Fordham Journal of Corporate & Financial Law

Volume 9, *Number* 2 2004 *Article* 7

Glass-Steagall: The American Nightmare that Became the Israeli Dream

Ehud Ofer*

*

GLASS-STEAGALL: THE AMERICAN NIGHTMARE THAT BECAME THE ISRAELI DREAM

Ehud Ofer[*]

INTRODUCTION

This Note will examine the securities activities of banks in Israel. The relatively new legislation dealing with this aspect—Regulation of Investment Advice and Investment Portfolio Management Law (the "Law")—was enacted in 1995 as a lesson learned from the Share Regulation Affair of October 1983 (the "Share Regulation Affair" or the "Crisis of 1983"). In many ways in economic history, 1983 was for Israel what 1929 was for the United States. This Note will compare Israel's episode with the U.S. episode and will use the comparison to review the adequacy of the Israeli legislative response to the Crisis of 1983. The Law was enacted, primarily, based on American experience and legislation. This Note will compare the legislation enacted in both countries. To better understand the differences, this Note will introduce the unique financial market in Israel. Furthermore, this Note will present the recent legislative development in the United States (*i.e.*, Gramm-Leach-Bliley Act) which repealed parts of the Depression-era Glass-Steagall Act. The Note will examine the necessity of Israeli "adjustments" to the Law due to this new development.

---

[*] Ehud Ofer is a graduate of the LL.M. program in Banking, Corporate and Finance Law at Fordham University School of Law. This Note was written as his Thesis for his LL.M. degree. The author would like to thank Sara Ofer and Hagit Hasson-Ofer for their invaluable research assistance.

I. AN OVERVIEW OF THE AMERICAN SYSTEM: FROM GLASS-STEAGALL TO GRAMM-LEACH-BLILEY

A. The Glass-Steagall Act

1. Brief History

In 1933, the United States economy had collapsed in all major aspects.[1] The unemployment rate among the formerly employed was at 25%, and "[o]ver 11,000 banks had failed or had to merge, reducing the number by forty percent, from 25,000 to 14,000."[2] Several state banks were closed by the respective state Governors, and in March of that year, President Roosevelt declared a national banking holiday.[3] As did much of the public, Congress placed the blame for the Great Depression squarely on the nation's commercial banks.[4] The enactment of the Banking Act of 1933[5] was President Roosevelt's response to the breakdown of the nation's financial and economic system.[6] The Banking Act of 1933 "reflected a determination that policies of competition, convenience or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the 'hazards' and 'financial dangers' that arise when commercial banks engage in the activities proscribed by the [Banking Act of 1933]."[7] Prohibiting banks from engaging in securities activities was thought to prevent the reoccurrence of future banking crises and financial calamities.[8]

---

1. GEORGE J. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING 1 (Oxford Univ. Press 1990).

2. *Id.*

3. *Id.*

4. *See* Sen. R. 77, 73d Cong., 1st Sess. 1 (1933).

5. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

6. *See* BENSTON, *supra* note 1, at 1.

7. Inv. Co. Instit. v. Camp, 401 U.S. 617, 630 (1971) (stating remarks of Sen. Bulkley).

8. Carlos D. Ramirez, *Will the Gramm-Leach-Bliley Act Change the Future of Corporate Finance?*, 4 NAT'L LEGAL CTR. FOR THE PUBLIC INTEREST 8, 12 (2000).

The primary force behind the Banking Act was Senator Carter Glass,[9] a former Treasury Secretary who is considered the "father" of the Federal Reserve System.[10] For several years prior to 1933 he had wanted to "restrict or forbid commercial banks from dealing in and holding corporate securities."[11] It was the "'fixed purpose of Congress' not to see the facilities of commercial banking diverted into speculative operations by the aggressive and promotional character of the investment banking business." [12] However, Glass was not able to accomplish his goal "until disclosures concerning National City Bank, the predecessor to Citibank, were brought out in the Senate Committee on Banking and Currency's Stock Exchange Practices Hearings."[13]

Despite having little interest in separating banking from Wall Street, Congressman Henry Steagall, Chairman of the House Banking and Currency Committee, signed on to the bill—eventually the Banking Act of 1933—after Glass agreed to add Steagall's amendment to the bill which authorized bank deposit insurance for the first time.[14]

2. General Provisions of Glass-Steagall

"The 'Glass-Steagall' Act ("Glass-Steagall") has come to mean only those sections of the Banking Act of 1933 that refer to banks' securities operations—sections 16, 20, 21 and 32."[15] These four sections of Glass-Steagall control commercial banks' domestic securities operations. Sections 16 and 21 relate to the direct operations of commercial banks,[16] while sections 20 and 32 refer to commercial bank affiliations.[17]

---

9. *See* Laura J. Cox, *The Impact of the Citicorp-Travelers Group Merger on Financial Modernization and the Repeal of Glass-Steagall*, 23 Nova L. Rev. 899, 903 (1999).

10. *E.g., id.*; *see also* Carter H. Golembe, *History Disputes Tales of Pre-1933 Securities Irregularities by Banks*, 14 No. 7 BANKING POL'Y REP. 3, 3 (Apr. 3, 1995).

11. Cox, *supra* note 9, at 904.

12. *Inv. Co. Instit.*, U.S. at 632 (1971).

13. Cox, *supra* note 9, at 904.

14. *Id.*

15. BENSTON, *supra* note 1, at 4–5. Sections 16, 20, 21 and 32 were codified as amended at 12 U.S.C. §§ 24(Seventh), 377, 378, and 78 (2003), respectively.

16. *See id.* at 7.

17. *See id.* at 8.

a. Section 16

Relevant parts of section 16 of Glass-Steagall provides as follows:

> The business of dealing in securities and stock by the [national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [national bank] shall not underwrite any issue of securities or stock: *Provided* that the [national bank] may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the [national bank] for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund . . . . The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof.[18]

In reading the above section, one can observe the following four facts.[19] The section applies only to national banks.[20] However, section 5 of the Banking Act of 1933 subjects state-chartered banks that became members of the Federal Reserve system—*i.e.*, state member banks—to the provisions of section 16 of Glass-Steagall.[21] Second, section 16 allows a national bank to act as a security broker without restriction.[22] Third, section 16 prohibits the purchasing of securities for the national bank's own account; however, national banks may purchase and hold

18. 12 U.S.C. § 24(Seventh) (2003). For the discussion in this Note, the reader may be satisfied with the above-mentioned part of section 24(Seventh), which during the years has grown extremely dense and long.

19. *See* CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES 145 (4th ed., 2001).

20. *Id.* The United States has a dual banking system: national banks and state banks. National banks are chartered by the Comptroller of the Currency, whereas state banks are chartered by a state agency. For a thorough description of the dual banking system, and its status subsequent to the enactment of the Federal Deposit Insurance Corporation Improvement Act, see *id.* at 19–32.5.

21. 12 U.S.C. § 335 (1999).

22. FELSENFELD, *supra* note 19, at 145.

investment securities to some extent.[23] The prohibition of "dealing in, underwriting and purchasing for its own account, investment securities" is not without exceptions.[24]

b. Section 20

Section 20 of Glass-Steagall provides as follows:

> [N]o member bank shall be affiliated . . . with any [entity] engaged principally in the issue, flotation, underwriting, public sale . . . of stocks, bonds, debentures, notes, or other securities.[25]

The section forbids member banks from affiliating with a company engaged principally in the above-mentioned activities.[26] This formulation invites the affiliation of member banks with companies dealing in those activities as agents, as opposed to principals.[27] The Federal Reserve defined the term "principally" as activities contributing more than ten percent of the affiliate's gross revenue.[28] The section, however, does not apply to nonmember state banks which are legally free to affiliate with securities firms.[29] Two reasons for this discrimination were presented.[30] First, in 1933 members of the Congress were uncertain as to Congress' power to regulate nonmember state banks.[31] Although section 21 of Glass-Steagall undoubtedly does apply to nonmember banks, Congress

---

23. *Id.*

24. *See* discussion *infra* Part I.B.3.

25. 12 U.S.C. § 377 (repealed 1999).

26. *See* BENSTON, *supra* note 1, at 8.

27. *See id.* at 8–9.

28. *See id.* at 9; *see also* Orders Issued under Section 4 of the Bank Holding Company Act: Citicorp, 73 Fed. Res. Bull. 473, 475 (1987) ("[T]he Board concluded that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross revenue from that activity does not exceed a range of between 5 to 10 percent of its total gross revenues.") [hereinafter Orders to Citicorp].

29. *See* BENSTON, *supra* note 1, at 9 n.4; *see also* Statement Policy on the Applicability of the Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Non-member Banks, FDIC News Release PR-72-82 (1982). Subsequently, the FDIC promulgated Regulations in this regard, restricting the activities permitted to nonmember state bank affiliates. *See* 12 C.F.R. § 337.4 (1984).

30. *See* FELSENFELD, *supra* note 19, at 148.2.

31. *See id.*

was reluctant to go further than it felt necessary.[32] Second, from a policy point of view, nonmember banks are relatively small and their affiliates are unlikely to get deeply enough involved in Wall Street-type activities to raise the concern that Glass-Steagall was created to remedy.[33]

c. Section 21

Section 21 of Glass-Steagall provides as follows:

> [I]t shall be unlawful . . . [f]or any [entity] engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a pass book, certificate of deposit, or other evidence of debt, or upon request of the depositor: Provided, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section [24 of this title].[34]

The above section is considered the "heart of the Glass-Steagall Act."[35] By prohibiting deposit-taking institutions[36] from engaging in investment banking, and vice versa, it "fundamentally divides the business of commercial banking (taking deposits) from investment banking (issuing, underwriting, selling or distributing securities)."[37] Nevertheless, deposit-taking institutions are allowed, to some extent, to engage in securities activities.

The prohibition contained in section 21 is followed by a proviso which, in interacting with section 16, allows deposit taking institutions

---

32. *See id.*

33. *See id.*

34. 12 U.S.C. § 378.

35. FELSENFELD, *supra* note 19, at 147.

36. This section applies to any deposit taking institution, as opposed to the remaining Glass-Steagall sections, which focus on national banks, and due to Section 5 of the Banking Act of 1933 also on state-member banks.

37. FELSENFELD, *supra* note 19, at 147.

to engage in the enumerated securities activities. More accurately, the national banks' powers are "expanded to all other deposit-taking institutions, which otherwise would be absolutely forbidden to underwrite and deal by section 21."[38]

d. Section 32

Section 32 of Glass-Steagall provides as follows:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution... of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.[39]

Professor Benston has noted that the above section "prohibits a member bank from having interlocking directorships or close officer or employee relationships with a firm 'principally engaged' in securities underwriting and distribution."[40] Furthermore, "[s]ection 32 applies even if there is no common ownership or corporate affiliation between the commercial bank and the investment company."[41] The Federal Reserve has also opined that the meaning given to the term "principally" in section 20 is equally applicable to the term "primarily" in this section.[42]

---

38. *Id.*

39. 12 U.S.C. § 78.

40. BENSTON, *supra* note 1, at 9.

41. *Id.*

42. *See generally* Orders Issued under Section 4 of the Bank Holding Company Act: Bankers Trust N.Y. Corp., 73 Fed. Res. Bull. 138 (1987) (explaining that given the similarity in language of sections 20 and 32, and given the fact that they were enacted at the same time for the same purpose and the fact that "principally" and "primarily" can be synonymous, the Board believes that these sections should be construed together and that the term "principally" in section 20 must, like the term "primarily" in section 32,

This section notes once more the discrimination of the member banks. The reasons described above are equally applicable to the present instance.[43]

3. The Rationale Behind Glass-Steagall

According to Professor Benston, the original rationale for separating commercial and investment banking, *i.e.*, for the enactment of Glass-Steagall, can be summarized as follows.[44] First, securities activities of banks "presented significant risk of loss to depositors and the federal government."[45] In addition, they were "more subject to failure with a resulting loss of public confidence in the banking system."[46] Second, the banks were "subject to conflicts of interests and other abuses, thereby resulting in harm to their customers."[47] Third, "[e]ven if there were no actual abuses, securities-related activities are contrary to the way banking ought to be conducted."[48] Fourth, the securities industry "want[s] to bar those banks that would offer securities and underwriting services from entering their markets."[49] Fifth, "[s]ecurities activities are risky and should not be permitted to banks that are protected with the federal 'safety net.'"[50] The fact that the banks were federally insured and had access to discount window borrowings at the Federal Reserve "permit[s] and even encourage[s] banks to take greater risks than are socially optimal."[51] Sixth, "banks get subsidized federal deposit insurance which gives them access to cheap deposit funds."[52] Thus, they have unfair competitive advantages over non-bank competitors while engaging in securities activities.[53] Seventh, "commercial banks' competitive advantages would result in their

---

denote any substantial activity); *see also* text accompanying Orders to Citicorp, *supra* note 28.

43. *See* text accompanying Orders to Citicorp, *supra* note 28.
44. *See* BENSTON, *supra* note 1, at 13.
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*

domination or takeover" of the securities firms.[54] This result would be an "unacceptable concentration of power and less-than-competitive performance."[55] Eighth, a universal banking system "would be detrimental to U.S. bank clients and the economy."[56]

4. Banks Securities Activities – the Misconception

At this preliminary stage, it can be observed that, notwithstanding Glass-Steagall, the divorce of commercial banking and investment banking was not without certain exceptions. Put in a different way, commercial banks were not totally prohibited from engaging in securities activities. This part of the Note will present the legitimate securities activities of commercial banks under Glass-Steagall. For the purpose of this inquiry, and given the recent legislative development—*i.e.*, the enactment of Gramm-Leach-Bliley Act—the reader may be satisfied with partial presentation of the following legitimate activities:[57] investment advisory services, brokerage, underwriting and dealing and investment.

Before presenting the above activities, a few preliminary observations are to be made. First, Glass-Stegall's restrictions apply only to national and state-member banks. Consequently, securities activities of state-chartered banks are subject to the laws and regulations of the states in which they are chartered. However, the Federal Deposit Insurance Corporation Improvement Act of 1991[58] changes this by limiting state banks' activities to those allowed to national banks.[59] Second, Glass-Steagall governs only commercial banks' domestic securities activities. In fact, "[m]any large United States banks either own or are closely affiliated with foreign investment banking firms and

54. *Id* at 14.

55. *Id.*

56. *Id.*

57. For a more thorough presentation of the permissible activities, see generally William M. Isaac & Melanie L. Fein, *Facing the Future - Life Without Glass-Steagall*, 37 CATH. U. L. REV. 281 (1988) and Thomas G. Fischer et al., *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467 (1984).

58. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, 105 Stat. 2236 (1991).

59. *See* FELSENFELD, *supra* note 19, at 32.5 (stating the view that the enactment of FDIC Improvement Act ended the dual banking system in the United States).

thereby engage in such traditionally prohibited activities as underwriting and dealing in corporate bonds and stock."[60]

a. Investment Advisory Services

Isaac and Fein note that the United States Supreme Court has held that Regulation Y of the Federal Reserve Board authorizes bank holding companies to provide portfolio investment advice,[61] "subject to observance of standards of care and conduct applicable to fiduciaries."[62] National banks provide similar services under their trust powers.[63]

Isaac and Fein further note that "Regulation Y authorizes bank holding companies to provide financial advice to state and local governments, such as with respect to matters such as the issuance of their securities."[64] Furthermore, by Order, the Board has permitted bank holding companies to engage in the activity of providing advice in connection with financing transactions for unaffiliated financial and non-financial, institutions.[65] "National banks have similar authority under their general banking powers to provide financial advice."[66]

According to Isaac and Fein, "Regulation Y also authorizes bank holding companies to furnish 'general economic information and advice, general economic statistical forecasting services and industry studies.'

60. Franklin R. Edwards, *Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act*, THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES 274 (Lawrence G. Goldberg & Lawrence J. White eds., 1979).

61. *See* David M. Easton, Comment: *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1199 (citing to 12 C.F.R. § 225.25(b)(4)(iii) (1994)).

62. Isaac & Fein, *supra* note 57, at 323 (Appendix) (citing 12 C.F.R. § 225.25(b)(4)(iii) (1987)).

63. *Id.*

64. *Id.* (citing 12 C.F.R. § 225.25(b)(4)(v) (1987)).

65. *See id.* (citing Orders Issued under Section 4 of the Bank Holding Company Act: Signet Banking Corp., 73 Fed. Res. Bull. 59, 59 (1987) [hereinafter Orders to Signet], approving applicant's proposal to provide "advice in connection with merger, acquisitions/divestiture and financing transactions for nonaffiliated financial and nonfinancial institutions"); *see also* Orders Issued under Section 4 of the Bank Holding Company Act: Sovran Fin. Corp., 73 Fed. Res. Bull. 744, 744 (1987).

66. *Id.* (citing 12 U.S.C. § 24(Seventh)).

National banks have similar authority under their general banking powers."[67]

Isaac and Fein further state that:

> Regulation Y authorizes bank holding companies to provide "advice, educational courses, and instructional materials to consumers on individual financial management matters, including . . . general investment management." In providing such services, however, a bank holding company may not provide advice on specific investments or provide portfolio management. If the counseling company also provides discount securities brokerage services, the brokerage and counseling services must be rendered by different personnel and in separate offices or in separate and distinctly marked areas. National banks have similar authority under their general banking powers.[68]

Isaac and Fein continue:

> Regulation Y authorizes bank holding companies to serve as investment advisers as defined in § 2(a)(20) of the Investment Company Act of 1940 . . . to both open-end and closed-end investment companies registered under that act, and to sponsor, organize, and manage a closed-end company, subject to restrictions in the Board's interpretive ruling on investment adviser activities.[69]

As to national banks, in 1983 the Comptroller of the Currency authorized American National Bank of Austin, Texas, to establish a subsidiary that will advise clients, distribute investment newsletter, and provide certain advisory services to corporate customers and correspondent bank trust departments.[70] The Comptroller had the view that advisory activities do not violate Glass-Steagall for the following reasons. First, historically, investment advice has been recognized as a

---

67. *Id.* (citing 12 C.F.R. § 225.25(b)(4)(iv) (1987)).

68. *Id.* at 324 (citation omitted).

69. *Id.* (citation omitted). *See also* Isaac & Fein, *supra* note 57, at 324 (citing 12 C.F.R. §§ 225.25(b)(4)(ii), 225.125 (1987)). The Supreme Court upheld this activity in Board of Governors of the Federal Reserve System v. Investment Company Institute, 450 U.S. 46 (1981).

70. *Id.* (citing Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice (Sept. 2, 1983), *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH), ¶ 99,723).

traditional banking service.[71] Second, the bank offers substantial amount of advisory services in its trust department, consequently established its ability to provide this service.[72] Third, the wording of Glass-Steagall section 16 is not the language that would be used to describe investment advice.[73] The Comptroller's authorization to establish a national bank's investment advisory subsidiary was viewed as "pav[ing] the way for a national bank to establish a full-service brokerage subsidiary."[74] However, as Isaac and Fein note: "[n]ational banks are subject to the more rigorous prohibitions of section 16 of the Glass-Steagall Act and may not sponsor or organize closed-end investment companies."[75]

Isaac and Fein add that "[n]ational banks are permitted to offer advice and assistance on corporate mergers and acquisitions, including planning, intermediary, research, and counseling services."[76] The Comptroller also approved that "a national bank may act as a 'finder' in bringing together buyers and sellers for a fee, but may not participate in subsequent negotiations."[77] In addition, "the Board by order has permitted bank holding companies to provide financial feasibility studies and valuations of companies for merger and acquisition transactions and other purposes, such as divestitures, tender offers, bankruptcy reorganization, employee stock ownership trusts, and charitable trusts."[78]

Regulation Y authorizes bank holding companies to provide management consulting advice to nonaffiliated bank and nonbank depository institutions; such advice may include advice on international banking, foreign exchange transactions, and investments.[79] The Board has issued an order approving the activity of providing an on-line stock

---

71. *See Breach Widened in Barrier to Bank-Brokerage*, AM. BANKER, Sept. 9, 1983, at 3.

72. *See id.*

73. *See id.*

74. Fischer et al., *supra* note 57, at 491.

75. Isaac & Fein, *supra* note 57, at 324 (citing 12 U.S.C. § 24(Seventh)).

76. *Id.* at 325 (citing Letter from Assistant Director of Legal Advisory Services Division (May 25, 1982)).

77. *Id.* (citing Letter from the Deputy Comptroller for the Northeastern District (May 25, 1984)).

78. *Id.* (citing Orders Issued under Section 4 of the Bank Holding Company Act: Sec. Pac. Corp., 71 Fed. Res. Bull. 118 (1985) and Orders to Signet).

79. *Id.* (citing 12 C.F.R. §§ 225.25(b)(11), 225.131 (1987)).

quotation and financial data base service for stock exchanges, brokerage firms, and financial institutions.[80]

b. Brokerage Activities

Engaging in brokerage activities is explicitly permissible under section 16 of Glass-Steagall.[81] Consequently, national and state-member banks (by virtue of section 5 of the Banking Act of 1933) can engage in this activity.[82] As to nonmember state banks, Glass-Steagall does not affect their ability to engage in brokerage activities; therefore, they may engage in whatever activities permissible by their state charters.[83] "The Federal Deposit Insurance Corporation issued a General Counsel's Opinion to this effect in 1983."[84]

The FDIC Improvement Act does not affect the state nonmember banks powers in this specific instance due to the following two reasons.[85] First, the fact that national banks have the power to engage in brokerage activities meant that nonmember state banks did as well.[86] Second, section 303 of the FDIC Improvement Act specifically states that "an insured State bank may not engage as principal in any type of activity that is not permissible for a national bank."[87] Since brokerage is an agency activity, as opposed to principal activity, the above Act is inapplicable.

In *Securities Industry Association v. Board of Governors*, the Supreme Court upheld the Board's determination that brokerage activities are permissible for bank holding companies under the Glass-Steagall Act and that such activities are specifically included on the list

80. *Id.* (citing Orders Issued under Section 4 of the Bank Holding Company Act: Citicorp, 72 Fed. Res. Bull. 497 (1986).

81. *See* discussion *supra* Part I.A.2.a.

82. *See* discussion *supra* Part I.A.2.a.

83. *See* FELSENFELD, *supra* note 19, at 148.8.

84. *Id.*

85. *See id.*

86. *See id.*

87. *Id.* at 132.4–132.5.

of permissible nonbanking activities in Regulation Y.[88] Further, brokerage activities also have been held permissible for national banks.[89]

c. Underwriting and Dealing Activities

Thus far, this Note has presented the "pure" brokerage activities permissible to banks. These are often related to as discount brokerage activities in which brokers charge less than the "full service" brokers because they offer fewer services.[90] The Note now describes the "full service" brokerage activities. The Comptroller has ruled that "national banks may engage in a combination of 'pure' brokerage and investment advice"—*i.e.*, "full service" brokerage—on a regular basis.[91] For the purpose of this Note, the reader may be satisfied with the above description without going into detail as to permissible "full service" brokerage activity of nonbank affiliates—*i.e.*, non-subsidiaries—of member banks.[92]

Section 21 of Glass-Steagall prohibits banks from underwriting and dealing in securities.[93] This prohibition applies to all deposit taking institutions, *i.e.* national, state, members, and nonmembers banks.[94] However, in interacting with section 16, section 21 authorizes deposit taking institutions to underwrite and deal in securities to the extent permitted under section 16.[95]

As noted above, from its inception, Glass-Steagall section 16 expressly authorizes national banks, and in turn state member banks, to underwrite and deal in securities of, *inter alia,* the United States, any State and any political subdivision thereof.[96] In addition, Regulation Y authorizes bank holding companies to underwrite and deal in securities

88. *See* 468 U.S. 207, 211 (1984); *see also* 12 C.F.R. § 225.25(b)(15) (1987).

89. *See* Sec. Indus. Assoc. v. Comptroller of the Currency, 577 F. Supp. 252, 257 (D.D.C. 1983) ("[T]he Glass-Steagall Act does not prohibit the ownership and operation by national banks of subsidiaries engaged in the brokerage business"), *aff'd*, 758 F.2d 739 (D.C. Cir. 1985).

90. *See* FELSENFELD, *supra* note 19, at 150.

91. *Id.* at 157 (citing to Comptroller's Interpretive Letter No. 622 (May 1993)).

92. For a thorough discussion of this topic, see FELSENFELD, *supra* note 19, at 157–58 and Isaac & Fein, *supra* note 57, at 326.

93. *See* FELSENFELD, *supra* note 19.

94. *See* discussion *supra* Part I.A.2.c.

95. *See* discussion *supra* Part I.A.2.c.

96. *See* discussion *supra* Part I.A.2.a.

to the extent permitted and subjects member banks to the same limitations that would apply to.[97]

Due to the fact that Glass-Steagall section 21 applies only to the banks themselves and not to banks' affiliates, and that Glass-Steagall section 20 applies only to member banks' affiliates, affiliates of nonmember state banks are not subject to the prohibition of underwriting and dealing in securities and are allowed to engage in underwriting and dealing in securities.[98]

Section 20 of Glass-Steagall prohibits the affiliation with any company "engaged principally" in underwriting and dealing in securities.[99] Thus, it permits the affiliation with a company which engages in these activities, but not "principally." The Federal Reserve Board originally defined "principally" as generating five percent or more of the company's gross revenue and that does not occupy more than five percent of the total market (the "market test").[100] In *Securities Industry Association v. Federal Reserve System*, the Fed's decision was partially affirmed.[101] The Court of Appeals rejected the five-percent market test and accepted the five-percent gross profit test.[102] On December 20, 1996, the Federal Reserve Board raised the gross revenue limitation—which at that time was ten percent—to twenty-five percent[103] because it found the ten percent "unduly restrictive."[104]

d. Investment Activities

Glass-Steagall section 16 authorizes national banks and state member banks[105] to purchase for their own account investment securities under such limitations and restrictions prescribed by the Comptroller,

---

97. *See* Isaac & Fein, *supra* note 57, at 330 (citing 12 C.F.R. § 225.25(b)(16) (1987)).

98. *See* FELSENFELD, *supra* note 19, at 164. For the purpose of this Note, it is not necessary to go into further details as to the limitations and restrictions adopted by the Federal Deposit Insurance Corporation.

99. *See* discussion *supra* Part I.A.2.b.

100. *See* BENSTON, *supra* note 1, at 9; *see also* text accompanying Orders to Citicorp, *supra* note 28.

101. 839 F.2d 47 (2d Cir. 1988).

102. *See* FELSENFELD, *supra* note 19, at 168.5–168.6.

103. *See id.*

104. *Id.*

105. *See* 12 U.S.C. § 335 (1993).

provided that in no event the total amount of the investment securities of any one obligor or maker, held by the bank for its own account, exceed at any time ten percent of its capital and surplus.[106] The Comptroller has defined "investment security" as a "marketable obligation in the form of a bond, note, or debenture which is commonly regarded as an investment security" and which is also "not predominantly speculative in nature."[107]

The Comptroller's Regulations describe five categories of investment securities.[108] The first category contains, *inter alia,* obligations of the United States, the states, and their political subdivisions, which may be bought without limits.[109] The remaining categories may be purchased in different amounts and are subject to different limitations.[110]

Isaac and Fein point out that bank holding companies may make comparable investments.[111] Meanwhile, state non-member banks are "unaffected" by Glass-Steagall section 16 and consequently may engage in investment activities "as approved by their state chartering authorities."[112] However, the Federal Deposit Insurance Corporation Improvement Act of 1991 (hereinafter FDICIA)[113] has limited state banks' activities to allowing them only those permitted to national banks.[114] Nevertheless, this limitation is subject to a number of exceptions that become important for state non-member bank's investment in securities.[115]

106. *See* 12 U.S.C. § 24(Seventh) (2003).
107. *See* Isaac & Fein, *supra* note 57, at 335 (citing 12 C.F.R. § 1.3 (1987)).
108. *See* FELSENFELD, *supra* note 19, at 148.2.
109. *Id.*
110. *Id.*
111. *See* Isaac & Fein, *supra* note 57, at 335 (citing 12 U.S.C. § 1843(c)(5) (1982)).
112. *See* FELSENFELD, *supra* note 19, at 148.3–148.4.
113. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, 102 Pub. L. No. 242, 105 Stat. 2236 (1991).
114. *See* FELSENFELD, *supra* note 19, at 148.6.
115. *See id.*

B. The Gramm-Leach-Bliley Act

1. Introduction

Almost as soon as Glass-Steagall was passed, calls for its repeal began. Ironically, the most vocal proponent of its repeal was Glass, one of the bill's authors.[116] Only two years after the enactment of Glass-Steagall, Glass believed the legislation was a mistake and an overreaction.[117] Nevertheless, the Depression-era legislation remained intact for over six decades. Over the years, commentators have challenged the rationale that led to the enactment of Glass-Steagall.[118] Some even described Glass-Steagall as artificial and obsolete.[119]

After twenty years of effort by industry lobbyists and lawmakers,[120] on November 12, 1999, the federal government enacted the Financial Modernization Act,[121] commonly known as the Gramm-Leach-Bliley Act of 1999 ("Gramm-Leach-Bliley"). Gramm-Leach-Bliley represents

---

116. *See* James A. Leach, *Modernization of Financial Institutions*, 25 IOWA J. CORP. L. 681, at 682.

117. *See* Michael Schroeder, *It's Alive - Why Glass-Steagall, Reviled for Decades, Just Won't Go Away*, WALL ST. J., Apr.10, 1998, at A6.

118. *See generally* Ramirez, *supra* note 8, at 12–13 (stating that the empirical findings over the years suggest that the Glass-Steagall Act was a misguided and unnecessary policy—it was enacted to correct a "problem" that did not exist); *see also* Randall S. Kroszner & Raghuram G. Rajan, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933*, AM. ECON. REV. 84, 810, 829 (1994) ("[O]ur results are not consistent with the popular belief that bank affiliates had underwritten and sold unsound and speculative securities, and published deliberately misleading prospectuses . . . Allowing commercial and investment banking to take place under one roof did not lead to widespread defrauding of investors."); *see also* GEORGE J. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED (1989) (finding that the allegation that commercial bankers abused their strategic position and pushed low quality securities to unsuspecting investors has no empirical validity).

119. *See* Ron Chernow, *The New Deal's Gift to Wall Street*, WALL ST. J., Nov. 11, 1999, at A26.

120. *See* Linda B. Tigges, *Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455 (1998) (stating that over the past 20 years ten attempts have been made to pass financial services reform legislation).

121. Gramm-Leach-Bliley Financial Modernization Act of 1999, Pub. L. No. 106-102, 113, Stat. 1338 (1999).

an overhaul of the Depression-era banking laws.[122] It removed the barriers that had separated banks and securities firms, thus providing financial organizations with flexibility in structuring such affiliations through a holding company structure or a financial subsidiary with certain limitations,[123] which will be presented in following sections of the Note.

Gramm-Leach-Bliley repealed two sections of Glass-Steagall, which separated commercial banking from investment banking: (1) section 20[124] which forbade member banks from affiliating with a company engaged principally in securities activities[125]; and (2) section 32,[126] which prohibited management interlocks.[127]

A few observations are of note here. First, Gramm-Leach-Bliley repealed "only" two out of four sections of Glass-Steagall. Consequently, the description of the demise of Glass-Steagall under Gramm-Leach-Bliley is not entirely accurate. Second, the securities powers of the banks themselves have not been changed by Gramm-Leach-Bliley. Thus, as for the banks themselves, the separation between commercial and investment banking still exist.[128]

Commentators have generally praised the enactment of Gramm-Leach-Bliley,[129] whereas others argue that it is not a very important statute given the fact that Glass-Steagall was already a dead statute and that all that Gramm-Leach-Bliley did was to formalize the death of the

---

122. *See Clinton Signs Legislation Overhauling Banking Laws*, N.Y. TIMES, Nov. 13, 1999, at C3 (reporting that President Clinton signed into law a sweeping overhaul of Depression-era banking laws). The measure lifted barriers in the industry and allowed banks, securities firms and insurance companies to merge and to sell each other's products. *See id.*

123. *See* Financial Services Modernization: Analysis of the Gramm-Leach-Bliley Act of 1999, at 6 (Lexis Publishing 2000) [hereinafter Financial Services Modernization].

124. Gramm-Leach-Bliley § 101(a) repealed Glass-Steagall § 20.

125. *See supra* note 25 and accompanying text.

126. Gramm-Leach-Bliley § 101(b) repealed Glass-Steagall § 32.

127. *See supra* note 39 and accompanying text.

128. *See* FELSENFELD, *supra* note 19, at 147.

129. *See* Adam Nguyen & Matt Watkins, *Financial Services Reform*, 37 HARV. J. LEGIS. 579 (2000); *see also* Paul J. Polking & Scott A. Cammarn, *Overview of the Gramm-Leach-Bliley Act*, 4 N.C. Banking Inst. 1,1 (Apr. 2000) (describing the Gramm-Leach-Bliley Act as the most important piece of federal banking legislation since the Depression).

latter.[130] Even those who argue that Gramm-Leach-Bliley is more psychological and symbolic[131] emphasize that their argument does not lead to the conclusion that Gramm-Leach-Bliley was a bad idea.[132]

2. Expanded Powers

Gramm-Leach-Bliley is a complex piece of legislation that modifies much of existing federal banking law.[133] Given its limited purpose, this Note will focus mainly on those expanded powers which are pertinent to the analysis in this Note.[134]

As noted above, the securities powers of the banks themselves remained intact.[135] However, the securities powers of bank holding companies, which elect to become financial holding companies, have changed. Before moving to describe the new securities powers given to financial holding companies, the Note will briefly present this new status.

Gramm-Leach-Bliley Section 103 adds new sections 4(k) and 4(*l*) to the Bank Holding Company Act of 1956.[136] These sections create the new status—"financial holding company." In order to become a financial holding company the bank holding company must file with the Board a declaration and comply with the provisions of Bank Holding

130. *See* Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 IOWA J. CORP. L. 691, 692; Randall Smith & Deborah Lohse, *Financial Firms Already Know How To Avoid Barrier Rules*, WALL ST. J., Oct. 22, 1999, at C1; Polking & Cammarn, *supra* note 129, at 3 ("The significant United States financial modernization has already taken place while the federal financial modernization legislation remained a victim of political impasse. . . . In any case, the Gramm-Leach-Bliley Act is undoubtedly significant").

131. *See* Smith & Lohse, *supra* note 130 (citing Samuel Hayes, professor emeritus of finance at the Harvard Business School).

132. *See* Macey, *supra* note 130, at 693.

133. *See* Nguyen & Watkins, *supra* note 129, at 581.

134. For further descriptions of the remaining aspects of the act, see Financial Services Modernization, *supra* note 123; *see also* KENNETH R. BENSON & KATALINA M. BIANCO, FINANCIAL SERVICES MODERNIZATION GRAMM-LEACH-BLILEY ACT OF 1999 (CCH LAW & EXPLANATION 1999).

135. *See supra* note 127 and accompanying text.

136. 12 U.S.C. § 1843.

Company Act section 4(*l*).[137] Upon gaining this new status, the financial holding company, under new section 4(k), may engage in any activity, or acquire the shares of any company engaged in any activity, that the Board determines to be: financial in nature or incidental to such; or complementary to a financial activity.[138] In addition, certain activities under new section 4(k)(4) of the Bank Holding Company Act are deemed to be financial in nature. These new financial activities includes, *inter alia*:[139] lending, investing or safeguarding money or securities; providing financial or investment advice; issuing or selling interest in pools of assets that a bank could hold; underwriting, dealing in or making market in securities; underwriting insurance or annuities, or acting as an insurance or annuity principal, agent or broker; merchant banking—to some extent and subject to qualifications;[140] lending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities; and arranging, effecting or facilitating financial transactions for third parties.

In addition, the Board is permitted to authorize, by regulation or order, other activities that it deems to be financial in nature or incidental, or complementary, to a financial activity, subject to the concurrence of the Department of Treasury.[141]

As a result of these expanded powers a financial holding company[142] may now own a bank, an insurance company and a securities firm—a so-called three-way street.[143] Professor Felsenfeld describes this as the most significant single change instituted by Gramm-Leach-Bliley.[144]

However, with the exception of merchant banking investments,[145] Gramm-Leach-Bliley maintains the wall between banking and

137. *See* Financial Services Modernization, *supra* note 123, at 11; *see also* FELSENFELD, *supra* note 19, at 99.

138. *See id.* at 11 (citing 12 U.S.C. § 1843(k)(1)).

139. *See* BENSON & BIANCO, *supra* note 134, at 33.

140. For an in-depth description, see FELSENFELD, *supra* note 19, at 105–106.2.

141. *See* Gramm-Leach-Bliley § 103. *see also* BENSON & BIANCO, *supra* note 134, at 34.

142. And vice versa: a securities firm, an insurance company and other financially related companies may now own a bank. *See* FELSENFELD, *supra* note 19, at 100.

143. *See* Leach, *supra* note 116, at 683; *see also* FELSENFELD, *supra* note 19, at 100.

144. *See* FELSENFELD, *supra* note 19, at 99.

145. *See* Polking & Cammarn, *supra* note 129, at 5.

commerce. While it opens the financial services industry to intense competition, it also forestalls the broad mixing of commerce and banking.[146] Nevertheless, if the financial holding company was not a bank holding company prior to November 12, 1999, Gramm-Leach-Bliley permits the former to retain its commercial activities, subject to certain limitations and grandfathering restrictions[147] set forth in section 103.[148]

Notwithstanding the above, it is up to the bank holding company to decide whether it elects to become a financial holding company and thus benefit from the expanded powers granted by Gramm-Leach-Bliley. If the bank holding company retains its former status, it will be restricted to the activities that the Board has decided as of November 11, 1999—a day before the enactment of Gramm-Leach-Bliley—to be closely related to banking.[149] As Professor Felsenfeld summarized it, the pre-Gramm-Leach-Bliley bank holding company is "frozen" as of November 11, 1999.[150]

3. Securities Activities: The Repeal of Bank Exemptions

Prior to Gramm-Leach-Bliley, banks enjoyed an exemption from regulation as a broker-dealer under the federal securities laws.[151] Gramm-Leach-Bliley section 201 amended the definition of broker under section 3(a)(4)[152] of the Securities Exchange Act of 1934 (the "Exchange Act"), to include any person engaged in the business of effecting transactions in securities for the account of others. Nevertheless, the amended definition contains certain exceptions, allowing the banks to continue to effect transactions in certain

146. *See* Leach, *supra* note 116, at 687; *see also* Polking & Cammarn, *supra* note 129, at 5.

147. Gramm-Leach-Bliley § 103 added sections 4(n) and 4(o) to the Bank Holding Company Act, to be codified at 12 U.S.C. §§ 1843(n) and 1843(o), respectively.

148. *See* Financial Services Modernization, *supra* note 123, at 16; *see* Polking & Cammarn, *supra* note 129, at 6.

149. Gramm-Leach-Bliley § 102 amended Bank Holding Company Act § 4(c)(8), codified at 12 U.S.C. § 1843(c)(8).

150. *See* FELSENFELD, *supra* note 19, at 100; *see also* Polking & Cammarn, *supra* note 129, at 6.

151. *See* 15 U.S.C. § 78(c)(a)(4)–(5).

152. *See* 15 U.S.C. § 78(c)(a)(4).

"identified banking products"[153] without being considered a broker. This provides a way to circumvent regulation by the Securities and Exchange Commission ("SEC") or a registration with the SEC.[154] In addition, subject to certain limitations, a bank will not be considered a broker while engaging in certain securities activities, even if not included in the "identified banking products" definition. Some of these securities activities include: third party brokerage arrangements,[155] trust activities,[156] traditional banking transactions such as commercial paper[157] and exempted securities,[158] employee and shareholder benefit plans,[159] sweep accounts,[160] affiliate transactions,[161] private placements,[162] safekeeping and custody services.[163]

Gramm-Leach-Bliley section 202 amended the definition of dealer under section 3(a)(5)[164] of the Exchange Act, to include any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. The term does not include a person that buys and sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular basis.[165] Similarly, the amended definition contains certain exceptions, under which a bank would not be considered a dealer, consequently avoiding the risk of SEC regulation or securities law registration. These exceptions include: permissible securities transactions[166] (*e.g.* commercial paper, bankers acceptance, or commercial bills, exempted securities); investment, trustee and fiduciary

153. This is the definition provided under section 206 of Gramm-Leach-Bliley. This definition includes, *inter alia*, a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank; a banker's acceptance; a letter of credit or a loan made by a bank; and debit account.

154. *See* Polking & Cammarn, *supra* note 129, at 16.

155. *See* Exchange Act § 3(a)(4)(B)(i), 15 U.S.C. § 78c(a)(4)(B)(i)).

156. *See* Exchange Act § 3(a)(4)(B)(ii), 15 U.S.C. § 78c(a)(4)(B)(ii)).

157. *See* Exchange Act § 3(a)(4)(B)(iii)(I), 15 U.S.C. § 78c(a)(4)(B)(iii)(I)).

158. *See* Exchange Act § 3(a)(4)(B)(iii)(II), 15 U.S.C. § 78c(a)(4)(B)(iii)(II)).

159. *See* Exchange Act § 3(a)(4)(B)(iv)(I), 15 U.S.C. § 78c(a)(4)(B)(iv)(I)).

160. *See* Exchange Act § 3(a)(4)(B)(v), 15 U.S.C. § 78c(a)(4)(B)(v)).

161. *See* Exchange Act § 3(a)(4)(B)(vi), 15 U.S.C. § 78c(a)(4)(B)(vi)).

162. *See* Exchange Act § 3(a)(4)(B)(vii), 15 U.S.C. § 78c(a)(4)(B)(vii)).

163. *See* Exchange Act § 3(a)(4)(B)(viii), 15 U.S.C. § 78c(a)(4)(B)(viii)).

164. *See* 15 U.S.C. § 78(c)(a)(5).

165. *See* 15 U.S.C. § 78(c)(a)(5)(B).

166. *See* 15 U.S.C. § 78c(a)(5)(C)(i).

transactions[167] (for the bank,[168] or for accounts for which the bank acts as a trustee or fiduciary);[169] and identified banking products,[170] as defined by section 206 of Gramm-Leach-Bliley.[171]

Section 217 of Gramm-Leach-Bliley amended section 202(a)(11)(A)[172] of the Investment Advisers Act of 1940 ("Advisers Act") to eliminate the bank exclusion from the definition of investment adviser. However, if a bank performs such services or actions through a separately identifiable department or division,[173] the department or division, rather than the bank itself, shall be deemed to be the investment adviser.[174] Of note here, the bank is not required to establish such a separately identifiable department or division, however, in order to avoid registration as well as the SEC oversight it must do so.

4. Functional Regulation and the Push-Out Effect

The above amendments to the broker-dealer definitions are part of the new theme of Gramm-Leach-Bliley: "functional regulation". Under the system of functional regulation, institutions are overseen by experts in their areas.[175] Thus, securities activities, of the banks as well, are supervised by securities experts, such as the SEC. By adopting functional regulation, Congress intended to achieve equality in oversight of securities activities: everyone gets the same rules, with no special advantages towards any party, in addition to enhancing consumer protections and safeguards no matter where the activities take place.[176]

---

167. *See* 15 U.S.C. § 78c(a)(5)(C)(ii).

168. *See* 15 U.S.C. § 78c(a)(5)(C)(ii)(I).

169. *See* 15 U.S.C. § 78c(a)(5)(C)(ii)(II).

170. *See* 15 U.S.C. § 78c(a)(5)(C)(iv).

171. *See* Polking & Cammarn, *supra* note 129.

172. 15 U.S.C. § 80b-2(a)(11)(A).

173. This definition is provided under section 202(a) of the Investment Adviser Act, codified at 15 U.S.C. § 80b-2(a).

174. *See id.*; *see also* Financial Services Modernization, *supra* note 123, at 50.

175. *See* Benson et al., *supra* note 134, at 53 (citing Sen. Rod Grams, Chairman of the Senate Securities Subcommittee).

176. *See id.* (citing Rep. Tom Bliley, Chairman of the House Commerce Committee, Cong. Rec., Nov. 4, 1999, at H11533).

Even prior to the enactment of Gramm-Leach-Bliley, the SEC attempted to achieve this status, although without much success.[177]

Notwithstanding the above, this concept of functional regulation is not without any exceptions. As described above, a few exceptions were added to the broker-dealer definitions, which enable banks to continue to render certain securities services, without the risk of SEC regulation or securities law registration.[178] In fact, Congress did not intend to regulate traditional banking activities, even though they involve certain securities activities.[179] Consequently, Gramm-Leach-Bliley excludes from the SEC's new jurisdiction certain traditional banking activities, although aspects of securities activities are involved.[180]

The above revision is said to have a "push-out" effect.[181] Instead of having the SEC supervise the bank itself, as well as register the bank as a broker dealer, banks are expected to conduct their securities activities, which are not excluded, outside the banks in distinct affiliated securities firms.[182] Put differently, the securities activities are expected to be "pushed out" of the banks.

II. THE ISRAELI SYSTEM

A. The Role of the Capital Market

An efficient capital market is a highly important factor in the growth of an economy.[183] The main role of the capital market is to direct savings to investment. This explains the capital market's influence on the allocation of resources in the economy.[184] It is common to distinguish between the capital market and the money market. This classification is based on the maturity of the claims. The market for

177. *See* FELSENFELD, *supra* note 19, at 153; *see also* Am. Bankers Assoc. v. S.E.C., 804 F.2d 739 (D.C. Cir. 1986).

178. *See supra* note 154 and accompanying text.

179. *See* FELSENFELD, *supra* note 19, at 155.

180. *See id.*

181. *See id.*; *see also* Polking & Cammarn, *supra* note 129, at 16.

182. *See id.*; *see also* Polking & Cammarn, *supra* note 129, at 16.

183. *See* Report of the Bejsky Commission of Inquiry on Regulation of the Bank Shares (Apr. 1986), at 53 (Hebrew, on file with author) [hereinafter Bejsky Report].

184. *See id.*

short-term debt (less than one year) is called the money market and the one for long-term is called the capital market.[185]

The capital market can be divided into two categories—the primary market and the secondary market. In the former, issuers raise capital by selling their shares to the public.[186] In the latter, the outstanding securities are being traded.[187] Notwithstanding the abovementioned distinction, there is a close connection between them. The existence of the secondary market is one of the key factors which encourage the purchase of securities in the primary market. It provides liquidity for the offered securities, which reduces the risk accompanying the investment.[188] Furthermore, the price levels in the secondary market affect the conditions of the offerings in the primary market, and in turn affect the allocation of resources in the economy.[189] For securities markets—both primary and secondary—to be able to efficiently fulfill their economic roles, they must be influenced only by considerations of profitability and risk.[190] Any artificial influence on the factors of yield and risk distorts the decisions of investors and thus distorts the allocation of resources in the market.[191]

1. Government Intervention in the Capital Market

Since the foundation of the Israeli State, its capital market has been subject to extensive government intervention, which is uncommon in Western democracies.[192] The Israeli government's continuing control of Israel's capital market verged on outright nationalization.[193] Most

185. *See* Zvi Bodie & Robert C. Merton, FINANCE 35 (Prentice Hall 2000).
186. *See* Bejsky Report, *supra* note 183, at 55.
187. *See id.*
188. *See id.*
189. *See id.*
190. *See id.*
191. *See id.*
192. *See id.* at 56.
193. Meir Heth labels the Israeli capital market until the 1985 liberalization as "virtually nationalized." MEIR HETH, 1 BANKING IN ISRAEL 121 (1994) [hereinafter HETH, 1 BANKING IN ISRAEL]. The 1985 liberalization, commonly known as the "1985 Financial Reform," had been formed to eliminate the triple-digit inflation rate, which had escalated rapidly from 50 percent in 1978 to almost 200 percent in 1983, to 445 percent in 1994. The 1985 financial reform, coupled with additional U.S. aid, resulted in diminishing inflation rates, economic growth, and the beginnings of a stock market

financial assets of the public constituted credit to the government, directly or indirectly.[194] The banks invested the public's middle and long-term financial assets in accordance with instructions given to them by the government, and funneled most of these monies to the government to finance its expenditures in return for government bonds.[195] Government obligations—such as government bonds and other deposits—amounted during the 1970s to 75% of the total financial assets in the market.[196]

Practically, the capital market in Israel is controlled by the Ministry of Finance. Securities Law 1968 section 39 states that every new issuance must receive an advanced approval of the Ministry of Finance.[197] In addition, the Ministry of Finance is responsible for setting the investment policy for the major institutional investors, such as mutual funds, pension funds and insurance companies. The situation is

---

recovery. In addition, the government liberalized the banking laws in order to revive the private sector by means of a free capital market in which competing financial institutions would be more active. *See id. See also* Avi Ben- Bassat, *Capital Market Reform in Israel*, 65 BANK OF ISRAEL ECON. REV. 17–30 (Jul. 1990) (Hebrew, on file with author); Marshall Samat & Joan Dilevsky, *The Development of Capital Market Regulation in Israel*, 118 Q. BANKING REV. 11–36 (Dec. 1991) (Hebrew, on file with author).

194. *See* Shlomi Shuv, *The Israeli Banking Market* (Jan. 1998), *available at* http://www.israeleconomy.org/bank.htm (last visited Dec. 5, 2003) (website for the Israeli Institute for Advanced Strategic and Political Studies).

195. *See* Bank of Israel, Annual Report 1977, at 325–57 (Hebrew, on file with author); Bank of Israel, Annual Report 1979, at 303–29 (Hebrew, on file with author).

196. In 1993, due to the Arrangement Bank Shares Law (Ad Hoc Provision), the government's obligations amounted to more than 80% of the total financial assets in the market.

197. *See* Jonas Prager, *Banking Privatization in Israel, 1983–1994: A Case Study in Political Economy* (describing a study of the capital market during the 1960s), *available at* http://www.israeleconomy.org/prager.htm (last visited Dec. 5, 2003). The author of that study records that the Treasury's New Issues Committee does not permit industrial and commercial firms to issue bonds, reserving this right almost solely for the government and financial institutions. The decisions of the latter are subject to considerable government control. Stock issues were less controlled, but in most years namely, to the mid-1960s, the volume of equity issues was quite insignificant. *See also* Haim Ben- Shahar et al., *The Capital Market in Israel*, ISRAEL AND THE COMMON MARKET 219–418 (Pierre Uri, ed., Weidenfeld & Nicolson) (on file with author). In 1987, the Treasury waived exclusivity over all bond and stock offerings, but maintained the option to revoke its waiver.

more acute in the bond market.[198] The Ministry of Finance dominated the bond market. In addition to being the largest bond issuer in the market, it also set the conditions for the new issues made by other issuers, such as interest rates, maturity dates, and type of indexing, thus eliminating any possible competition.[199]

The control of the capital market by the government had an extremely negative effect on the structure of the capital market and its efficiency. It distorted the efficient resource allocation in the capital market, which instead was being executed by administrative orders without any underlying economic justification.[200] In addition, it impeded the fundamental characteristic of an efficient capital market: the free-willed intersection of buyers and sellers, *i.e.* the equilibrium point.[201]

The Share Regulation Affair, which resulted in a re-arrangement, even further increased the government's intervention in the capital market.[202] *De jure* the government became the owner of the arranged banks; *de facto* the government restricted its ownership to appointments of the bank's senior echelon, directors and few debt breakdowns.[203]

The harsh consequences of the government's intervention in the capital market, which led to the adoption of the 1985 Financial Reform,[204] enabled the government to diminish its intervention and enter into the process of privatization.

2. Banks and the Capital Market

Banking is one of Israel's largest industries. In 1996, the banking industry generated NIS 15.25 Billion ($4.69 Billion) in added-value,[205]

198. *See* Bejsky Report, *supra* note 183, at 56.

199. *See* Marshall Sarnat, *Israel's Capital Market – Thoughts about Public's Confidence Crisis*, 99 Q. BANKING REV. 107 (Apr. 1987) (Hebrew, on file with author).

200. *See id.*

201. *See id.*

202. *See* Asher Blass et al., *Corporate Governance in an Emerging Market: The Case of Israel*, J. OF APPLIED CORP. FIN. 10, 79–89 (1998).

203. *See id.*

204. *See* Bodie & Merton, *supra* note 185.

205. In the banking industry, added value is the bank's total profits before taxes, payroll, depreciation and amortization. *The Banking System in Israel*, Annual Review 1996, at 5 (Bank of Israel 1997) (Hebrew, on file with author).

accounting for eight percent of business sector product and twenty percent of total product in trade and services.[206]

Most of today's banking institutions in Israel predate the formation of Israel.[207] Most of them were founded by public institutions associated with the political parties of the time.[208] For example, the World Zionist Movement, which formed the post-state Labor government, established Bank Leumi Le-Israel in 1903 as the Anglo-Palestine Bank.[209] Bank Hapoalim's connection with the political establishment followed a different path. Bank Hapoalim, established in 1921, is a creature of the Histadrut, the national labor federation.[210] Bank Hapoalim is the financial subsidiary of the Histadrut's industrial holding company, Hevrat Ha'Ovdim ("The Workers' Corporation"), whose *raison d'être* was to serve the agricultural cooperatives and Histadrut economic enterprises.[211] A similar relationship existed for United Mizrahi Bank and the National Religious party, a critical partner in all government coalitions. Only the latecomer, Israel Discount Bank, founded in 1935, is not affiliated with a political organization. It is a family-run organization, whose growth is attributed to the "energetic activities" of the entrepreneurial Recanati family.[212] Nevertheless, the Recanatis are an integral component of the Israeli establishment.[213]

Along the banks, a network of credit cooperatives also provided key banking services, similar to credit unions in the United States. In a quantitative sense, they were never significant, and by the late-1960s

206. Annual Information on Banking Corporations, at 134–35 (Bank of Israel, 1997) (Hebrew, on file with author).

207. *See infra* Exhibit A (listing Israel's existing commercial banks in chronological order of their formation).

208. *See* MEIR HETH, BANKING INSTITUTIONS IN ISRAEL 32 (1966) [hereinafter HETH, BANKING INSTITUTIONS] (Hebrew, on file with author); *see also* MICHAEL SHALEV, LABOR AND THE POLITICAL ECONOMY IN ISRAEL 303 (Oxford Univ. 1992).

209. *See id.*

210. *See* ZVI ONN, HEVRAT OVDIM: ISRAEL'S LABOUR ECONOMY 48 (Tel Aviv: 76th Council of the Histadrut (1964) (Hebrew, on file with author); *see* also MEIR HETH, 2 BANKING IN ISRAEL 170–71 (1994) (Hebrew, on file with author).

211. *See id.*

212. *See* A.P. Michaelis, *100 Years of Banking and Money in the Land of Israel*, 91 Q. BANKING REV. 90 (Dec. 1984) (Hebrew, on file with author).

213. *See* Prager, *supra* note 197.

were no more than a handful.[214] Eventually, they disappeared from the published banking records after Israel's basic banking act[215] was revised in 1981.[216] Exhibit A summarizes the historical development of Israeli banks and credit cooperatives by number and size for selected years.

As depicted above, most of today's banking institutions were founded during the British Mandate. Thus, one may ponder why they did not emulate the narrowly focused banking model applied in Britain,[217] rather than adopting the German "universal banking" model. The Israeli banks were engaged in broad variety of financial, and nonfinancial, activities.[218] In addition to the traditional banking functions of making loans and taking deposits, they were engaged in broker-dealer activities, underwriting, mutual and provident funds management and investment counseling.[219] Furthermore, similar to their German counterparts, the Israeli banks directly, and through investment funds, actively controlled nonfinancial enterprises.[220]

The government's intervention in the capital market blocked the development of private financial institutions. Until the late 1970s the relatively limited size of the capital market did not justify the appearance of new financial institutions specializing solely in securities activities.[221] Only "diversified" institutions, such as the banks, that derived their earnings primarily from additional activities, had financial viability. Consequently, the commercial banks dominance in the capital

214. *See* HETH, BANKING INSTITUTIONS, *supra* note 208, at 10–11 (documenting and explaining the decline of the credit cooperatives) (Hebrew, on file with author).

215. The Banking (Licensing) Law of 1981 (replacing mandate-era Banking Ordinance, 1936).

216. *See* HETH, BANKING INSTITUTIONS, *supra* note 208 at 10–11.

217. *See* Amir Geva, *Banks as Linchpin in the Israeli Capital Market*, 99 Q. BANKING REV. 101 (Apr. 1987) (providing a brief summary of the Britain banking model, stating that the Britain banks have never been legally prohibited from engaging in the securities market; stating, nevertheless, that until "The Big Bang" reform in 1986, they were not engaged in this market, the reason for that being custom, which amounts to a law in Britain) (Hebrew, on file with author); *see also* Meir Heth, *Should the Banks Activities in the Securities Market be Restricted?*, 87 Q. BANKING REV. 34 (Nov. 1983) (Hebrew, on file with author).

218. *See infra* note 252 and accompanying text.

219. *See* Bejsky Report, *supra* note 183, at 58.

220. *See* Prager, *supra* note 197.

221. *See* Bejsky Report, *supra* note 183, at 58.

market was incontestable.[222] As stated above, the banks have functioned as brokers who buy and sell securities for customers. Only members of the Tel Aviv Stock Exchange may buy and sell securities there, and most of the members are commercial banks. Until the early 1990s, more than eighty percent of stock exchange activity in Israel was conducted by the commercial banks.[223] From 1973 to 1983, the banks' shares constituted almost sixty percent of all issues in the capital market.[224]

Lately, a different pattern has evolved. As of 1992, the five large banks' part in the capital market has been diminishing gradually.[225] Their share decreased from almost seventy percent in the 1992 to nearly fifty percent in 2001.[226] In turn, the small banks and the nonbanks exchange members increased.[227] Nevertheless, the banks taken as a whole, *i.e.* the large and small banks together, still dominate the capital market.[228]

Due to the 1985 Financial Reform,[229] the government deficit decreased, and the inflation was restricted.[230] Consequently, the government's role in the financial market gradually diminished, which led to even further dominance of the banks in the capital market.[231]

---

222. In order to reconcile our description of the government's control over the capital market, it is sufficient, at this preliminary stage, to say that the government controlled the debt market, whereas the banks controlled the equity market.

223. *See* Shuv, *supra* note 194.

224. *See id.*

225. *See generally* statistics published at the Tel-Aviv Stock Exchange website, *at* http://www.tase.co.il.

226. *See id.*

227. *See id.*

228. This important development will affect our examination of the adequacy of the Law, and in turn our recommendations as to the necessary revisions.

229. *See* Bodie & Merton, *supra* note 185.

230. *See* Sylvia Piterman, *Stabilization, Vulnerability and Liquidity as a Safety Net: Some Thoughts Evoked by the Israeli Experience*, BANK OF ISRAEL (2001) (describing that following the 1985 Financial Reform the annual inflation rate stabilized at 18–20 percent and remained at that level until the early 1990s; further stating that since 1992 the monetary policy implementation brought a gradual decrease in the inflation rate to 3–4 percent and that eventually, in August 2000, the government for the first time adopted an inflation rate target of 1–3 percent).

231. *See* Asher Blass & Oved Yosha, *The Financial Reform in Israel and the Public Industrial Corporations' Cash Flows*, Bank of Israel Research Department (Jun. 2000) (on file with author).

3. Concentration in the Financial Market

Since statehood, the Israeli banking sector has become increasingly concentrated. Exhibit 2[232] illustrates the gradual decrease in the number of banking institutions, and in turn further concentration in this sector. This upturn in concentration occurred with the knowledge of the Bank of Israel (Israel's central bank) and, to some extent, with its support.[233] The Bank of Israel, established in 1954, has subjected the banks to regulations and restrictions as one of its paramount strategies in pursuit of its economic goals.[234] The seven years following its establishment were the key period for drastic changes in the banking system.[235] The demise of the small banks and the contraction of the cooperative credit union sector are considered to be the result of the following two processes. First, the Bank of Israel set rather high liquidity ratios that restricted the amount of credit the banks could extend.[236] Second, the Interest Law of 1957 established an interest rate ceiling.[237] The Bank of Israel further assisted the process of concentration by withholding licenses for new banks, approving takeovers of small and medium banks by the large banking groups, and allowing the banks to spread their financial and nonfinancial reach throughout the economy.[238] Coupled with the government's intervention in the capital market, the above status represents an entrance barrier to new competitors in the financial market.

Aside from Ireland, Israel's banking system is the most concentrated in the Westernized world in both financial and nonfinancial terms.[239] Competition in the banking industry takes place among a limited number of players, which reflects the lack of competition not only in the financial sector, but also in the nonfinancial.[240] Despite the

---

232. *See infra* Exhibit B (depicting the process of concentration in the banking sector).

233. *See* Shuv, *supra* note 194.

234. *See id.*

235. *See id.*

236. *See id.*

237. *See id.*

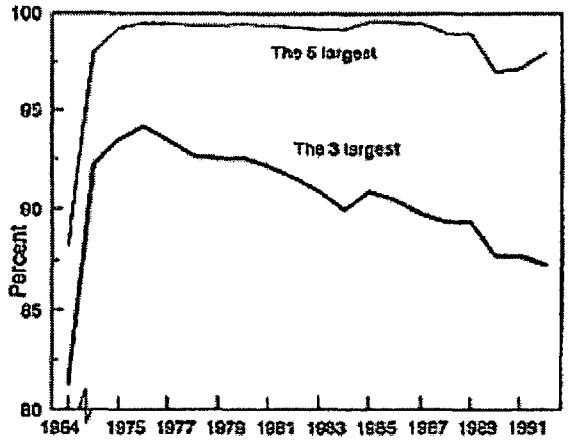
238. *See id.*

239. *See id.*

240. *See* Report of the Committee for Examination of Aspects of Bank Holdings in Nonbanking Corporations, at 49 (Dec. 1995) (Hebrew, on file with author).

relatively large number of banking institutions for a small country, a few giant banking conglomerates hold a disproportionately large share of the nation's deposits and banking assets. As of December 31, 1996, the two largest banks in Israel held sixty-five percent of total bank assets and the three largest held eighty-one percent.[241] The following Figure illustrates the share of total assets held by the three and five largest banking groups[242]:

Proportion of Total Assets
Held by the Three and Five Largest Banking Groups
1964–1992[243]



The 1985 Financial Reform[244] reflects the government's new attitude toward the banking system. As part of the reform the government resolved to liberalize the banking laws in order to revive the private sector and to increase the competition in the financial market.

241. *See infra* Exhibit C (describing the total capital and assets held by the two largest banks and the five largest banking groups, relative to the total equity and assets of the entire banking system).

242. *See* Prager, *supra* note 197 (emphasizing that the data may understate banking concentration, due to the fact that banking groups include not only banking institutions but also other affiliated institutions, stating that, for example, the share of the large five banks in 1992 in the narrower concept of banking organizations that excludes nonblank financial intermediaries was 86.3 as opposed to 81.6 percent share of the broader concept).

243. *Id.*

244. *See supra* note 193.

The results of the reform are quite in controversy. Some argue that the results are quite substantial, leading to a slight decrease in the level of banking system centralization,[245] whereas others are of the view that the banks became more pivotal in the capital market due to the government's decreased intervention in the capital market.[246] However, some believe that, despite the increased competition and the diminished banks' role in the capital market, it is still too early to determine whether the reform succeeded or not.[247]

B. The Share Regulation Affair

1. Background[248]

As described above, the Israeli capital market has been subject to extensive government intervention since its founding. The control of the

245. *See* Shuv, *supra* note 194.

246. *See* Blass & Yosha, *supra* note 231.

247. *See* Saul Bronfeld, *The Decrease in the Bank's Weight in the Securities Market*, 143 Q. BANKING REV. (Nov. 1999) (Hebrew, on file with author).

Securities' Trading Volumes of Tel Aviv Stock Exchange

Period	5 Large Banks	Other Banks	Nonbanks Members
1992	72.5%	4.5%	23%
1993	71.2%	9.7%	19.1%
1994	71%	12.3%	16.7%
1995	65.5%	14.3%	20.2%
1996	62.4%	15.5%	22.1%
1997	58.5%	15.1%	26.4%
1998	52.6%	13.3%	34.1%
1999 (1-6)	55.4%	13.4%	31.2%

Id. The following conclusions can be drawn from the above table: (1) the 5 large banks share in the securities has diminished; (2) the nonbanks' and other banks' share increased, which might reflect the beginning of competition in the securities market; (3) however, the last data from 1999 show some regression from the new trend; (4) nevertheless, the banks, taken as a whole, share in the securities market is still high in comparison to the nonbanks share. This remark will affect our recommendations in subsequent parts of the Note.

248. *See* Bejsky Report, *supra* note 183.

capital market by the government had an extremely negative effect on the structure of the capital market and its efficiency. In 1977 the six largest banks, representing virtually all commercial banks in Israel, began to compete with the government for the public's money (the banks issued shares and the government issued bonds).[249] In order to do this, the banks began to manipulate the trading in their shares, which became the most liquid securities on the capital market.[250] The public concluded that it could, at any time, realize its investment without suffering losses and that, as the share price continued to rise, the banks would continue to support the new price level.[251] From 1977 through 1983, the banks' shares prices quadrupled in real terms.[252] During this period, share appreciation coupled with share offering contributed to a 700 percent increase in the banks market values.[253] Even when the Industrial Index declined in real terms by seventy percent in 1978 and 1979 and by fifty percent in the first half of 1983, the banks' intervention successfully prevented bank shares from plummeting.[254] In October 1983, the public began to massively sell off their bank shares.[255] The banks reacted, as they had done during previous episodes of excess supply, by purchasing their own shares.[256] Consequently, the banks were left holding shares worth $920 Million—which by Israeli standards is an astronomical sum.[257] The banks did not have the necessary means to continue to regulate the price of their shares and the government had to intervene.[258] On October 6, 1983 the Tel-Aviv Stock Exchange was

249. *See id.*

250. *See id.*

251. *See id.*

252. *See* Asher A. Blass & Richard R. Grossman, *A Harmful Guarantee? The 1983 Israel Bank Share Crisis Revisited*, Research Department Bank of Israel, at 7 (May 1996) (unpublished manuscript, on file with author) [hereinafter Blass & Grossman, *A Harmful Guarantee?*].

253. *See id.*

254. *See id.* (noting that, normally, it might be difficult to successfully sustain price levels not in accordance with fundamental values for long periods of time; however, also noting that, since the capital market in Israel was then, and to an extent is today, characterized by unique features that allowed the intervention to succeed for many years).

255. *See* Bejsky Report, *supra* note 183.

256. *See id.*

257. *See id.*

258. *See id.*

shut down for eighteen days.[259] During the closure, the government devalued the Shekel by seventeen percent, assumed control of the banks, and converted the banks' shares into government zero coupon bonds.[260] Israel's internal debt grew to $7 Billion and the capital market was paralyzed.[261] This has come to be known as the "Share Regulation Affair."

2. *Raison d'être*

The Bejsky Commission opened its findings with the following conclusion. The banks chose to regulate their shares.[262] They were not forced to by any authority.[263] Bank of Israel, Securities Authority, Minister of Finance and Supervisor of Banks all learned about the Share Regulation Affair after its initiation.[264]

The Bejsky Report presented two key motives for the Share Regulation Affair, as alleged by the banks.[265] First, in order to maintain required capital ratios during the 1970s and early 1980s, in which high inflation had prevailed reaching annual rates exceeding 200 percent, the banks were forced to repeatedly raise equity.[266] Further, until the mid-1980s,[267] equity was generally stated at historical values, whereas other balance sheet items were stated at current values, which, beginning in 1979, more than doubled every year.[268] Consequently, without raising additional funds by frequently issuing new shares, equity-to-asset ratios

259. *See id.*

260. *See* Asher A. Blass & Richard R. Grossman, *Assessing Damages: the 1983 Israeli Bank Shares Crisis*, CONTEMP. ECON. POL'Y (Jan. 2001) [hereinafter Blass & Grossman, *Assessing Damages*].

261. *See id.*

262. *See* Bejsky Report, *supra* note 183.

263. *See id.*

264. *See id.* at 77.

265. As noted above, the banks allegations were rejected by Bejsky Commission. *See supra* note 264 and accompanying text.

266. *See* Bejsky Report, *supra* note 183.

267. *See supra* note 193.

268. *See* Asher A. Blass & Richard R. Grossman, *Financial Fraud and Banking Stability: The Israeli Bank Crisis of 1983 and Trial of 1990*, 16(4) INT'L REV. OF L. & ECON. 463 (1996) [hereinafter Blass & Grossman, *Financial Fraud and Banking Stability*].

would have fallen below regulatory requirements.[269] The Bejsky Report noted that during those years, the banks raised from the public through stock issues $1.35 Billion.[270] And as described above, at 1983 the banks were left holding shares worth $920 Million.[271] In other words, most of the money raised from the public, under the pretext of maintaining required capital ratios, has been used to repurchase the shares when their prices plummeted. Second, interest groups pressured the banks to continue to regulate their shares.[272] Each bank's personnel, irrespective of their level, held large amounts of banks' shares, some of whom even "represented" other groups of shareholders.[273] Thus, as long as market prices kept above the shares' economic value, the offering of additional shares at the prevailing market prices benefited them at the expense of new shareholders.[274] In fact, even after the 1983 Crisis, in which the banks lost half of their value, shareholders who bought their shares prior to 1980 gained much more than investors in nonbank shares, realizing annualized real return of more than ten percent.[275]

3. *Techniques Employed by the Banks*

In order to support their share prices the banks employed variety of techniques. Each bank maintained inventories of its own shares for the stated purpose of pegging the prices of its shares, and supporting their new levels. In fact, more than a third, and at times as much as ninety percent, of trading in bank shares were purchases and sales for bank inventories.[276] Eventually, by September 1983, the banks were left with inventories of more than $1 Billion[277] resulting in liquidity problems that led to government intervention.[278]

---

269. *See id.*

270. *See* Bejsky Report, *supra* note 183.

271. *See id.*

272. *See id.*

273. *See id.*

274. *See id.*, at 80. *See also* Blass & Grossman, *A Harmful Guarantee?*, *supra* note 252, at 8.

275. *See id.*

276. *See* Asher A. Blass & Richard R. Grossman, *Who Needs Glass-Steagall? Evidence from Israel's Bank Shares Crisis and the Great Depression*, CONTEMP. ECON. POL'Y (Apr. 1998) [hereinafter Blass & Grossman, *Who Needs Glass-Steagall?*].

277. *But see* discussion *supra* Part II.B.1. This difference is attributed to the different sources. The data of $920 million was taken from Bejsky Report, *supra* note

The banks rendered brokerage and consulting services to the investing public.[279] The banks' brokers, who accounted for almost ninety percent of trading in securities of all types, almost always recommended the banks' own shares. In addition, incentives were given to bank branches that attained certain bank share sales quotas, while branches that did not meet expectations were financially punished.[280]

Banks extended credit to customers who purchased the banks' own shares and curtailed the credit for those who sold them.[281] Given the fact that credit was tight and regulated in Israel during the 1970s and 1980s, it was difficult for customers, businesses, and households to obtain credit at any interest rate. By tying access to credit to bank share holdings, the banks were able to increase demand for their shares. At times of new issues, banks provided large amounts of credit to the purchasers of these shares.[282]

Mutual funds and provident funds controlled by the banks, whose assets represented more than ninety percent of all funds' assets, purchased bank shares when demand was low, consequently supporting the prices. In addition, the funds made loans to parent banks, providing additional resources to the latter to buy stock.[283]

Through a "parking" arrangement between Bank Leumi Le-Israel and Discount bank, Bank Leumi Le-Israel temporarily took on some of Discount bank inventory of Discount bank stock, and vice versa. In doing so, each bank supported the other's stock price, whereas the balance sheets of both banks were "window- dressed" to meet reserve requirements.[284]

183, whereas the $1 billion was taken from Blass & Grossman, *Who Needs Glass-Steagall?*, *supra* note 276.

278. *See* Blass & Grossman, *Who Needs Glass-Steagall?*, *supra* note 276.

279. *See* Bejsky Report, *supra* note 183, at 126.

280. *See id.* at 142.

281. *See id.*

282. *See id.* at 148.

283. *See id.*

284. *See id.*

4. The Trial of 1990

Based on the Bejsky Report's publication, in which the banks were found responsible for the 1983 Crisis,[285] the State Attorney ultimately indicted the banks and many key bank executives (Defendants). In *State of Israel v. Bank Leumi Le-Israel, Ltd.*,[286] the court held that the banks were responsible for the 1983 Crisis and were guilty of providing fraudulent guarantees that the share prices would continue to rise. The banks' senior echelons were sentenced to prison and the Defendants to pay fines.[287]

C. The Legislative Status Prior to the Law

The crisis on the capital market showed the need to re-examine the nature of the activities of investment advisers and portfolio managers (the "Service Providers"). The emphasis was placed on creating an appropriate framework for the provision of these services.

The central problem characterizing securities activities is as follows.[288] The lack of requirements for professional and personal qualifications in these occupations left them open to anyone so desiring, including those not meeting minimum requirements for integrity, reliability, education, background and professional experience. The absence of a licensing system led, among other things, to a situation where a Service Provider, who had been guilty of serious misconduct

285. *See* Bejsky Report, *supra* note 183, at 205.

286. Cr.C. 524/90 (Hebrew; on file with author).

287. *See id. See also* Blass & Grossman, *Financial Fraud and Banking Stability*, *supra* note 268, at 461–63. For the purpose of this Note, the reader may be satisfied with the above description. However, I will briefly present the three criminal counts on which the Defendants were indicted, as described by Blass & Grossman. First, Defendants impaired the banks' ability to meeting their commitments, a violation of section 14B(a) of the Banking Order (and for the bank holding company defendant I.D.B. section 424(1) of the Penal Code), by fraudulently guaranteeing to shareholders that share prices would not fall even though they knew or should have known that the guarantees might not be fulfilled. Second, Defendants knowingly gave false investment advice, a violation of the Securities Law section 54(a)(1), the Banking Law sections 3, 10 and 11, and Penal Code section 415. Third, Defendants committed accounting violations under section 423 of the Penal Code. *See id.*

288. *See* Ayala Prokatzia, *Legislative Tendencies in the Field of Capital Market*, Q. BANKING REV. 76 (1986) (Hebrew, on file with author).

during the course of his work, was not prevented from continuing to provide professional services, despite the fact that integrity and loyalty to clients constituted an essential part of them. The absence of professional norms defining the fiduciary duty and duty of care that the investment adviser and portfolio manager owed their clients was egregious.

D. Recommendations of the Different Commissions

Before moving to describe the different recommendations of the different commissions, this Note will draw some preliminary conclusions, which will help the reader analyze and criticize the former.

By now, the banks' dominance in the Israeli capital market should have become apparent. As described above, such dominance enabled them to successfully regulate their shares and support their constant price rise. Of course, when they could no longer do that because of liquidity shortages, the government intervened and took control over the banks. The banks' responsibility for the Crisis of 1983 has been proved beyond all reasonable doubt.[289]

The lack of competitors—or more accurately adequate, the lack of financially attractive and accessible competitors—in the capital market is also apparent. The unique characteristics of the Israeli capital market perpetuate this combined status, in which the banks dominate the capital market and no accessible substitutes are available.[290] In the event that substitutes do exist, one should take into consideration the following aspects. First, one should consider the advantages of receiving all financial services in one place, *i.e.* in a financial supermarket such as the Israeli banks at that time, and to some extent even to date. This aspect of convenience bears significant implications. Frequently, customers will be willing to pay an additional premium, up to a reasonable amount, in order to benefit from the availability of one-stop-shopping.

Second, one should also consider the cost of receiving financial services from those competitors. As noted above, receiving the

289. The Defendants were found guilty in the 1990 trial, which was a criminal case. In order to do that, the plaintiff, in this case the State of Israel, must prove all elements of the accusations beyond a reasonable doubt. *See supra* note 286 and accompanying text. Moreover, Bejsky Commission found the banks responsible for the 1983 Crisis. For a brief comparison of 1983 Crisis and the Great Depression, see *infra* Part II.E.

290. *See* Bejsky Report, *supra* note 183, at 58.

requested financial services from the banks had few valuable advantages. The accessibility to the financial services and products must not be barred, in a financial sense, to the populace. The latter will be literally barred from these financial products and services if they will have to bear the financial consequences of receiving the services from the private competitors, which are not subject to the same set of rules and regulations.

Third, one should consider the cost to the banking system in the event that one does decide to divest them from the above activities (*i.e.* lay offs of respective bank personnel, reduction in bank profits), which in turn might affect the bank's safety and soundness. Fourth, the solution should not discriminate the banks.[291] One must try, to the extent possible, to solve the evil at all fronts, and with all players, equally.

Finally, one must consider whether the evils that one wanted to suppress will ever recur, even in a stronger form, when the activities will be given by private competitors.

After the above preamble, one may be better equipped to tackle the different recommendations. The Note now presents the different commissions and their respective recommendations. However, the Note will focus mainly on the conflicts of interests.

1. Bejsky Commission

In January 1985, following massive public outrage, the government appointed a state commission of inquiry headed by the retired Supreme Court Justice, Moshe Bejsky.[292] The commission concluded, in April 1986, that banks shall not:[293] render advisory services as regard to securities in general;[294] render, directly or indirectly, brokerage services; trade in shares for their own account, as opposed to investing in them; or

291. This aspect is derived from the Israeli Basic Laws, which is the Israeli semi constitution. In this regard, see Yechiel Bahat, *The Basic Laws and the Legislative Intervention in Banking*, 129 Q. BANKING REV. 101 (1994) (Hebrew, on file with author).

292. *See* Shuv, *supra* note 194.

293. The Note presents only part of the commission's recommendations pertinent to the inquiry hereunder. *See* Bejsky Report, *supra* note 183; Shuv, *supra* note 194.

294. However, this recommendation was followed by a proviso that adequate substitutes must develop before implementing it.

manage, directly or indirectly, mutual and provident funds.[295] The commission also concluded that an appropriate framework should be created for the provision of investment advice and portfolio management.[296]

2. Gabai Commission

Following the 1983 Crisis, the Ministry of Justice appointed a commission, headed by the then-Director-General of the Ministry of Justice, Meir Gabai, in order to propose legislative arrangements for the capital market.[297] The Gabai Commission published its report in August 1985.[298] The commission's members were divided in their opinions. The first group's recommendation was an outright and immediate prohibition, without any prior changes in the capital market,[299] of banks from engaging in securities activities. The members further noted that they were aware of the fact that immediate implementation of this recommendation would result in a void.[300] Consequently they were of the opinion that in the interim, for a period of five years, the banks should be allowed to engage in securities activities, however only indirectly, *i.e.* through distinct subsidiaries.[301]

The second group's recommendation was as follows. Given the unique characteristics of the Israeli financial market, outright prohibition of banks from engaging in securities activities is neither required nor feasible.[302] The banks should be allowed to continue to engage in securities activities, subject to the creation of an appropriate framework for the provision of these services.[303]

---

295. *See* Shuv, *supra* note 194.

296. *See supra* note 288 and accompanying text.

297. *See* Gabai Commission – The Report of the Commission To Propose Legislative Arrangements for the Capital Market (Aug. 1985) (Hebrew, on file with author) [hereinafter Gabai Commission].

298. *See id.*

299. This contrasts with the Bejsky Commission's recommendation to prohibit banks from rendering advisory services to securities in general only if adequate substitutes will develop. *See supra* note 293 and accompanying text.

300. *See* Gabai Commission, *supra* note 297, at 168.

301. *See id.*

302. *See id.*

303. *See id.*

E. Share Regulation Affair and the Great Depression

In many ways, 1983 was in Israel's economic history what 1929 was to the United States.[304] However, the two episodes emerged from extremely different financial backgrounds. As described above, the Israeli financial market has unique characteristics. Furthermore, the banks' role in the financial market, in addition to the existence of substitutes for the banks, in both countries is extremely different as well.

Both episodes ended with widely publicized official inquiries and spectacular criminal trials, although the trials in the United States were not for manipulation per se, but for other offenses, such as tax evasion and fraud.[305] However, the Israeli trial ended with findings that the banks were responsible for the 1983 Crisis and were guilty of providing fraudulent guarantees that the share prices would continue to rise.[306]

The United State's episode ended with the passage of Glass-Steagall which, among other things, separated commercial and investment banking. In Israel, however, the legislative response came only twelve years later, with the enactment of the Law. Of note here, despite the Bejsky Commission's recommendation for the adoption of a Glass-Steagall-style law,[307] the Israeli legislature did not follow this line of advice.[308] Following the passage of Gramm-Leach-Bliley, which ended the separation of commercial and investment banking, the legislative status of both countries, in this regard, is not altogether dissimilar. However, one should not forget that Gramm-Leach-Bliley did not change the powers of the banks themselves. Thus, as to the banks themselves, the powers of the respective banks are much different.

As described above, eventually the U.S. episode ended with the conclusion that the accusations, as to the banks' responsibility for the Great Depression, were a mistake and the enactment of Glass-Steagall was an overreaction. This, in turn, led to the passage of Gramm-Leach-Bliley.[309] Although the Israeli episode is relatively new and the subject

---

304. *See* Sarnat, *supra* note 199, at 105; *see also* Blass & Grossman, *Who Needs Glass-Steagall?*, *supra* note 276.

305. *See id.*

306. *See supra* note 286 and accompanying text.

307. For Bejsky Commission's recommendations, see *supra* note 293 and accompanying text.

308. For a presentation of the Law, see *infra* Part II.F.

309. For Glass's remarks, see *supra* note 117 and accompanying text.

is still reviewed by commentators and legislators, the passage of time will not make a difference as to the banks' responsibility for the 1983 Crisis, which has been proved beyond all reasonable doubt.[310]

F. Regulation of Investment Advice and Investment Portfolio Management Law, 1995

In order to better understand the banks' securities powers as contained in the Law, the Note will briefly present two additional aspects, which the Law remedied.

1. Personal and Professional Qualifications

As previously stated, prior to the enactment of the Law, there was no mandatory regulation determining who could act as investment adviser or portfolio manager. Such a situation is unacceptable in any well-run state. The Law provided that activity as an investment adviser or portfolio manager would be reserved for licensees only,[311] as is the case for lawyers, doctors, and accountants. In order to receive a license under the Law, candidates must meet a number of conditions, complete an internship and pass written professional examinations.[312] In this respect, the Law adopted the British,[313] as opposed to the American,[314]

---

310. *See supra* note 286 and accompanying text.

311. *See* § 2 of the Law.

312. *See* § 8 of the Law.

313. *See* Meir Heth, Supervision of Investment Advisers and Portfolio Managers in Britain, 132 Q. BANKING REV. (1995) (Hebrew, on file with author). Supervision of investment advisers in Britain is based on "*Authorization*" which in fact means licensing. In addition to registration, an investment adviser requires a license to carry on the profession. The Financial Services Act (1986) forbids carrying on investment businesses without authorization, unless there is a specified exemption in the law. Persons operating investment businesses without authorization are guilty of a criminal act, and ,furthermore, heavy civil sanctions are imposed—the courts will not enforce contracts signed by such persons with their clients. The definition of investment businesses includes the sale and purchase of investments on behalf of other persons, portfolio management, investment consulting and management of mutual funds. In order to receive a license the applicant must present suitable qualifications for managing an investment business. The aim of the law is to verify that persons engaged in the investment sector possess suitable qualifications and an acceptable past. *See id.*

314. *See id.* In the United States, supervision of the investment advisory sector is based on reasonable disclosure, a requirement for registration but not authorization or

approach. The Law seeks to ensure that the conditions set for receiving such a license will continue to apply in the future.[315] If the licensee fails to maintain any of the conditions, the Securities Authority may cancel or suspend the license.[316] In addition, the Law provides a number of circumstances which entitle the Securities Authority to cancel or suspend a license previously granted: if a person has been declared bankrupt, lacks legal capacity,[317] or faces indictment.[318] The Law has achieved its aims in establishing professional and personal qualifications for investment advisers and portfolio managers.

2. Duties of Licensees

Investment advisers and portfolio managers are subject to two main duties: the duty of care in providing services and a duty of loyalty toward the client. Prior to the enactment of the Law, Israeli legislation did not contain any specific reference to the duty of care or the fiduciary duty applicable to the above occupations. However, it was, and still is, possible to apply general norms of law to the relationship created between the investment adviser or the portfolio manager and his client. Following the recommendations of the Gabai Commission, the above duties were established in the Law.

---

licensing. Although registration has similarities with licensing, there are fundamental differences between the two. Persons wishing to give investment advice must register with the Securities and Exchange Commission. They are required to fill in a questionnaire and give full details of their occupation, qualifications, business plans, as well as to state whether they have been prevented from engaging in any activity for reasons which may disqualify them from acting as advisers. Based on the answers to the questionnaire, the Securities and Exchange Commission decides whether or not to accept the registration application; thus, in fact, registration and licensing are very close in meaning. However, in the United States, registration is not subject to pre-determined qualifications and, therefore, if the Securities and Exchange Commission finds that the details submitted in the questionnaire are satisfactory, a person will be registered and may act as an investment adviser without reference to his professional qualifications. *See id.*

315. *See* § 10 of the Law.

316. *See* § 10(a) of the Law.

317. *See* § 10(a)(5) of the Law.

318. *See* § 10(c) of the Law.

3. Securities Powers

The Bejsky Commission's recommendation to divest the banks from their securities powers has not been accepted by the Israeli legislature. Consequently, the securities powers of the banks remained,[319] almost as they were prior to 1983 Crisis.[320]

From the name of the Law, it may be apparent that it deals only with investment advice and portfolio management. With regard to underwriting or additional securities activities, such as merchant banking, the Law does not apply. The "Provisions of the Supervisor of the Banks: Adequate Banking Practices"[321] allow Israeli banks to engage in these activities only through affiliates. Thus, due to the fact that the banks were allowed to retain their securities powers as existed prior to 1983 Crisis, the Israeli legislature decided not to deal with the affiliates' securities powers in the Law. By doing so, the Israeli legislature perpetuated the banks affiliates' securities powers. As noted above, Bejsky and Gabai Commissions wanted to prohibit the banks from engaging in these securities activities even through affiliates.

Section 9(a) of the Law states that a bank may not engage in portfolio management.[322] In practice, this prohibition did not affect the banks, which even prior to the Law, and as a lesson from the 1983 Crisis, transferred this activity to affiliated companies.[323] The Law does not prohibit affiliates of a bank from engaging in the above activity. However, the Law does not specifically permit affiliates to engage in this activity. Of note, when the bill for the Law was presented, it did contain a specific permission to engage in this activity. However, the fact that the banks' affiliates are engaged in this activity without being warned by the regulators makes this issue semantic and meaningless.

Section 9(b) of the Law states that a bank may engage in investment advice without a need to receive a license; however, the

---

319. *See infra* note 321 and accompanying text.

320. However, some bankers claim that, due to the Law, their securities activities are frozen. The reasons for this claim, which stem from the duties and norms contained in the Law, are beyond the scope of this Note.

321. *See* Provisions of the Supervisor of the Banks: Adequate Banking Practices, Section 4(a) (Hebrew, on file with author).

322. *See* Regulation of Investment Advice and Investment Portfolio Management Law (1995) (Hebrew, on file with author).

323. *See supra* note 321.

banks' personnel who provide this service must obtain a license.[324] In this regard, the legislature adopted the "Chinese wall" solution, as opposed to the Commissions' recommendations to prohibit banks from rendering this service. The Law does not explicitly require the banks to separate their investment advice activities from the traditional banking activities, *i.e.* erecting a "Chinese wall". However, the duties and norms contained in the Law require the banks, in order to fulfill those duties, to separate its investment advice activities from its traditional banking activities. Nevertheless, section 10 of the Provisions of the Supervisor of the Banks: Adequate Banking Practices does require a bank, which directly engages in investment advice activities, to separate these activities from its remaining traditional banking activities. Consequently, the fact that the Law does not require the separation is again meaningless.

G. Examination of Bejsky Commission's Recommendations

The Bejsky Commission wanted to replicate the U.S. Depression-era-type legislation, such as Glass-Steagall. It wanted to separate the commercial and investment banking without any exceptions. However, as described above, even in the United States the separation was not an absolute one. Regarding the question of whether an outright separation will benefit the financial system and prevent the reoccurrence of additional crisis, even the Bejsky commission could not answer.

The author is of the view that the Bejsky Commission's recommendation is not applicable to the Israeli financial market. The solution for the problem must not disregard the unique financial environment in which it will be implemented. Due to the pivotal role of the banks in the financial market, the substitutes are scarce and inaccessible to the populace. In addition, one must not forget that by separating commercial and investment banking, one transfers the ball to the investment banks' field. Query as to whether that field is greener than that of the banks. The Bejsky Commission did not examine Israeli investment company's practices. It is not obvious that the latter will be able to render better and safer securities services. From a financial sense, the separation will affect the populace's ability to receive

324. Regulation of Investment Advice and Investment Portfolio Management Law (1995) (Hebrew, on file with author).

financial services. In order to receive financial services from the private institutions the customers should have larger amounts than they need in order to receive the same services from commercial banks. Further, the costs of receiving these services are much higher than those charged by commercial banks.[325] If one wants to adopt such an old-fashioned system, one should carefully examine the practices of the substitutes, or one evil could be replaced with a bigger evil.

The Bejsky Commission did not examine the implications of separating commercial and investment banks as regard to the banks themselves. The separation might end up with significant losses to the commercial banks, which might affect their safety and soundness and, in turn, the financial system as a whole. The aim should be to strengthen the financial system and to protect the customer, rather than the punishment of the responsible banks. From a policy point of view, one should also consider the banks' employees that might suffer from this kind of separation.

Even those[326] who argue that Glass-Steagall-type legislation will prevent the reoccurrence of such a crisis will not accept the outright prohibition of banks from engaging in securities activities, as recommended by the Bejsky Commission. As described above, even under Glass-Steagall, banks were allowed to engage in securities activities to some non-negligible extent.

Ironically, the country that invented the separation has also abandoned it, while the Israeli legislature thinks about reviving it. The Note intentionally presented the development in the United States in this regard in order to allow the Israeli legislature and commentators to be more familiar with the new developments that occurred there.

Finally, one must take into consideration the constitutional aspect. The constitutional revolution in Israel, which took place in 1994, has some significant implications to any new legislation.[327] First, new legislation must not discriminate the banks. Second, section 4 of the Basic Law : Freedom of Occupation states as follows: "There shall be no violation of freedom of occupation except by a law befitting the values of the State of Israel, enacted for a proper purpose, and to an extent no

325. For example, the advisory services are given free of charge in the commercial banks. *See* Bahat, *supra* note 291.

326. *See* Blass & Grossman, *Who Needs Glass-Steagall?*, *supra* note 276.

327. *See* Bahat, *supra* note 291.

greater than is required, or by regulation enacted by virtue of express authorization in such law."[328] Thus, in order to separate the commercial and investment banking, the Israeli legislature must prove that it is "for a proper purpose and to an extent no greater than is required." The author doubts if this is the case in this instance. Due to the above Basic Law, the Israeli legislature must adopt a solution that will cause the least possible damage. Given the U.S. experience with Glass-Steagall, it is almost impossible for the Israeli legislature to adopt such a pattern. There is a wide variety of solutions besides the Glass-Steagall-type. Presumably, the Israeli legislature was aware of this aspect, and consequently adopted a different pattern in the Law.

H. The Adequacy of the Israeli Legislation

The various commissions emphasized certain failures, which have been solved in the Law. First, the Gabai Commission observed the absence of professional norms that define the fiduciary duty and duty of care that the investment adviser and portfolio manager owed their clients.[329] As briefly presented above, in this regard the Law achieved the Gabai Commission's aim. Second, it also observed the lack of requirements for professional and personal qualifications.[330] In this regard, as well, the Law achieved the Gabai Commission's aim.

Third, Bejsky Commission observed the egregious conflicts of interest between the Service Providers and the customers.[331] In this regard, the legislature followed the Bejsky Commission's recommendation only to a limited extent. The legislature did not separate the commercial and investment businesses, as the commission proposed. However, the Law established duties and norms that should solve the problem of conflicts of interests. The author is of the view that this is the best solution for Israel's unique financial system. However, only time will be able to tell whether the problem has truly been solved. In the event that the capital market will change—and as described in Saul Bronfeld's article, it has changed to a limited extent[332]—only then

328. *See* The Knesset, *at* http://www.knesset.gov.il (last visited Dec. 28, 2003).
329. *See* Gabai Commission, *supra* note 297, at 150.
330. *See id.*
331. *See* Bejsky Report, *supra* note 183, at 128.
332. *See* Bronfeld, *supra* note 247.

might one consider applying Glass-Steagall-type legislation. Then one should reconsider the fact that in the Israeli episode, as opposed to the American, the banks have been found guilty. By saying that one does not mean to support the outright adoption of Glass-Steagall-type law, however, given the banks' proven fault, a moderate Glass-Steagall-type legislation might remedy the illness in the Israeli banking system that led to the 1983 Crisis.

The Note now turns to examine whether the enactment of Gramm-Leach-Bliley affects, or should affect, the Law. Given the fact that the Israeli legislature chose not to adopt a Glass-Steagall-type law, the enactment of the former does not have any direct significant implications to the Law. However, some indirect implications may be inferred from its enactment. First and foremost, it might signal to the Israeli legislature, which considers adopting such pattern, that the old solution did not succeed, or that there are better solutions for these kinds of problems. Second, it might serve as the right and moderate model for tackling these kinds of problems.

Finally, as described above, the most significant changes introduced by Gramm-Leach-Bliley relate to the affiliates of the banks, rather than to the banks themselves. This is not a perspective of the Law, which specifically focuses on the banks themselves.

CONCLUSION

This Note intended to present the real picture, as opposed to the common belief, of the securities powers of U.S. commercial banks prior, and subsequent, to the enactment of Gramm-Leach-Bliley. From its inception the separation was not without exceptions, and as the years went by, the separation was blurred even further. Eventually, the separation was considered to cause more damage than good, or as the Note described it, replacing an evil with a bigger one.

This Note stresses that even if the tragedies bear resemblance to some extent the solution must not disregard the specific environment in which it will be implemented. Put differently, even if the 1983 Crisis and the Great Depression were similar, it does not mean necessarily that the same legislative response will prevent the reoccurrence of these evils or remedy the defective practices. To illustrate this point, the Note presented unique features of the financial market in Israel. The Note concludes that a Glass-Steagall-type solution—even though it has been

proved to be inadequate and to some extent even harmful—cannot be replicated without significant adjustments in Israel. Not only will it not achieve its aims—safety and soundness of the banking system and the financial system as a whole—but it may end up with greater risks to the banking system and in turn to the financial system as a whole.

Finally, in presenting certain aspects of the Law, the Note briefly described the significant revisions introduced by the Law to the banking system. The Note concludes that these revisions, coupled with the banks' experience, should be sufficient to prevent the reoccurrence of additional crisis.

EXHIBIT A

Corporations Holding Commercial Banking Licenses as of December 31, 1996[333]

Commercial Bank	Year Established	Previous Name (Year of Change)	Remarks	Affiliated with Banking Group As of 12/31/96
Bank Leumi le-Israel	1903	Anglo-Palestine Bank (1954)	Established toward the end of the Ottoman era by the World Zionist Organization	Leumi
Bank Hapoalim	1922		Established by the Histadrut (General Federation of Labor), affiliated with the Labor Party	Hapoalim
Union Bank of Israel	1922	Palestine Association (1951)	Acquired from Bank Leumi le-Israel by the Eliyahu group in 1993	Independent (Leumi holds 17% of shares)
Mercantile Bank of Israel	1924	Palestine Mercantile Bank (1953)		Discount
United Mizrahi Bank	1925		Established by the National Religious Party, merged in 1969 with Hapoel Hamizrahi Bank, and became United Mizrahi Bank	Mizrahi
Mercantile Discount Bank	1926	Barclay's Bank (1972), Barclay's Discount Bank (1993)	Entered into partnership with Israel Discount Bank in 1972, in Barclay's Discount Bank	Discount

333. Shuv, *supra* note 194. This table lists only banks that are separate legal entities and excludes banks that merged into banking groups over the years.

Commercial Bank	Year Established	Previous Name (Year of Change)	Remarks	Affiliated with Banking Group As of 12/31/96
Polska Kasa Opieki, S.A. Bank	1932		A Polish bank that became an ordinary banking corporation in 1993	Independent
American Israel Bank	1933	Yefet Bank (1975)	Control transferred to Bank Hapoalim in 1970	Hapoalim
Israel General Bank	1934	The Palestine Credit Utility Bank (1964)	Sold in 1964 to the founders of Israel General Bank; controlled by the Investech Group of South Africa	Independent
Israel Discount Bank	1935	Palestine Discount Bank (1957)		Discount
Trade Bank	1936	Palestine Trade Bank (1953), Atid Bank (1937)		Independent
Bank Otzar Hahayal	1946		A financial institution until 1970; acquired by Hapoalim in 1977	Hapoalim
Haoved Haleumi Savings and Loan Fund, Netanya[1]	1947		Founded by veterans of the Irgun and the Stern Group; the only cooperative association that still functions as an independent bank in Israel	Independent
Bank Yahav Le-Ovdey Hamedina[1]	1954		A financial institution until 1976	Hapoalim
The First International Bank of Israel	1956	The Foreign Trade Bank (1972)		First International
Arab Israel Bank	1960			Leumi
Maritime Bank	1962		A commercial bank since 1978; owned by the Arison Group	Independent

Commercial Bank	Year Established	Previous Name (Year of Change)	Remarks	Affiliated with Banking Group As of 12/31/96
Israel Continental Bank	1974			Hapoalim
Bank Massad	1977	[Previously a cooperative association]	Obtained banking license in 1977 and acquired by Bank Hapoalim	Hapoalim
Poaley Agudat Israel Bank	1977	[Previously a cooperative association]	Acquired banking license in 1977; remained under control of First International Bank	First International
Euro-Trade Bank	1978		Founded by the Contractors' Center as a sectoral bank for the construction industry	Independent

(1) This bank functions as a commercial bank without a banking license, by permission of the Bank of Israel. The independently owned Global Investment Bank began to operate in 1994 along similar lines.

EXHIBIT B

Development of the Israeli Banking System Since Statehood[334]

Year	Commercial Banks	Cooperative Credit Associations	All Providers of Banking Services	Number of Branches	Population per Branch	Total Assets (Current $ Billions)	Share of the Three Largest Banks in Total Bank Assets
1948	23	70	93	175	8,571	0.431	50%
1954	23	95	118	315	5,365	1.687	50%
1960	26	29	55	515	4,111	0.898(2)	67%
1965	27	20	47	715	3,585	1.816	81%
1970	25(1)	14	39(1)	793	3,750	4.512	88%
1975	20(1)	9	29(1)	935	3,695	13.335	93%
1980	25(1)	2	27(1)	1,099	3,569	25.426	92%
1985	25(1)	1	26(1)	1,095	3,918	50.931	91%
1990	25(1)	1	26(1)	1,038	4,645	95	87%
1996	22(1)	1	23(1)	1,074	5,367	125	81%

(1) This figure includes banks that are separate legal entities and held by other banks.

(2) The apparent drop in assets is because the official exchange rate climbed from 0.36 Israel Lira (Sept. 18, 1949) to 1.8 Israel Lira (Jul. 1, 1955).

334. Shuv, *supra* note 194. Dollar exchange rates are published by the Israeli government (Bureau of Certified Public Accountants, 1996).

EXHIBIT C

Israel's Large Banking Groups as of December 31, 1996
$ billions (exchange rate of December 31, 1996)[335]

Group	Assets	Proportion of Total Commercial Bank Assets	Capital	Proportion of Total Commercial Bank Capital
Hapoalim[(1)]	46.1	37%	2.4	32%
Leumi[(2)]	35.7	28%	2.1	28%
Discount[(3)]	19.7	16%	1.2	17%
Three Largest Banks	101.5	81%	5.7	77%
First International[(4)]	8.6	7%	0.6	8%
United Mizrahi	7.1	6%	0.6	8%
Five Largest Banks	117.2	94%	6.9	93%
Independent[(5)]	7.4	6%	0.6	7%
TOTAL	124.6	100%	7.5	100%

(1) This figure includes American Israel Bank, Israel Continental Bank, Bank Yahav, Bank Massad, and Bank Otsar Hahayal.
(2) This figure includes Arab Israel Bank.
(3) As of December 31, 1996, Israel Discount Bank held a 26.4 percent equity stake in First International Bank. This figure includes Mercantile Discount Bank and Mercantile Bank of Israel.
(4) This figure includes Poaley Agudat Israel Bank.
(5) Union Bank of Israel, Industrial Development Bank of Israel, Israel General Bank, Maritime Bank, Trade Bank, P.K.O. Bank, Euro-Trade Bank, Global Investment Bank, Haoved Haleumi Savings and Loan Fund, Netanya.

335. Shuv, *supra* note 194.