

Interim Report of the Inter-Ministerial Committee for the Study of the Establishment of a Dedicated Stock Exchange for Small and Medium-Sized Companies in Israel



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This translation of a short version the full Interim Report. For the full original text in Hebrew (submitted in 2017), please see:

http://www.isa.gov.il/הודעות2017/פרסומים/Reports/177/Documents/Designated_Stock_Exchange.pdf

1. Introduction

On April 26, 2016, Minister of Finance Moshe Kahlon and Minister of Justice Ayelet Shaked announced the appointment of a team to study the establishment of a capital market specifically for small and medium-sized enterprises (hereinafter, “the Team”), whose members would be representatives of the Ministry of Finance, the Israel Securities Authority (hereinafter, “the ISA”), the Ministry of Finance Budget Division, and the Tax Authority.¹

A review of the high-growth companies and small and medium-sized enterprises (SME) in the local capital market leads to the conclusion that the stock exchange has not served as an effective alternative arena for capital raising by such firms, especially due to reasons related to the companies’ size and scope of operations; the listing requirements are too high for them, the current regulatory costs are disproportionate to SME size; and the existence of more attractive alternatives for capital raising.

International opinion concurs that SMEs make a significant contribution to economic growth and development of economies, and constitute a driver of improvement in employment rates, innovation, and business development.

As in other countries the world over, SMEs are major drivers of growth in the Israeli economy, yet most find it difficult to obtain financing for their operations through the currently existing channels, for several reasons. The government’s policy to assist SMEs, whose , -prompted an initiative to establish a dedicated stock exchange for SMEs (hereinafter, “the SME Exchange”). The SME Exchange will give small and medium-sized enterprises access to public financing channels that have not been available to them to date. Public financing has many advantages including relatively low costs, liquidity for investors, diversification of risks, the public directly benefits from the success of these companies, and promotion of long-term growth.

Until now, the TASE did not constitute a significant alternative for high-growth firms either,² although for slightly different reasons. High-growth firms are typically firms in the early stage of their development, and require capital and credit to finance their business operations and develop into mature firms with stable and strong cash flows. Access to public financing gives such companies a new channel of financing and also contributes to the development of the capital market and increases the diversity of the

¹For the announcement by the Ministry of Finance, see: [link to the Ministry of Finance website](#).

² This term is mainly used to describe companies that are a relatively early stage in their business and maturity. Usually these companies’ business is related to the development of technological or scientific products. Most of these firms lack a significant stream of income or operating profit, they have a need for external financing to develop or expand their business operations, they are in the R&D stage, lack a finished product, and so on and so forth.

investment vehicles available to investors. Furthermore, establishment of an SME Exchange will help increase the Israeli public's exposure to high-growth and technology-intensive firms that have accounted for an insignificant share of capital market activities until now; it will create a stepping stone to major markets for high-growth companies; it will help promote the country's interests to keep these companies in the local market, consequently enhancing Israel's competitive edge as a technological world power and contributing to increased economic productivity.

In view of these benefits, the Team was requested to present its recommendations to the ministers regarding the means and measures that will enable the establishment of an SME Exchange, in which small and medium-sized enterprises will be listed, with emphasis on removing barriers and relaxing requirements to accommodate the needs of these firms, without compromising on protection of the interests of the investor public and proper trading rules and procedures. The members of the inter-ministerial team for the establishment of an SME exchange in Israel are:

- Committee Chair: Prof. Shmuel Hauser, Chair of the ISA
- Committee Chair: Attorney Meir Levine, Deputy Attorney General (Economic Law)
- Attorney and CPA Moshe Asher, Director of the Tax Authority
- Ms. Nirit Ibbi, Adviser to the General Director of the Ministry of Finance
- Mr. Amir Levy, former head of budgets, Ministry of Finance; subsequently replaced by:
- Mr. Yogev Gardos, Deputy head of budgets, Ministry of Finance

Inter-ministerial committee coordinators:

- CPA Ilan Zioni, Director of Disclosure and Reporting, Corporate Department, ISA
- Attorney Ronny Talmor, Senior (acting) head of Corporate Laws, Department of Consultation and Legislation (Economic Law), Ministry of Justice

In addition to the members of the inter-ministerial team, many people contributed to this report, and we express our gratitude to them: The Economic Department, the Corporate Department, and the Investment Department, ISA; The Consultation and Legislation (Economic Law) Department, Ministry of Justice; Budget Division, Ministry of Finance; professional consultation to the director of the Tax Authority and the Professional Division, Tax Authority.

For the Team's letter of appointment, see Appendix A attached to this Report.

http://www.isa.gov.il/פורסומים%20הודעות2017/Reports/177/Documents/Designated_Stock_Exchange.pdf

2. Highlights of the Team’s Recommendations

Following is a brief summary of the Team’s recommendations:

2.1. The supervisory model

The Team believes that the optimal supervisory model for the SME Exchange is the model adopted by the AIM³ in the UK, which has been applied in several variations in secondary exchanges worldwide. According to this model, the stock exchange supervises the companies listed on the secondary exchange through regulatory advisers (known as nominated advisers, or Nomads) who perform continuous oversight, in contrast to the regulation model used by the London Stock Exchange (LSE), where the listed companies are supervised by the regulatory authority, the Financial Conduct Authority (FCA).

The Team believes that the model of supervision through nominated advisers should also be implemented in the SME Exchange in Israel. Pursuant to this model, the SME Exchange will play a major role in system of supervision and control that applies both to the nominated advisers and to the listed companies, while the ISA will have residual authority over the nomads and listed companies (hereinafter, “the optimal model”).

However, because an appropriate infrastructure is currently lacking, and the current regulatory structure in Israel is not supportive of the option of granting significant supervision and enforcement authorities to the SME Exchange, which would be a private entity, at this stage the Team recommends to implement an alternative supervision model, based on the current supervision model used in Israel, yet similar to the supervision model that applies to the Canadian exchanges — the Toronto Stock Exchange (TSX) and its secondary market, the Toronto Stock Exchange Ventures (TSXV). These markets are supervised by the regulator, similar to the situation in Israel. In the future, the Team proposes to revisit the potential implementation of a NOMAD-based supervision mechanism for the SME Exchange. To complete the picture, Chapter 6 of this Report summarizes the highlights of the AIM regulation model, on which the optimal model is based.⁴

³ AIM – Alternative Investment Market, established within the LSE for small and high-growth firms.

⁴ In a nutshell, the AIM regulation is model is based on direct regulation of the firms that is the authority of the AIM, but is effectively conducted by NOMADs. NOMADs are entities licensed by the LSE, subject to qualifications and other criteria, and subject to its regulation. Firms are obligated to appoint a NOMAD as long as they are listed on the secondary market. The NOMAD’s main function is to ensure that the firm meets the secondary market’s rules, and to accompany it in complying with regulatory requirements and corporate governance. See Appendix B of the Report for a graphic depiction of AIM’s regulatory structure.

Under the current circumstances, the Team recommends that the SME Exchange be set up under a supervisory model that is similar to the supervision that applies to the companies listed on the TASE (“the Primary Market”). In other words, the companies will be supervised directly by the ISA, in line with the regulation that is proposed to apply to these companies (described in this Report below), in line with the nature of these companies, their size, and other features, in line with other globally accepted models in which the regulator is the primary supervising entity.

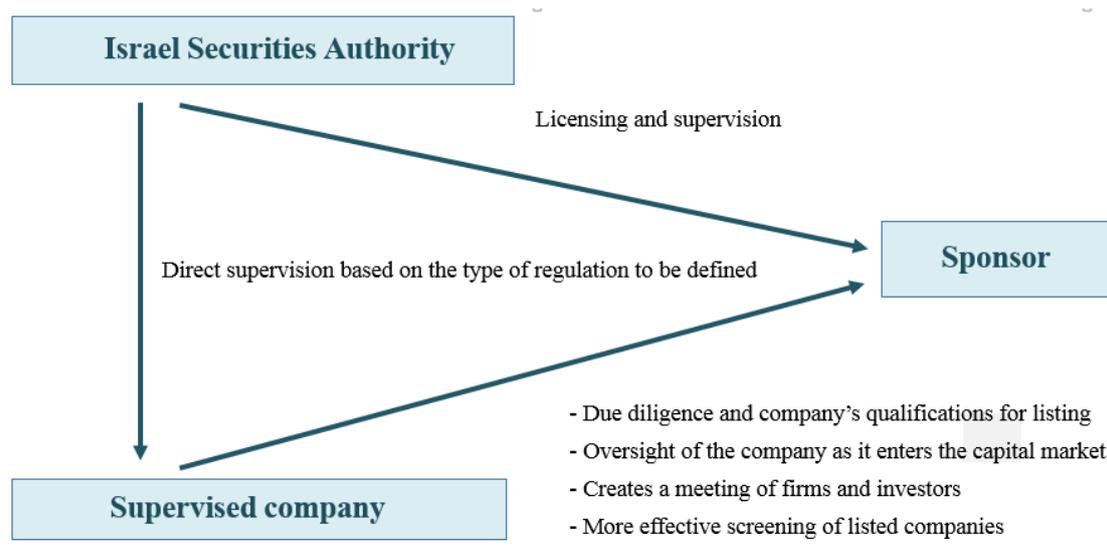
Direct supervision by the ISA obviates the need to appoint nominated advisers and therefore, under this supervisory model, an obligation to do so would only constitute an additional regulatory burden and added costs for companies listed on the SME Exchange.

At the same time, in view of the assumption that a considerable number of the companies that will apply for listing on the SME Exchange will be smaller and have a distinct risk profile; the information available on them is more limited; their officers have relatively limited experience with the capital market; and they companies lack sufficient resources to establish the regulatory and marketing system required for capital market activities; and in view of the findings of a comparative legal review, which emphasize the significance of effectively screening companies for listing on the SME Exchange — the Team considers it important to create a support system of an appointed sponsor, which is similar to the supervisory model adopted by the Canadian Stock Exchange. The sponsors will help these companies implement the regulatory adjustments and business preparations for an IPO and subsequent rounds of capital raising. The sponsor’s main role will be to conduct due diligence on the companies, oversee their (initial and subsequent) issues and capital raising activities, and help them reaching out and meet the investor public and promote their securities issues.

In addition to the benefits of such a function from the companies’ perspective, and the assistance to them in their initial steps in the capital market, the sponsor also makes a contribution to the capital market in general, on several counts. By definition, the sponsor will help create a more effective screening procedure, filtering out companies that are unsuitable or unready to enter the capital market, and reducing the public’s exposure to such companies. The sponsor might also enhance the image of the SME Exchange and encourage institutional investors to enter this market and invest in the listed companies, thereby contributing to a

The sponsor will be subject to supervision by the ISA and will be licensed by the ISA.

The following figure describes the division of roles in the proposed model (until the SME Exchange adopts the nomad-based supervisory model, subject to future review):



For additional information on the supervisory model, see Chapter 6 of this Report.

2.2. Profile of the target investors

The Team recommends not to restrict the type of investors who may invest in the SME Exchange, in view of the desire to increase the demand side in this venue and give access to the SME Exchange to all types of investors.

2.2.1. The Team recommends not to modify the current requirements that apply to licensees, underwriters, and distributors.

For more information on the profile of target investors, see Chapter 7 of this Report.

2.3. Features of firms that may register for trade on the SME Exchange

2.3.1. The Team recommends that a minimum operating history of one year should be defined.

2.3.2. The Team recommends that no restrictions or limitations related to sector or industry should be defined.

2.3.3. The Team recommends that no minimum financial requirements should be defined, and companies should not be required to maintain a business model.

For more information on the features of firms that may register for trade, see Chapter 8 of this Report.

2.4. Conditions for registration and trading

Public shareholdings spread

2.4.1. For an IPO

- The Team recommends that a minimum public shareholding rule should be defined (in multiples of 20% and 30%, depending on the company's market capitalization for the IPO).
- The Team recommends that the minimum number of investors in the IPO should be defined as 50.

2.4.2. Trading activity

The Team recommends that the minimum public shareholder should be set at 15% during continuous trading, similar to the current condition in the Primary Market, in order to ensure a minimum level of trading in the shares.

Furthermore, the Team recommends to use the same definition of the term "public" that is currently used in the Primary Market, for the purpose of calculating the minimum public shareholding.

Setting minimum requirements for scope of capital raising

2.4.3. Minimum capital raising requirement

The Team recommends that securities should be issued for a minimum of NIS 6 million, which is the maximum amount for raising capital on a crowdsourcing platform.

2.4.4. Maximum capital raised

The Team recommends that no maximum amount should be set for the capital raised, although a company's post-money valuation should not exceed NIS 300 million on the issue date.

Restrictions on related party shareholders

- 2.4.5. The Team recommends that blocking regulations should apply to interested parties from the date of the IPO, similarly to the restrictions that currently apply to the Primary Market.

Encouraging money making

- 2.4.6. The Team recommends that companies that elect to appoint a market maker should have a minimum of 35 investors in their IPO, rather than 50.
- 2.4.7. The Team recommends that trading in securities of companies that elect to appoint a market maker should be conducted in continuous trading (rather than trading once or twice a day).

Nature of trading

2.4.8. The Team recommends that the model of companies listed on the SME Exchange should be modified to allow the entry of e-brokers.

2.4.9. The Team recommends to set up an electronic IPO system for participating in IPOs.

For more information on registration requirements and trading conditions, see Chapter 9 of this Report.

2.5. Securities offerings

The Team proposes that permit should be permitted to offer securities at different prices in their IPOs, by defining the entities to which the securities will be issued, and the allotment rate with respect to each bid.

For additional information on the structure of the SME Exchange, see Chapter 10 of this Report

2.6. Securities listing transfers

Transferring a listing from the Primary Market to the SME Exchange

2.6.1. The Team proposes that companies should be permit to transfer their listing, according to rules to be determined at the end of a 3-year trial period, which will begin at the establishment of the SME Exchange, during which the implications of permitting such transfers will be studied.

Automatic listing transfer from the SME Exchange to the Primary Market

2.6.2. The Team proposes that no mandatory listing transfer be defined for companies listed on the SME Exchange, under any circumstances, independent of company valuation or type of issued security. It is nonetheless proposed that companies whose market capitalization exceeds NIS 600 million (twice the valuation of a “Small Corporation”, as defined in Securities Regulations (Periodic and Immediate Reports) 1970)) will be subject to the regulation rules of reporting and corporate governance that apply to companies in the Primary Market, and a transition period should be defined during which the companies will make the proper arrangements for implementing these rules.

2.6.3. For additional information on listing transfers, see Chapter 11 of this Report.

2.7. Types of securities that may be issued on the SME Exchange

Debt securities

- 2.7.1. The Team proposes that companies may issue debt securities already from their IPO, provided that the companies already issued equity securities or equity issued are also issued at that time.
- 2.7.2. The Team proposes that debt securities issues in the SME Exchange should be limited to amounts between NIS 6 million and NIS 36 million, and in any case, never to exceed 100% of the issued equity.
- 2.7.3. It is concurrently proposed to establish a track for small debt issues on the Primary Market, subject to full regulatory oversight.
- 2.7.4. Finally, it is proposed to revisit the need to modify the format for debt issues three years after the establishment of the SME Exchange.

Issues of instruments that do not conform to the “one share one vote” principle (“equalization of voting rights” rule) under Section 46B of the Securities Law 5728-1968 (hereinafter, “the Securities Law”)

- 2.7.5. It is proposed to retain the “one share one vote” principle, including the option of issuing preference shares, based on the issuing restrictions that apply to all reporting corporations on the Primary Market, as defined in the TASE Articles of Association.

For additional information on the types of securities that may be issued, see Chapter 12 of this Report.

2.8. Disclosure and reporting requirements

Periodic reports

- 2.8.1. Frequency of publication
- 2.8.2. The Team proposes that companies that issue equity securities should be subject to a requirement to publish semi-annual periodic reports, similarly to the relaxed reporting requirement that currently applies to “Small Corporations” that issue equity securities on the Primary Market. Similarly to the model adopted by the Primary Market, companies that issue bonds are subject to a requirement to file quarterly reports, in order to provide information to bond investors at a greater frequency, and due to the inherent features and risks that debt versus equity securities represent. It is further proposed that companies that generate no income in the period of the financial statements should only be required to provide information on their “burn rate” in their semi-annual report, in lieu of a financial statement.

- 2.8.3. The information accompanying financial statements: The Team proposes that companies should publish an “extended management report” (in other words, a management report pursuant to the Financial Reporting Improvement Project; to provides a more extensive description of the nature of their business), and not to require them to publish a description of the company’s business in the format defined in the First Addendum to the Securities Regulations (Details of Prospectus and Draft Prospectus) 5729-1969 (hereinafter, “the Prospectus Detail Regulations”).
- 2.8.4. Attached documents: The Team proposes not to impose a requirement to attach valuations and solo financial statements. It is also proposed to increase the criterion for inclusion of affiliates’ financial statements to 40%, even in annual financial statements, with the aim of reducing to a minimum the requirement to attach various documents and statements. The remaining attachment requirements that currently apply to companies listed on the Primary Market will continue to apply to the SME Exchange without modification.
- 2.8.5. Report of the effectiveness of the internal control on financial reporting and disclosure (ISOX) – The Team proposes not to impose this regulation on the SME Exchange.
- 2.8.6. Accounting standards - The Team proposes to permit implementation of IFRS, US GAAP, and Israeli accounting standards in the companies’ financial statements.
- 2.8.7. Presentation of comparative financial statements – The Team proposes not to require presentation of more than a single comparative period (subject to compliance with generally accepted accounting principles).
- 2.8.8. Disclosure of executive compensation – The Team proposes to require a disclosure of the remuneration of a company’s three highest-paid executives (in lieu of the current requirement to disclose the remuneration of a company’s five highest-paid executives).

Immediate reports

- 2.8.9. Content and scope of duty of immediate disclosure: The Team proposes to define a general disclosure requirement concerning material events that are outside a company’s ordinary course of business, due to their nature, scope, or potential results, and which have or potentially have a material impact on the company; and concerning events or interests that may have a significant impact on the price of the company’s securities, similarly to Regulation 36 of the Securities Regulations (Periodic and Immediate

Reports) 5730-1970 (hereinafter, “the Reports Regulations”), and to exempt the companies from all other immediate reporting requirements.

2.8.10. Furthermore, it is proposed to accompany the regulation with a non-exhaustive list of events that require reporting.

2.8.11. Timing of immediate reports: It is proposed to define that immediate reports must be published no later than 48 hours after the relevant event.

For additional information on disclosure and reporting requirements, see Chapter 13 of this Report.

2.9. Corporate governance and interested party transactions

Controlling shareholder transactions

2.9.1. The Team proposes not to relax the provisions that apply under the Companies Law regarding the mechanism of approvals required for transactions with controlling shareholders (such transactions will require approval of the audit committee, the board of directors, and the general meeting [based on a majority of the minority shareholders]).

2.9.2. Nonetheless, the Team proposes to define that terms of service and employment or terms of services rendered by a controlling shareholder or a relative thereof, will be approved once every five years (in lieu of the current requirement defined in the Companies Law to issue approvals once every three years).

Rules concerning executive remuneration and remuneration policy (Amendment 20 to the Companies Law)

2.9.3. The Team proposes that companies be required to define a remuneration policy, but such policy will not be subject to approval by the general meeting.

2.9.4. The Team proposes not to require the general meeting to approve terms of service for the CEO where these terms are consistent with the company’s remuneration policy.

Additional proposed arrangements that constitute a relaxation of the laws currently applicable to public companies

2.9.5. The Team proposes to permit dual tenure as chairman of the board of directors and as CEO of a person or his/her relative (subject to no special approval mechanisms).

2.9.6. The Team proposes to require companies to appoint a single independent committee only (in lieu of an audit committee and a remuneration

committee) and to relax the cumulative requirements that apply to the composition of the committee.

2.9.7. The Team proposes not to impose a requirement to appoint an internal auditor in companies with a value or number of employees that is lower than a specific amount or number, to be defined.

2.9.8. The Team proposes not to impose the requirement to conduct a competitive proceeding according to Section 117(B1) of the Companies Law regarding transactions with controlling shareholders, or transactions in which controlling shareholders have an interest.

For additional information on corporate governance and controlling shareholder transactions, see Chapter 14 of this Report.

2.10. Enforcement

The enforcement regime will be developed based on decisions on multiple issues, including the identity of the supervising entity and the enforcement powers and measures, which are a function of the supervisory model that will be applied to the SME Exchange. Therefore, this issue should be discussed and decided after the Team receives public comments on the proposed supervision regime, and determines its features.

2.11. Structure of the SME Exchange

The Team proposes to establish a new stock exchange for small and medium-sized companies and high-growth firms, as a corporation that is separate from the Primary Market (rather than as a new list on the Primary Exchange). A differentiated corporation will allow the SME Exchange to conduct its own branding activities, independent management, and collaborations with foreign stock exchanges. The experience of similar exchanges worldwide indicates that it is important for the Primary Market and the SME Exchange to maintain close links, yet retain separate branding and management arrangements. Establishing the new exchange will also address potential conflicts of interests between the Primary Market and the SME Exchange.

For additional information on structure of the SME Exchange, see Chapter 15 of this Report.

2.12. Incentives

- Economic incentives
 - Incentives to companies
 - The Team proposes to reduce or cancel the fees that the ISA charges, for a period of up to two years, beginning from the date a company is listed on the SME Exchange, and to reduce the securities listing fees during that period.

The Team proposes that such relaxed requirements should also apply both to companies that list on the SME Exchange and to companies that are issuing securities on the Primary Market for the first time.

- The Team proposes to operate a program to subsidize the cost of analyses, which will be published and available to all investors, subject to an appropriate budgetary allowance.
 - The Team proposes to study relaxation of other requirements, such as deferring the refunds of government grants.
 - The Team proposes to explore participation in issuing costs, including the costs of drafting prospectuses for public offerings.
- Incentives to institutional investors

The Team proposes to exempt institutional investors from attending the general meetings of corporations listed on the SME Exchange.

2.12.1. Encourage market making

The Team proposes to encourage market making by granting economic incentives to market makers.

The Team studied the following tax incentives

The Team studied various tax incentives for companies that list their securities on the SME Exchange.

There is uncertainty regarding the number of firms that will elect to list their securities for trade on the SME Exchange at its establishment. Therefore, the Team concurred that certain tax incentives may encourage companies to list their securities in the initial phase of the SME Exchange's operations. Such tax incentives would be defined for a period of two years (hereinafter, "the Establishment Stage") under a temporary order.

The Team recommends the following tax incentives, under a temporary order, to companies that list their securities on the SME Exchange during the Establishment Stage:

2.12.2. To companies: The company's issuance costs will be recognized as allowable expenses for tax purposes in the year the expenses were incurred.

2.12.3. To controlling shareholders⁵ in listing companies: Controlling shareholders who are employed by companies that list their shares on the SME Exchange during the Establishment Period may elect to apply a

⁵ Controlling shareholders – as defined in Section 32(9) of the Income Tax Ordinance (New Version) 5721-1961.

capital gains tax track under Section 102 of the Income Tax Ordinance (New Version) 5721-1961 (hereinafter, “the Ordinance”) to any gain in value of options they received before the company listed on the SME Exchange and that were awarded under employee option plans.

For additional information on incentives, see Chapter 16 of the full Report.

How the proposed model differs from the current situation in the Primary Market

For the sake of convenience, the following table presents a summary of the differences between the rules that currently apply to public companies trading on the Primary Market, and the proposed model for small and medium-sized firms that will trade on the SME Exchange:

Topic	Current state in the Primary Market	Proposed model for the SME Exchange
Supervisory model	Supervised directly by the ISA	Supervised by the ISA, with sponsors being appointed for companies' IPOs and subsequent capital raising rounds. ⁶
Listing requirements⁷		
Operating history	One year	One year
Minimum public holding	Between 7. % and 25%, depending on the value of public holdings on the issue date	Between 20% and 30%, depending on the company's valuation on the issue date
Minimum number of investors	100 (or 35 if the company appoints a market maker)	50 (or 35 if the company appoints a market maker)
Minimum scope of issue	NIS 20 million (effective)	NIS 6 million
Company valuation/equity	Over NIS 25 million in equity after the issue. Effective valuation of NIS 100 million or more.	Company valuation of up to NIS 300 million (after the money) on the issue date
Trading conditions		
Minimum public holding	15% (or 12.5% if the company appointed a market maker)	15%

⁶ As described above, the optimal supervision model is supervision by the Secondary Exchange through nominated advisers.

⁷The listing requirements that apply to R&D firms are different: R&D firms are not required to show an operating history or pre-IPO equity; the required post-IPO equity is NIS 8 million; value of public shareholding as a result of the IPO– NIS 16 million; where the value of public shareholding is over NIS 16 million, the value of public shareholding must be at least 10%, or NIS 50 million and 7.5%, respectively; the minimum number of shareholders is 35, and the minimum value of an individual shareholding is NIS 16,000.

Topic	Current state in the Primary Market	Proposed model for the SME Exchange
Value of public holdings	Over NIS 5 million (or NIS 4 million if the company appointed a market maker)	---
Blocking rules	Blocked period of 18 and 9 months for interested parties and others, respectively	Blocked period of 18 and 9 months for interested parties and others, respectively
Continuous or daily / twice-daily trading sessions	Continuous trading	1-2 daily trading sessions (or continuous trading if a company appointed a market maker)
Securities offering method	Uniform offering	IPO may offer different prices to different investors
Types of securities and listing transfers		
Debt issues	Over NIS 36 million (effective). It is also proposed to establish a debt issue track on the Primary Market for small issues, subject to full regulation.	NIS 6-36 million, provided that equity was already issued or is also issued on the same date.
Classes of shares	Ordinary and preference shares can be listed for trading (according to the restrictions defined in the articles of association)	Ordinary and preference shares can be listed (according to the restrictions defined in the articles of association)
Disclosure and reporting requirements		
Frequency of publication of financial statements	Quarterly reporting. Semi-annual reporting for small firms that only issued shares	Semi-annual reporting. Quarterly reporting for firms that issued bonds.
Information accompanying financial statements	Description of the company's business Chapter and report of directors	Extended executive report. Furthermore, attachment of valuations and solo financial statements is not required.

Topic	Current state in the Primary Market	Proposed model for the SME Exchange
Accounting standards	IFRS (and in some cases, financial reporting based on US GAAP is permitted)	IFRS / US GAAP / Israeli accounting standards
Reporting periods	Two comparative periods	A single comparative period (subject to GAAP)
Disclosure of executive salary – Regulation 21	Disclosure concerning 5 highest-paid executives	Disclosure concerning 3 highest-paid executives
Immediate reports	Pursuant to specific disclosure regulations and Regulation 36 of the Reporting Regulations (defined above)	General requirement to disclose material events and issues that are outside the company's ordinary course of business (similar to Regulation 36 of the Reports Regulations) plus publication of guidelines to assist implementation of this requirement.
Timing of immediate reporting requirement	Between 3.5 and 24 hours, depending on the time the information was discovered	Maximum 48 hours
Corporate governance and transactions with interested parties		
Mechanism for approving controlling shareholder transactions	Transactions are approved by the audit committee, the BOD, and the general meeting (majority of minority shareholders)	Transactions are approved by the independent committee, the BOD, and the general meeting (majority of minority shareholders)
Approval of terms of service or employment or service provision by controlling shareholder or relative	Once every three years	Once every five years
Remuneration policy	Remuneration policy must be defined and approved by the remuneration committee, the BOD, and	Remuneration policy must be defined and approved by the independent committee, the BOD

Topic	Current state in the Primary Market	Proposed model for the SME Exchange
	the general meeting (majority of minority shareholders)	
CEO's remuneration is consistent with remuneration policy	Terms of service and employment approved by the remuneration committee, the BOD, and the general meeting (majority of minority shareholders)	Terms of service and employment approved by the independent committee, the BOD
CBOD-CEO	Dual service (of a single individual or an individual and his or her relative) approved by the general meeting (by majority of minority shareholders) once every three years	No restriction on dual service as CEO and CBOD (by an individual or his or her relative)
Composition of the BOD	2 external directors must be appointed	2 external directors must be appointed
BOD committees	<p>Audit committee, remuneration committee, and balance sheet committee must be appointed</p> <p>*A small corporation for which fewer than 5 years elapsed from the date it first offered its securities to the public, may refrain from appointing a balance sheet committee, and consequently its financial statements are approved by the BOD alone, all subject to certain conditions.</p> <p>Furthermore, according to the law, the audit,</p>	One independent committee must be appointed (based on the qualifications required of the audit committee)

Topic	Current state in the Primary Market	Proposed model for the SME Exchange
	remuneration, and balance sheet committees may be merged, provided that the merged committee meets all the requirements that apply to each committee	
Internal auditor	Internal auditor must be appointed	Internal auditor must be appointed only above a specific valuation or number of employees, to be determined
Competitive proceeding	The audit committee must conduct a competitive or other proceeding before entering into a transaction with the controlling shareholder or a transaction in which the controlling shareholder has a personal interest	No requirement to apply

3. Review of the Team's work

The Team's work focused on three main issues: (a) a review of literature and research, including an analysis of the structural features, advantages, and shortcomings of secondary stock exchanges worldwide; (b) meetings with capital market players, and identification of the needs of small and medium-sized firms in Israel; (c) Team meetings to present findings and insights that emerged from the analysis of literature and research and meetings with market players, and to analyze all the aspects related to the establishment of an SME exchange; Finally, the recommendations presented in the Report were developed into a program outlining the establishment of an SME exchange in Israel.

This study was performed to establish a prototype that would be based on models that have proven success worldwide, yet are compatible with the features of the local capital market.

3.1. Review of research literature, empirical findings, and comparative law

To develop the proposed model, the Team conducted a review of international models currently used in the major exchanges for small and high-growth firms in Europe,⁸ England, Poland, the US, Canada, Singapore, South Korea, India, China, and Hong Kong (hereinafter, "the Selected Sample" or "the Selected Secondary Exchanges"); professional and academic studies that discuss incentives for establishing secondary markets, their features, and the factors underlying their success or failure; and an empirical study of various parameters of the Selected Secondary Exchanges, in order to learn from the relatively extensive experience accumulated worldwide on the establishment of secondary exchanges and to correctly implement the insights that emerge from this experience. Notably, over 35 capital markets worldwide have established secondary exchanges for small and medium-sized firms.

Several major findings emerge from the review of professional literature and the empirical study of data from the Selected Secondary Exchanges:

3.1.1. Features of the firms

- The firms that are listed on secondary exchanges are relatively smaller than those listed on primary markets. The average market cap of listed companies⁹ is EUR 55 million, in contrast to an average of EUR 1,332 million for companies listed on primary markets.

⁸ First-North and Alternext.

⁹ According to the value of assets in their financial statements immediately prior to the IPO date.

- The initial scope of equity that companies raise in secondary markets is relatively small – EUR 24 million per issue, in contrast to EUR 290 million per issue on primary markets.
- Companies listed on secondary markets are relatively young. On average, the age of these firms is one third the age of companies listed on primary markets.
- Foreign companies account for 14% of the IPOs on secondary exchanges, which is twice the share of foreign companies in primary market IPOs.
- Pre-IPO pricing of companies in secondary markets is more optimistic than pre-IPO pricing of companies listed on primary markets.
- Secondary markets vary across economies on multiple parameters, including their relative market share (compared to the market share of the main market in their country). Nonetheless the following can be stated:
 - In most countries in the Selected Sample, the number of firms in secondary markets is between one third and one half of the total number of firms that are traded in the capital market.
 - The total market value of firms listed in the secondary market is as high as 5% of the total market value of the main market firms (exceptions are China and South Korea, in which secondary market firms' value is higher).
 - The average size of firms in a secondary market ranges from 0.4% to 10% of the average size of firms in the primary market (the exception is China, with significantly larger firms in the secondary market).

3.1.2. Listing, capital raising, ongoing trading

- In general, we can state that dedicated SME Exchanges are designed mainly to give small and high-growth firms access to the capital market. Thus, in most countries, listing requirements are significantly reduced in comparison to main market requirements. Still, a review of the regulatory regime, and specifically, issues related to corporate governance, interested party transactions, and disclosure requirements, indicates that in several countries, the listing requirements on the secondary market are similar or identical to the requirements for listing on the primary market, while other countries allow more relaxed implementation in practice, for example, under a “comply or explain” regime.
- Most countries that were studied have a minimum operating history requirement of 2 or 3 years, and a minimum public shareholding requirement (these countries have similar requirements for the primary market). There is a statistically significant but not very large difference between the average public shareholding in secondary market firms (30%) and in primary market firms (35%).
- Most countries have no restrictions on listing transfers (for additional information, see Chapter 11 of the Report, on listing transfers).

- Listing fees and ongoing commissions are lower in secondary markets than in primary markets. Several countries adopted additional economic incentives such as tax benefits. In some cases, the reduction in fees is subsidized by the primary market.
- More issues are performed in secondary markets than in primary markets. Approximately 80% of all issues take place on secondary markets. The amount of capital raised per issue is lower (on average, a mere 8% of the capital raised per issue on primary markets) but the total capital raised in the secondary markets is significant and accounts for 22% of the total capital raised in the capital market.

3.1.3. Companies' performance

- Several studies show that, on average, performance of firms in secondary markets is significantly inferior to the performance of comparable firms in main markets. The main findings refer to the performance of firms in secondary markets in Europe including the AIM in London, compared to the primary markets in those countries and in the US, between 1995 and 2009.¹⁰ These comparisons show that companies trading in secondary markets have inferior performance and lower returns compared to companies, venture capital funds, or alternative funds trading on primary markets.
- Still, several studies report different findings and dispute the above conclusion.
- The empirical study that we performed indicates that secondary markets indices achieved lower returns, in most cases, compared to primary market indices, although specific shares on these secondary markets generated significant higher returns.

3.1.4. Listing patterns and transfers

- One of the main goals of secondary exchanges is to help small and medium-sized firms grow and eventually transfer to the primary markets.
- Studies show that only 1%-5% of all firms eventually make such a move. Approximately 64% of the firms that transferred to a primary market noted "investors' interest" as the main reason for the transition, and 36% of the firms noted "exposure to the public."
- Comparing the failure rate (delisting due to bankruptcy or financial distress) of firms on secondary and primary markets, findings are inconsistent, but in general, it appears that the percentage of firms delisted due to bankruptcy or financial distress is similar in secondary and main US exchanges.
- There is some evidence that listing transfers take place. In the period of the study, 18% of the delisted firms from LSE transferred to AIM. In some years, this share reached 25%.

¹⁰ In 2008, significant modifications were made to AIM rules. Most studies reviewed in this document are based on the period preceding these modification, and therefore do not necessary reflect the situation in the AIM after these modifications were introduced.

- The companies that transferred their listings from LSE to AIM noted the following reasons for their transfer: low costs (32%), opportunities for mergers and acquisitions (31%), growth potential (29%), and flexibility (20%).

3.1.5. Liquidity

The literature review shows that insufficient liquidity is one of the problems that plagues most secondary exchanges. Studies indicate that the level of liquidity in secondary exchanges is 20%-30% the level of liquidity in main markets.¹¹

3.1.6. Investors

- Most secondary exchanges have no restrictions on the type of investors who may invest, or on investment amounts.
- Most investors in secondary markets are local investors.
- The share of holdings of private investors is relative high in secondary markets. In several of these markets, the presence of institutional investors is insignificant, which may reduce liquidity, undermine a correct allocation of investments, and lead to insufficient control of companies' activities.
- In several secondary markets, private investors are eligible for tax benefits in respect of their activities on these markets.
- Evidence shows that underperformance of shares in these markets stems from private investors' behavioral biases in pricing the shares.

3.1.7. Corporate governance

- Many studies have examined the corporate governance features of companies that trade on secondary versus primary markets. Some studies acknowledge that optimal corporate governance should vary from firm to firm (including firms in secondary and primary markets).
- Findings show that companies on AIM and other secondary exchanges adopted similar models that feature extensive "comply or adopt" mechanisms. As a result, the corporate governance regimes they adopt are less extensive than the regimes adopted by companies listed on primary markets. In anticipation of their transfer of listing to the main market, AIM firms gradually adjust their corporate governance regimes to the standards conventionally accepted on the primary market. The reverse process occurs in firms that transfer their listing from the primary market to the AIM.

3.1.8. Important success factors in secondary markets

¹¹ Various secondary markets took different steps to address the liquidity issue. For example, in one half of the countries, firms are required to appoint a market maker in order to ensure liquidity and trading. In other exchanges, a subsidy is granted to analysts. In most markets, a minimum public shareholding is required.

- As noted, it is internationally recognized that companies trading on secondary markets make a significant contribution to the growth and economic development of their economies, and serve as drivers that improve levels of employment, innovation, and entrepreneurship. Therefore, a regulatory infrastructure that ensures the success of these markets is critical for economic growth and prosperity. The principles underlying success in secondary markets are: defining appropriate size and growth rate criteria for firms seeking to trade on secondary markets. Secondary markets should focus on high-growth firms with expanding trading volumes and growing the number of employees over an extended period, and whose trading volume meets a predefined criterion.
- Organizational structure – The establishment of a secondary market that is subordinate or linked to a primary market allows the secondary market to maintain low trading costs and to benefit from the reputation of the primary market. This type of structure is critical for the success of an exchange in cases where the secondary market is not expected to become profitable in its initial years of operation and will require the support of the primary market. At the same time, the organizational structure must allow managerial separation. Another point is that a secondary market that is a non-profit organization may be inefficient.
- Effective screening of companies interested in listing – Ineffective screening may lead to scandals that damage the reputation of the secondary market, which was the case concerning the Emerging Companies Market (of the Cyprus Stock Exchange). Secondary markets use various measures to address the screening challenge, such as listing requirements and appointment of nomads.
- Strict regulation and sanctions on licensed advisers/intermediaries in the issues.
- Correct balance between regulatory burden and protection of investors – by lowering costs for firms while maintaining the regulatory requirements necessary to protect investors' interests, and adding new requirements as such interests require.
- Trading method: The trading method should aspire to support maximum liquidity. According to the literature, there is no agreement whether a dealer market or an auction market is preferable.
- Listing of private placements – Permitting private placements to be listed or setting relaxed requirements for their listing is helpful to companies because it lowers costs and reduces the length of time required to complete the listing process.
- Reduced information asymmetry between companies and investors.
- Simplification and downsizing of reporting requirements: Since most secondary markets are controlled by private investors, and since companies on secondary markets are smaller, have less resources and are less complex, the reporting requirements for these companies should be simple and succinct.

- Research or analyses of firms: Research is essential for the success of secondary markets because it promotes investors' interest and improves liquidity. Analysts typically do not cover small firms, both due to the limited financial expediency and the challenges in obtaining information about them. Therefore, many secondary exchanges subsidize research in various ways. Subsidizing research may, however, cause distortions in the market and therefore must be performed with caution.
- Increased regulatory enforcement against manipulations, fraud, and insider trading: Closer regulatory enforcement of these offenses, with the aim of protecting investors' trust in the exchange and protecting its reputation.
- Branding: Branding has a significant effect on the success of a secondary market. Many secondary markets chose an integrated branding approach – branding themselves both as a market for high-growth companies and a market for small companies. Such a branding approach also must address the fact that investors' underestimation of the risks entailed in secondary markets may increase their “sense of loss,” deter investors, and create an unfavorable reputation for these markets. Furthermore, another challenge for secondary markets is that, over time, private investors increasingly prefer passive investment strategies and prefer to invest in large rather than small firms.
- Government incentives and support
 - Incentives, benefits, and grants that are typically given to firms and/or investors
 - Raise companies' awareness: informing companies of the benefits of listing and refuting incorrect beliefs related to listing.
 - Training, advice, and support for companies: training for firms on topics such as corporate governance and disclosure. Support and advice on preparing the documents required for listing, and the valuation and pricing process, how to attract investors and manage investor relations, and compliance with exchange requirements.
 - Raising investors' awareness: seminars, courses, and symposia on investments in secondary market for investors.
 - Cooperation with government ministries: highlighting the significance and contribution of a secondary market to the economy, and encourage investments in a secondary market through cooperative activities with government entities.

3.1.9. Comparative law

Due to the significance and formative function of the supervisory model applied to companies trading on the SME Exchange, the Team devoted extensive efforts to study the supervisory models applied in various countries, and specifically in exchanges that

adopted the private supervisory model, where supervision is performed through nomads, who mediate between the firms and the market, while the regulatory authority exercises its authority on various aspects of the market's operations, especially enforcement. The countries that apply a regulatory model of this kind include England, Singapore, Hong Kong, Europe (First North), and Poland. In the other countries studied by the Team, the relevant regulatory authority supervises the market in conjunction with the primary stock exchange. The Team mainly studied the model in the AIM, which served as the model for stock exchanges in many other countries, especially those that adopted the nomad supervisory model, as well as other supervisory regimes, such as the Canadian model (TSX), where the Canadian Securities Authority supervises the market.

Below is a brief summary of the main points of the model applied to AIM, England's secondary market. This was the model on which the Team based its recommendations (for additional information, see Chapter 6 of the Report on the supervisory model), including the adjustments necessary in view of the unique features of the Israeli market and its regulatory structure.

- The London Stock Exchange operates two trading platforms: (a) the AIM (Alternative Investment Market); and (b) the Main Market. The AIM was established in 1995 for small and high-growth firms.
- **Supervisory model:** Firms that trade on the AIM are subject to the AIM Rules for Companies, and are regulated through Nomads (nominated advisers). The firms are also subject to some rules of the FCA. Nomads and the LSE supervise the firms and their compliance with AIM Rules, while the FCA supervises specific aspects related to the applicable FCA rules. The FCA also has residual authority. For the sake of comparison, companies that trade on the LSE are subject to FCA rules and LSE rules, and are subject to ongoing regulation by the FCA.
- **Listing transfers:** Firms may transfer from the AIM to the LSE. When a firm wishes to do so, it is required to meet LSE listing requirements. There is no criterion that obligates a firm to transfer its listing from the AIM to the LSE. Firms may transfer from the LSE to the AIM in two stages: delisting from the LSE and listing on the AIM. Notably, delisting from the LSE requires approval of 75% of the firm's shareholders.
- **Additional arrangements:** The main requirement for listing on the AIM is an accounting history of at least 3 years. Firms must also appoint a NOMAD to accompany it as long as it is traded on the AIM. No other listing requirements apply (in line with the global trend to minimize listing requirements). Securities are generally offered through a listing document (rather than a prospectus), which is more concise than a prospectus. Firms must appoint a market maker and must submit semi-annual financial statements.

For additional information on the review of literature and empirical examination and comparative law, see Chapter 4 and Chapter 5 of the Report.

3.2. Feedback from the field

In its work on designing the features of the SME Exchange, in January 2017 the ISA staff issued a Call for Public Comments, inviting the public to offer suggestions and present their ideas on various aspects of establishing a dedicated exchange for SMEs.¹² The Team also conducted meetings and round-table sessions with a broad range of stakeholders from various capital market sectors, including entrepreneurs, underwriters, financial advisers, law firms that have experience with hi-tech firms and issues of Israeli companies active on secondary exchanges overseas, accounting firms, investment banks, investment portfolio managers, incubators and accelerators, credit funds that finance small and medium-sized businesses, representatives of foreign stock exchanges, the Innovation Authority, the Institute of Certified Public Accountants, and the Ministry of Economics — in order to enrich the Team’s knowledge of market barriers, shed light on the needs of high-growth companies, the market potential, and offer suggestions on the broad range of topics noted in the Call.

Furthermore, hearings were conducted to hear the positions of various representatives from the economy and the capital market on key issues underlying the establishment of the SME Exchange.

Representatives of the following agencies and firms appeared at the hearings:

1. The TASE
2. Representative of the Toronto exchange (TSX) in Israel
3. Representatives of the law firm Doron, Tikotzky, Kantor and Ass.
4. The Small and Medium-Sized Business Agency
5. The Innovation Authority
6. Deputy Chair of NASDAQ
7. Representatives of the Haifa Economic Company and Haifa Municipality

The picture that emerges from an analysis of the public comments and the impressions from these meetings is that a broad range of opinions exist in the capital market, with little agreement on the topics noted in the Call. Nonetheless, the commenters expressed

¹² See

<http://www.isa.gov.il/%D7%92%D7%95%D7%A4%D7%99%D7%9D%20%D7%9E%D7%A4%D7%95%D7%A7%D7%97%D7%99%D7%9D/Corporations/Legislation/Paper/Documents/SmallEntitiesTradingList.pdf>

a clear belief that to be successful, the new exchange should not be based solely on cosmetic adjustments: It is essential for the new market to be revolutionary and involve significant changes compared to the existing primary market, which create significant differentiation from the primary market. The new model must also be simple, accessible, and appealing to high-growth firms.

3.3. Developing the recommendations

Based on the conclusions and the insights emerging from the Team's work, described above, the Team jointly developed a series of recommendations and suggestions regarding various aspects entailed in laying the regulatory foundation and the regulation necessary to establish an exchange for small and medium-sized firms in Israel. The Team aspired to develop a holistic outline that optimally balance the needs of these firms and the needs of investors, to ensure that the SME Exchange is considered an appropriate investment alternative. The Team believes that implementing these recommendations will contribute to a market that will constitute a significant financing alternative for small and medium-sized firms in Israel.

It should be stressed that in developing its recommendations, the Team took into consideration lessons and findings of a study of secondary markets in other countries, including the regulatory mechanisms in place, their operations and structure, and the main factors that explain the lack of success of these markets. These lessons and findings received the most weight in developing the Team's recommendations to set up a more successful secondary market, with emphasis on the need to point to the risks of investing in SMEs and adjusting the supervisory model to the features of the Israeli market.

The main issues that were stressed in developing the structure of the proposed model were:

- Regulatory efficiency: simple, accessible regulation that matches the scale of small and medium-sized firms.
- Effective screening of firms for the SME Exchange
- Significant reduction of regulatory costs
- Quality (rather than quantity) of reporting information
- Protection of investors in line with the size of the firms
- Ensure liquidity and marketability of the secondary market
- Propose solution for various barriers currently existing at the capital market