one assumes that the buyer or seller has the negotiation power to capture
the surplus produced by the transaction.  

33 The significance of the empirical evidence about the high levels of control premia in Israel was
disputed in the submission by IDB in response to the Interim Committee report, Nov. 27, 2011, and a
report by Professor Efraim Ben-Melech included as an attachment to this submission. However, I do not
find their objections persuasive.

IDB representatives argue in their submission that a new controller might be willing to pay more
for a control block than the pre-transaction market price because the controller might be able to manage
the company better, might be able to use its control to cause a payment of dividends that would raise the
value of all shares, and might view the pre-transaction market price as undervaluing the company. This
set of objections overlooks the fact that in the Dyck-Zingales standard methodology, control premia are
measured by reference to the post-transaction market price, not the pre-transaction price. Consider a buyer
that approaches the controller of a company currently trading at 9 NIS per share, buys the controller’s
50% block for a price of 13 NIS per share, with shares trading up to 10 NIS per share following the
announcement of the transaction. What can explain the 30% control premium in this example? If the
controller believed that the cash flows expected to come to each share under the post-transaction
management would be 13 NIS, then the new controller would have an incentive not to buy just the 50%
block but to subsequently keep buying shares at the 10 NIS price as long as the market price does not
move toward 13 NIS. A standard situation in which the buyer purchases the control block but does not
buy additional shares on the market post-transaction, even though they sell at prices substantially below
the per share value price paid for shares in the control block, suggests that the new controller expects
some of the value paid for the control block to be returned to the buyer directly as private benefits of
control and not in the form of cash flows that would reach each of the shareholders.

Professor Ben-Melech raises several reasons for his reservations. First, he observes that Israel’s
formal rules with respect to shareholder rights and interested party transactions rank well on standard
indices and that control premia should not be viewed as measures of the quality of such rules but rather
may depend on other factors. As Dyck and Zingales stress, private control benefits depend not just on the
laws on the books but on non-legal factors. Second, Professor Ben-Melech stresses that the Dyck-
Zingales study measures control benefits in Israel using a small number of transactions. However, as I
explain above, subsequent studies using data from later years, not mentioned in Professor Ben-Melech’s
report, continue to find high control premia. Third, Professor Ben-Melech suggests that high control
premia might theoretically reflect not private benefits to controllers but the tendency of controllers to
overpay systematically. As Professor Ben-Melech notes, Dyck and Zingales suggest that control premia
The evidence that private benefits in Israel are high relative to international levels, and are higher than in other advanced OECD countries, indicates that agency problems and extraction of private benefits are especially significant in Israel. The need for measures to address such problems is, correspondingly, relatively significant in Israel. Moreover, evidence about the levels of control premia will be useful to Israeli authorities in the future as a barometer for the effectiveness of whatever reforms are adopted. As long as control premia in Israeli public firms do not substantially decline from their high levels, public officials should remain concerned about agency problems and the extraction of private benefits in such firms.

VI. POTENTIAL COUNTERVAILING BENEFITS

A. Contracting Benefits in Emerging Economies

Some researchers have suggested that, especially in developing economies, large pyramidal business groups can produce some efficiency benefits. When external markets and institutions are poor, it is argued, a large business group can avoid dealing with them by doing so internally. In particular, when equity markets and institutions are underdeveloped, making it difficult for relatively small firms to raise capital, a pyramidal business group can avoid this problem by creating an “internal capital market” in which excess cash flow from mature and cash-producing elements of the pyramid is allocated to other elements that are in need of additional capital. Similarly, when contracting with outside business partners is unreliable because of poor judicial and enforcement systems or otherwise, a sprawling corporate pyramid makes it possible to bypass this problem by having certain elements of the pyramid do much of their necessary trading with other elements of the pyramid. Finally, in the absence of labor market institutions that produce a steady flow of trained workers and managers, a corporate pyramid can substitute for such institutions by investing in the needed training and then using trained personnel across many firms in the group.

While conglomerate pyramids may produce benefits by substituting weak institutions in underdeveloped economies, they are unlikely to produce significant benefits in this way in developed economies, such as the Israeli economy at the present time. Randal Morck, a leading researcher of pyramids, stated that "business group member firms are relatively strong performers in developing economies…but mediocre-to-weak performers in developed economies…but mediocre-to-weak performers in developed

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34 For a comprehensive discussion, see Tarun Khanna and Yishay Yafeh, "Business Groups in Emerging Markets: Paragons or Parasites?," 45(2) Journal of Economic Literature 331–372 (2007).
In the case of the Israeli economy, the development outside of the economy’s large businesses of so many successful high-technology firms highlights that the Israeli economy does not lack institutions that enable firms operating outside pyramidal conglomerates to raise needed capital, contract reliably with business partners, and obtain skilled workers and managers.

Indeed, there is a significant body of empirical work finding that, in developed countries, putting together firms operating in diverse industries within one corporate conglomerate not only fails to produce efficiency benefits, but is also likely to produce efficiency costs. There is a significant body of evidence documenting the existence of a “conglomerate discount” in the United States and other countries with developed capital markets. The empirical literature began with a well-known study by Philip Berger and Eli Ofek. Investigating U.S. data on conglomerates, the study finds that, on average, conglomerates operating in different industries are traded at a significant discount of their firm value against a matched sample of stand-alone firms. The findings of this study were confirmed by subsequent studies. There is also work on countries outside the U.S. that finds a conglomerate discount in other developed economies such as those of the United Kingdom and Japan.

B. Rent-Seeking Advantages

In addition to the possibility of producing significant efficiency gains by overcoming impediments to reliable contracting in emerging economies, the literature also discusses ways in which large business groups facilitated by pyramids could produce benefits for shareholders from improved ability to capture rents. By putting together large amounts of resources under a

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single command, pyramids enable firms to capture rents at the expense of other groups in the economy.

First, researchers have suggested that the elaborate business groups made possible by pyramids enable the capture of benefits from increased market power.39 Such pyramidal groups bring under one command firms that operate in different markets and increase the opportunities for a wide range of multi-market interactions that can result in reduced competition and higher pricing. Note, however, that benefits to shareholders produced from weakened competition do not represent social efficiently gains. Such benefits to shareholders come at the expense of consumers who bear larger losses. Indeed, to the extent that pyramids have such effects, these effects are negative from a social perspective.

Second, researchers have suggested that corporate pyramids enable their controllers to be effective in lobbying and influencing political and governmental decision-making and thereby in capturing political rents.40 Controllers that command a wide range of economic activities have at their disposal many ways of benefiting relevant players without violating applicable rules. Furthermore, by being repeat players in the political influence game, the implicit promises of such controllers can gain added credibility. As a result, firms belonging to pyramids can expect to obtain more favorable outcomes from political and governmental decision-making than they would if they were operating outside a pyramidal business group. While such favorable outcomes could produce gains to shareholders, these gains could well represent rents coming at the expense of other players such as competitors, potential entrants, agents adversely affected from lax regulations, and so forth.

Thus, while pyramids are unlikely to provide substantial efficiency gains in a developed economy, they might provide both controllers and public minority shareholders some rent-seeking advantages. These rent-seeking advantages, however, could very well not represent social gains. Thus, because pyramids are likely to have negative externalities on stakeholders in the economy, they might not be socially efficient overall, not only when they are value-reducing for public minority shareholders but even when they are not value-reducing for such shareholders.


C. Evidence on Pyramids and Shareholder Value

There is a significant body of evidence documenting that pyramidal structures are often associated with reduced value for public investors, and that this reduction in value is higher when the separation between cash flow rights and control rights increases. Relevant studies from the literature include:

- Stijn Claessens, Simeon Djankov, Joseph Fan and Larry Lang, studying publicly traded corporations in eight East Asian countries, provide evidence that substantial separation of control and cash flow rights is associated with worse performance for shareholders.\(^4\) They find that firm value, measured by market to book ratio, rises with the cash flow rights of the largest shareholder and falls as the control rights of the largest shareholder decline relative to cash flow rights.

- Karl Lins, studying data on firms from eighteen emerging markets,\(^2\) finds that firm value is negatively correlated (after controlling for firm size, investment rate, leverage and country) with the excess of insider blockholders’ control rights over their cash flow rights.

- Sung Wook Joh, using data from Korea, similarly reports that a higher excess of control rights over cash flow rights is associated with lower profitability.\(^3\)

- Marianne Bertrand, Simon Johnson, Krislert Samphantharak and Antoinette Schoar, researching business groups in Thailand, document that family business groups with a larger number of smaller firms tend to have lower performance, more fragmented internal capital markets, and possibly more tunneling at lower levels of the pyramidal structure.\(^4\)


- An Buysschaert, Marc Deloof, Marc Jegers and An Rommens, studying Belgium group-affiliated companies, find that they were less profitable than stand-alone Belgian companies.\textsuperscript{45}

- Yves Bozec and Claude Laurin, studying Canadian public firms with controlling shareholders, provide additional evidence about the negative association between a firm's performance and the separation between voting rights and cash flow rights.\textsuperscript{46} The authors find this negative association to be especially significant when the dominant shareholder gains effective control of the firm (and therefore such a shareholder has enough voting rights to expropriate minority shareholders), when it also has less than 25% of the cash flow rights (so that it has an incentive to expropriate minority shareholders), and when the firm that it controls has above average free cash flows (so that it has the opportunity to expropriate minority shareholders).\textsuperscript{47}

Negative association between pyramidal affiliation and firm value is also reported for Israeli data in articles by Konstantin Kosenko and by Kosenko and Yishay Yafeh.\textsuperscript{48} The reported evidence indicates that, in comparison with unaffiliated firms, group-affiliated companies trade at lower firm value as measured by market to book ratio. In addition, the authors find that the growth rate of group-affiliated companies is lower in comparison with stand-alone firms. According to the authors, one possible interpretation to the group-affiliation discount is that there is little economic advantage to the existence of diversified business groups in Israel due to its developed economy and well-functioning capital markets.\textsuperscript{49}


\textsuperscript{47} Paul Gompers, Joy Ishii and Andrew Metrick, studying U.S. dual-class stock corporations, find evidence that when the separation between cash flow rights and voting rights is larger, agency problems and resulting reductions in firm value are more severe. See Paul A. Gompers, Joy Ishii and Andrew Metrick "Extreme Governance: An Analysis of Dual-Class Firms in the United States," 23(3) Review of Financial Studies 1051-1088 (2010). While this study focuses on the context of dual-class companies rather than pyramids, the context of dual-class stock is economically similar to that of pyramids in important ways.


\textsuperscript{49} A report by Professor Efraim Ben-Melech, included as an appendix to the Nov. 27, 2011 response submitted to the Committee by the IDB group, criticizes the findings in the early working paper version of the study by Kosenko, supra note 6, which was attached to the Interim Committee Report. Professor
It should be noted that the body of empirical evidence about the association between pyramids and firm value is not uniform in its findings, and that some studies of countries around the world do not find the negative association reported by other studies. But much of the work in this area, including the work done using Israeli data, finds a negative association between pyramids and shareholder value. Furthermore, as explained earlier in this Part, policymakers assessing pyramids from a social perspective need to take into account that pyramids can provide benefits to shareholders from increased market power and enhanced lobbying ability, which might not reflect social gains, and that pyramids could thus be socially inefficient even in cases in which they were not overall value-decreasing for shareholders.

VII. PROHIBITING CREATION OF PYRAMIDS WITH THREE OR MORE LEVELS

I now turn to policy recommendations. Throughout my work for the Committee, I stressed the need for the adoption not only of governance arrangements for pyramids that take their existing elaborate structures as given, but also of structural rules that seek to influence these structures. A structural limit on the number of levels permissible in pyramids, on which the Committee settled with my support, would produce desirable structural changes.

This part focuses on the two-level limitation recommended by the Committee for pyramids created in the future. Section A explains why Israel’s special circumstances raise unique concerns that warrant the adoption of a significant structural measure. Section B explains the benefits of focusing on levels as the basis for the policy. Throughout this section I focus on the Committee’s recommendation to limit the future creation of pyramids with three or more levels. I defer the subject of existing pyramids to the next section.

A. Why Structural Measures are Warranted for Israel

While limiting pyramids to two levels is a novel approach, Israeli public officials have good reasons to seek more significant limitations on pyramids than are currently in place in other countries. The Israeli economy has several unique features that generate especially strong concerns regarding the country’s pyramidal structures.

Ben-Melech argues that the study “does not meet the scientific standard that typically lead to a refereed publication in one of the leading economics or finance journals.” However, the Kosenko study did not claim to make the type of novel scientific contribution that would merit publication in a top financial or economics journal. Nonetheless, the study contributes by applying familiar methodology to Israeli data, and its findings are useful and should be taken into account by Israeli policymakers.  
50 See, e.g., Masulis et al., supra note 7.
First, as discussed in Part V, the levels of private benefits of control in the Israeli economy are especially high, as reflected in control premia paid in acquisitions. These levels stand out relative to those in other comparably advanced economies.

Second, as discussed in Part II, Israel’s corporate pyramids play a more dominant role in Israel’s economy than pyramids play in other comparably advanced economies, and Israeli pyramids tend to have more levels than those in other comparably advanced economies. As a result, pyramids in general, and multi-leveled pyramids in particular, are of substantial practical significance for Israeli public officials. This second feature is related to the first feature; around the world, pyramidal structures tend to be associated with higher levels of private benefits of control. When private benefits of control are high, controllers have strong incentives to maintain their hold on control, as well as to create additional levels lower in the pyramid.

Third, as noted in Part IV, Israel has developed rules on interested party transactions. The high control premia that nonetheless characterize the Israeli market for corporate control indicate that controllers have been able to obtain high levels of control benefits despite the existence of such rules, and raise questions about the effectiveness of additional process requirements in curtailing control benefits. This consideration has contributed to the substantial attention the Committee has devoted to structural measures.

Fourth, as explained in Part III, when levels of private benefits of control are high, pyramidal structures have a strong likelihood of persisting even when they are inefficient, and existing pyramids tend to expand and add additional levels even when doing so is inefficient. Given the high level of private benefits in the Israeli economy, these problems of persistence and expansion weigh in favor of a structural approach.

Fifth, Israel is not an emerging economy, in which it may be difficult for firms to transact with firms outside their business group due to unreliable contracting or missing institutions. To be sure, pyramids may have been useful in addressing such problems in the early stages of the country’s development. However, given the current state of Israel’s development, multi-level pyramids are unlikely to bring the type of efficiency benefits that (as discussed in Part VI) the literature attributes to pyramids in emerging economies.

Sixth, Israel has a long-standing policy of disallowing the creation of dual-class stock structures, which prevents controllers from using such structures to maintain control of a company with only a small minority of the cash flow rights. Corporate pyramids enable controllers to get around this prohibition and maintain their control of corporate assets even when they have a minority (or even a small minority) of the equity capital funding those assets. Structural limitations on pyramidal structures can be viewed as limiting the extent to which
pyramidal structures can be used to get around the prohibition on deviations from the one-share-one-vote principle of Israeli law.

Finally, while the introduction of a legal limit on the number of levels permissible in a pyramid would be a novel strategy, the resulting landscape of corporate structures such a limit would produce would hardly be unusual. On the contrary, without multi-level pyramids, whose presence currently differentiates Israel from other comparable advanced economies, Israel’s corporate landscape would become more (rather than less) similar to that of other advanced economies. As a result, concerns that the measure might deter foreign investors in Israel’s capital markets by creating an unfamiliar situation are misplaced. Instead, the measure would contribute to the creation a corporate landscape that is similar to that of other advanced economies around the world, and familiar to international investors.

B. Focusing on Pyramids with Three or More Levels

The Committee’s decision to limit the extent to which pyramids can be used to separate cash flow rights from voting rights in deviation from the one-share-one-vote principle leads to the question of what limits to put in place in order to achieve this. Limiting the number of levels is a simple and effective way to limit the extent to which inefficient pyramidal structures may be used.

The more levels permitted in a pyramid, the smaller the fraction of cash flow rights that a controller may hold at operating companies further down the pyramid while still retaining control. As a result, limiting the permissible number of levels in pyramids complements the long-standing limitation on dual-class stock structures, and prevents the dual-class stock limitation from being undermined by the use of pyramids.

In addition, the greater the number of levels in a pyramid, the greater the potential for conflicts as controllers have more choices as to where to place business. Furthermore, expressing the limitation in terms of levels, rather than in terms of the resulting gap between cash flows and voting power, would be easy to apply and administer.\footnote{51 In contrast, the gap between cash flow and voting power in companies within a corporate pyramid may change frequently as shares are bought and sold both at the level of the relevant company and at higher levels of the pyramid.}

In my view, once the decision is made to adopt a structural solution based on the number of levels, a two-level limit represents the best limitation policy. Such a limit would allow the use of holding company structures, which have a significant incidence in many other advanced
economies. However, a two-level limit would prevent the creation of structures that allow for radical separation between cash flows and control. If a controller were limited to two levels, then in order to ensure control of second-level companies (by controlling at least 50% of the votes at each level), the controller would need to maintain at least 25% of the second-level companies’ cash flow rights.

It should be stressed that, even though the two-level limitation would place significant limits on the extent to which pyramids can be used to produce a separation between cash flow rights and voting rights, second-level companies in pyramids might still have significant levels of such separation and would thus raise elevated agency concerns. The Committee sought to address this problem by adopting strengthened governance arrangements for such second-level companies.

The Committee considered, but did not adopt, a more lenient limitation that would have limited future pyramids to three levels. In my view, such a relaxation of the limitation would be undesirable and counterproductive. With three levels a controller could ensure control of a third-level company (by holding 50% of the voting power at each level) while owning just 12.5% of the cash flow rights in the third-level companies. Moreover, three-level structures do not present any compelling efficiency gains that would warrant allowing such a widening of the possible disparity between cash flow rights and control.

VIII. EXISTING PYRAMIDS

The Committee’s conclusion that pyramids with three or more levels are unlikely to be efficient and are best avoided, leads to the question of how to treat existing pyramids. The Committee chose (i) to allow existing pyramids four years to comply with adopted limits on the number of permitted levels in a pyramid, and (ii) to subject existing pyramids to a three-level limitation rather than a two-level limitation, essentially grandfathering third-level companies in existing pyramids.

Section A focuses on the recommended transition arrangements for existing structures, explaining that these arrangements are sufficient to address legitimate interests of controllers and public minority shareholders in existing companies. Section B discusses whether the limitations with which existing pyramids would have to comply should ultimately be more lenient than those that would apply to new structures, and explains why, in my view, subjecting existing pyramids to a two-level limitation, with appropriate transition arrangements, would be preferable to grandfathering third levels in existing pyramids.
A. Transition Arrangements

Existing pyramids that have more levels than will be permitted after the rule comes into effect will be forced to take steps to eliminate excess levels. Existing pyramids can use mergers or spin-offs to move assets to higher levels that will remain permissible, or can dispose of companies in impermissible levels by selling their control blocks in such companies. Given that a limitation on the number of levels may result in such sales, the Committee has chosen to adopt transition arrangements that would address legitimate interests that controllers and public minority shareholders have in avoiding the necessity to sell assets at depressed prices in a “fire sale.”

The Committee’s recommendation would allow existing pyramids four years to comply with the limitation. In my view, a four-year period would provide controllers of multi-level pyramids with ample time to transition to compliance, and would address concerns that would arise if controllers were given a short window that could force a sale at an unfavorable time. With a four-year period to move to compliance, controllers and public minority shareholders in remaining pyramidal levels would have sufficient time to capture the fair value of the control blocks sold in the parts of pyramids that would have to be separated. Furthermore, the Committee has recommended the adoption of favorable tax arrangements that would further help avoid the imposition of an unfair penalty on the controller and public minority shareholders at higher levels of existing pyramids.

To be sure, controllers of existing pyramids that would have to sell assets and contract the size of their group might see the controllers’ levels of private benefits decline following the structural changes. However, controllers should not be viewed as entitled to retain current levels of private benefits. Suppose that the adopted limitation would require a controller to have company C sell its control block in company D. Even assuming that the sale provides C and its shareholders with fair value for the control block, the sale would contract the scope of the assets controlled by the pyramid’s controller. The controller could be made worse off by the sale since some of the forgone private benefits of control may have been provided directly to the controller, whereas the control premium received by C for its control block in D would be shared by the controller with the public minority shareholders in C. The sale may therefore also make the public minority shareholders of C better off as a result. However the controller should not be viewed as having an entitlement to extract private benefits directly from the company, and therefore the fact that the adopted limitation may reduce the controller’s opportunities to extract private benefits of control should not be considered a basis for opposing the limitation.
B. Should Existing Third-Level Companies be Grandfathered?

I turn to the question of whether existing pyramids should eventually be subject to the same two-level limitation or a more lenient three-level limitation. In my view, given that the Committee has concluded that three-level pyramids are unlikely to be efficient and should be restricted, it would be undesirable to allow some such three-level pyramids to remain indefinitely.

Given the Committee’s conclusion about the general undesirability of three-level pyramids, the only reasons to make an exception for existing pyramids are transition concerns that separating more levels from existing pyramids would be substantially more difficult and impose undue costs on existing pyramids’ controllers and shareholders. As discussed above, however, the Committee’s recommendations already provide a sufficient transition period.

Moreover, in order to comply with a two-level limitation, a multi-leveled pyramid would not have to sell control blocks in every company at or below the third level individually. Rather, selling a company held at a pyramid’s third level would also separate from the pyramid those companies at the fourth-level that are held through the third-level company being sold. An analysis that takes this consideration into account indicates that a two-level limitation would require a sale of only a fraction of the companies now held at the third (or greater) level of existing pyramids. Further, such an analysis indicates that a two-level limitation would not necessarily result in sales of more control blocks, or sales with a greater aggregate value, and might potentially result in fewer sales of control blocks, or sales with a lower aggregate value, than a three-level limitation.\footnote{To illustrate this point, consider a pyramid that has four-levels, including two third-level companies, C1 and C2, each with assets consisting only of control blocks in four-level companies, and four fourth-level companies, D1 and D2 (both controlled by C1), and D3 and D4 (both controlled by C2). In this case, a two-level limitation would result in sales of the control blocks in C1 and C2, while a three-level limitation would result in sales of the control blocks in D1, D2, D3 and D4. A two-level limitation scenario may therefore require fewer buyers with less capital in the aggregate than a three-level limitation.}

In any event, concerns about the length of an appropriate transition period and the rate at which appropriate buyers may become available should at most lead to the adoption of a longer period for the disposal of companies at the third level of existing pyramids. Such concerns should not lead to an indefinite grandfathering of such structures. To the extent that third levels are presumed to be undesirable and the creation of new three-level pyramids is disallowed, three-level pyramids should not be permitted to remain indefinitely solely on the basis of the date they were created.
Recall that allowing three levels implies that controllers would be able to retain absolute control over third-level companies while holding no more than 12.5% of the cash flow rights in such companies. Recall also that the existing multi-level structures in the Israeli economy set it apart from many other advanced economies and raise significant concerns. Thus, given the conclusion regarding the undesirability of three-level pyramids, it would be desirable not to provide existing pyramids with an indefinite exemption from the two-level limitation.53

IX. CORPORATE GOVERNANCE IMPROVEMENTS

Finally, before concluding, I would like to express briefly my support for two corporate governance measures on which I worked in the course of my engagement that are included in the Committee’s final recommendations.

A. Outside Directors Elected by the Minority Shareholders

The Committee’s final recommendations seek to strengthen the independence of outside directors in firms that the Committee viewed as likely to raise especially significant agency concerns by introducing outside directors that public minority shareholders may elect and not only veto. In my opinion, introducing such outside directors would be beneficial.

Under existing rules, public investors merely have a veto right over the controller’s choice of outside directors. Allowing the controller to select the outside directors, however, is not an effective mechanism for ensuring that outside directors carry out their important role in limiting choices that would benefit the controller but not the shareholders in general. The 2008 report of the Hamdani committee54 recommended providing public investors with the power to choose outside directors,55 and subsequent legislation requires companies either to comply with

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53 If existing third-level companies were to be grandfathered, it would be desirable to provide public minority shareholders in such companies with exit rights in connection with outside premium offers as described in the Interim expert Report, supra note 2, at 8-9. Such exit rights might prevent such minority shareholders from being locked up indefinitely in an inefficient third-level structure. However, given the costs of having a regulatory arrangement for a small number of companies, applying the two-level limitation to existing pyramids would be preferable.


55 In the interests of full disclosure, I note that I served as an adviser to the Hamdani committee and supported this recommendation.
such an arrangement or to explain why they do not do so.\textsuperscript{56} While such an arrangement is, in my view, desirable for any controlled public companies in which public investors have a sufficiently significant stake, it is especially warranted for companies in which policymakers view agency problems as elevated.

It should be noted that legislation requiring public companies to enable minority shareholders to determine the identity of some board members is not unprecedented. The Italian company law adopted in 2005 requires listed companies to use the 'voto di lista' mechanism, pursuant to which the election of the board of directors must be done with the slate voting system.\textsuperscript{57} While a certain percentage of directors are elected from a nominee list that is effectively presented by the majority shareholders, at least one director is elected by the minority shareholders from so-called "minority lists" of nominees put forward by minority shareholders.\textsuperscript{58}

\textsuperscript{56} Amendment 16 to the Israeli Companies Law, 1999 (the "Companies Law"), which was enacted in March 2011 ("Amendment 16"). Pursuant to the Amendment, a company is entitled to include in its articles of association certain corporate governance rules from a list of recommended rules set forth in the First Addendum to the Companies Law. The Israeli Securities Authority applies certain disclosure obligations to public companies with respect to the recommended rules, so that a company that elects not to adopt such corporate governance rules shall be required to disclose this fact to the public. The recommended corporate governance rules regarding the appointment of outside directors provide that the election of an outside director will require the vote of a majority of the shares voted at the meeting subject to the following conditions: (i) the votes of controlling shareholders and shareholders who do have a personal interest in such election, as well as the abstentions, shall not be included in the voting count; and (ii) the total number of shares held by non-controlling shareholders and shareholders who do not have a personal interest in such election that voted in favor the election of the outside director exceed 2\% of the aggregate voting rights in the company.


\textsuperscript{58} By June 30, 2007, all Italian listed corporations were required to modify their bylaws and to allow the appointment to the board of directors of at least one representative of minority shareholders, through the use of the ‘voto di lista’ mechanism. Corrado Malberti and Emiliano Sironi, studying data from the transitory period, find evidence that the existence of representatives of minority shareholders on the board of directors is positively associated with capitalization and with the percentage of non-executive directors sitting on the board, but negatively associated with a dummy variable that indicates whether a corporation is a bank. See, id.
B. Audit Committee Supervision of Interested Party Transactions

In the course of my work, I advised the Committee that it would be desirable to expand the authority of the audit committee to include supervision of interested party transactions that do not require a shareholder vote but are still financially consequential. In my view, such a moderate expansion of the authority of the audit committee, which the Committee’s final recommendation would mandate for all public firms, would be beneficial.

Because a public company’s audit committee must include a majority of directors that are not affiliated with the controller,\(^{59}\) requiring approval by this committee can be beneficial with respect to decisions that raise agency concerns. Requiring audit committee involvement in appointments of directors of controlled public subsidiaries may discourage the selection of directors who would not be best for the position, but whom the controller might prefer due to family relations or other private considerations. Similarly, when a set of interested party transactions cannot, because of practical considerations, be submitted to a vote for shareholder approval but is financially consequential in the aggregate, supervision by the audit committee may limit the extent to which such a set of transactions can be used to divert value to the controller.

X. CONCLUSION

The dominant role and elaborate structures of Israel’s corporate pyramids raise serious concerns and warrant the adoption of significant measures. The two-level limitation adopted by the Committee with my support would be beneficial and make a significant contribution to addressing valid concerns. Applying this limitation both to new third levels and to existing structures would enhance the effectiveness of the adopted policy in addressing these concerns.

\(^{59}\) See Section 115 of the Companies Law, which requires that the majority of the members of the audit committee shall be “Unaffiliated Directors,” and that the chairman thereof shall be an outside director. An “Unaffiliated Director” is an outside director who: (i) meets the qualifications of an outside director under the Companies Law as determined by the audit committee; and (ii) does not serve as a director in the company for more than nine consecutive years. Pursuant to Section 240, an individual who is qualified for appointment as a director may be appointed as an outside director, as long as (i) such individual or any of her relatives, partners, employers or a corporation in which she has control, has no connection with the company or with a holder of control of the company on the date of appointment; (ii) any other position or business of hers does not give rise to a conflict of interest with her role as director, or might not harm her ability to act as a director; (iii) such individual does not serve as an outside director of one company and a director of another company, if at such time, a director of the first company is acting as an outside director of the second company; or (iv) such individual is not a member or employee of the Securities Authority or the Israeli stock exchange.