Israel Securities Authority

Diversification of Capital Sources for High-Tech Companies and Promotion of their Access to the Local Capital Market Summary

November 2019

Executive Summary

In the last three decades, the State of Israel has set to promote the high-tech industry, recognizing this sector's role as the growth engine of the Israeli economy. To promote this sector which has put Israel at the forefront of technological innovation, the State has failed to expand the public's involvement in the high-tech sector, both in terms of the number of its employees, and in terms of the public's access to investments in that sector. As a result, this sector involves a limited number of entrepreneurs, skilled employees, institutional investors, and private investors. . In the span of those decades, several public committees were established to promote the high-tech sector, including the Committee for the Promotion of Investments in Public Companies, which focuses on R&D ("the R&D Committee") and was established by the Israel Securities Authority ("the ISA") in September 2012.

The R&D Committee's final report was published in January 2014, and included four main recommendations: enhancing high-tech companies' access to the Tel Aviv Stock Exchange ("**TASE**") by relaxing restrictions and offering various benefits; establishing traded high-tech funds; non-bank sources of financing including crowdfunding and sophisticated investor clubs; and encouraging financial institutions' investments in listed high-tech companies.

In an effort to promote the local high-tech sector and enhance its access to the Israeli capital market, senior ISA staff prepared a document at the request of the Chair of the ISA, which analyzes the Israeli high-tech industry. The document highlights (a) the segments that are expected to be future industry leaders in this industry; (b) the main players in the local capital market, including reference to the scope of their investments in local high-tech companies; (c) the capital sources currently available to Israeli high-tech companies seeking capital; and (d) the main obstacles preventing institutional investors' greater involvement in the local high-tech sector. The document also reviews the various extant investment vehicles in other countries, and various steps that have been taken in the past and in the past year.

The following is a brief summary of the main insights to emerge from the original document (the "**Complete Report**"), with the aim of providing background material for the deliberations of the ISA's Advisory Committee on Technology and Capital Market Matters, which will convene to explore, among other things, how to enhance the local high-tech industry's access to the Israeli capital market.

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1. The Israeli high-tech sector – The growth engine of the Israeli economy

> **"The State of Israel has set to promote the high-tech industry, recognizing the role of all manifestations of this sector as the industry of the future and the growth engine of the Israeli economy."[1]**

The basic assumption of the discussion here is that the high-tech industry is critical in order to ensure sustained economic growth and stability. In recent decades, this industry has been the growth engine of the Israeli economy and is characterized by high added value, technological innovation, and a scientifically and technologically educated work force.

The industry's contribution is evident on several levels, including the increase in exports, which have almost doubled in the last five years, completing a sharp aggregate rise of 80% and an average annual growth exceeding 12%. In 2018, Israel's high-tech exports (goods and services) increased by 9%, reaching a total of USD 51 billion, and are now estimated to account for 46% of Israel's total exports.[2]

Moreover, the gross added value[3] also reflects this situation. According to data from the Central Bureau of Statistics ("**CBS**") in the Statistical Abstract of Israel for 2018 ("**CBS Report**"[4]), the gross added value in the high-tech sectors for 2015 accounted for 19.2% of the total gross added value of the commercial sector. Gross added value in the high-tech sectors that year totaled NIS 130.2 billion, an increase of 7.4% from 2014, and contributed to the 6.4% increase in gross added value of the commercial sector in 2015.

With respect to the state of local startup companies, according to the OECD data,[5] the State of Israel attracts more venture capital (as a percentage of GDP) than any other member country, and most of the financing is given to seed-stage/early-stage high-tech companies. It should, however, be noted that of the, 4,029 startup companies that were established in Israel between 2011 and 2016, 1,059 of these companies had discontinued their operations by 2016.

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[1] R&D Committee Report.

[2] https://www.export.gov.il/api/Media/Default/Files/Economy/ExportMegamotSikum2018.pdf

[3] Gross added value (GVA) is the measure of the value of goods and services produced, less the intermediate consumption, which is the difference between the gross output and the net output.

[4] https://www.cbs.gov.il/he/publications/DocLib/2018/shnaton69/shnaton69.pdf

[5] According to OECD data included in the CBS Report.

An analysis of the start-up companies in the past two years, conducted by the IVC research institute,[6] indicates that investor capital inflows into these companies continued to grow consistently in 2018 as well, where start-up companies raised a total of USD 6.4 billion in capital, up from USD 5.3 billion in 2017. As 623 deals were conducted in 2018, average capital raising soared to USD 10.2 million.

Most of the increase in capital raisings in recent years is attributed to companies in the growth stages, with a decline in companies in their early stages. Consequently, after several consecutive years in which more than 1,000 new startup companies opened each year, 770 startup companies opened in 2017, and preliminary data reveal that the decline continued in 2018. There has also been a decline in the number of exits and their total financial scope compared with the peak amounts recorded in 2015.

In general, the Israeli high-tech industry is greatly impacted by global trends, and there is therefore a high correlation between global and local developments in Israel. Consequently, similar to the global trend of venture capital funds' preference to gamble on a small number of promising startup companies and to fuel them for a longer time with generous financing, investors in the Israeli high-tech industry have also begun to invest larger amounts for longer periods in a smaller number of startup companies in recent years. Accordingly, the number of capital-raising transactions in Israel has been declining steadily in recent years, especially transactions involving seed-stage companies, while median round B funding has increased. To illustrate, median round B funding was USD 10 million in 2015, and by 2018 had reached USD 20 million.

**** For details and further information on the leading sectors and the trends and developments in the industry, see the Complete Report.***

The growth in venture capital investments in 2018 described above indicates a steady, consistent rise in capital raisings by technological companies in Israel for the sixth consecutive year running, with **a total increase of 120% in investments in this sector between 2013 and 2018.**

It should be emphasized that two figures stand out over the past few years – on the one hand, we are witnessing a steep, persistent rise the total capital raised by companies in the local high-tech industry, and on the other hand, moderate decline in the number of annual transactions is also evident. These data indicate that the capital requirements for each funding round are significantly high, which may attest to the market's maturation, and indicate that investments have become concentrated in mid- and late-stage transactions. For example, 5 transactions in 2018 were in the

[6] https://www.ivc-online.com/Portals/0/RC/Survey/IVC_Q4-18%20Capital%20Raising_Survey_Final.pdf

excess of USD 100 million each, and the aggregate total of these 5 transactions accounted for 13% of total investments that year.

According to a joint report by the IVC Research Center and the law firm of ZAG-S&W,[7] the first quarter of 2019 was characterized by the continued flourishing of venture capital investments in Israel, with Israeli high-tech companies raising USD 1.55 billion, representing a 28% increase from total investments in the high-tech sector in the corresponding quarter of 2018.

Growth in the volume of investments is also evident in the increase in the average investment per transaction and in late-stage investments rounds. In the first quarter of 2019, the AI sector dominated the volume of investments with a record of USD 599 million. Additionally noteworthy is the fact that most of the investments in AI companies were made in the early capital-raising rounds. The IVC Research Center report also indicates that these transactions were mainly backed by venture **capital funds**, followed closely by **private investors** and **corporate funds**.[8]

In a related note, corporate venture capital funds have an especially strong presence in Israel. Forty such funds currently operate in Israel, including four of the world's five most active venture capital funds, and in 2017 the volume of their investments in Israel was in excess of USD 1 billion. Corporate fund accounted for 33%[9] of the total venture capital investments in Israel—which significantly differs from their weight in venture capital investments on a global scale (20%).

The distribution of financing sources for the Israeli high-tech industry indicates that, over the years, **the lion's share of financing for this industry has come from outside Israel**. Indeed, according to IVC Research Center data, in the last five years, 65%-75% of the funding for the local high-tech industry came from abroad, mainly from the United States (35% of the total funding for the high-tech industry).

Notably, high-tech industry exports contribute to the economy not only due to the increase in their volume but also due to their composition. The product and the salaries of those employed are 50% greater than the average in the economy, and the Bank of Israel claims that "the success of the high-tech sector triggers increased efficiencies in all commercial sectors and gradually contributes to an increase in their productivity."[10] Concerning employment rates in the local high-tech

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[7] https://www.ivc-online.com/Portals/0/RC/Survey/IVC-ZAG%20Full%20Survey%20Q2-19-Final.pdf

[8] A corporate fund Is a risk capital fund set up by a global corporation with widespread operations, such as: Microsoft.

[9] https://www.ivc-online.com/Portals/0/RC/Survey/IVC-ZAG%20Full%20Survey%20Q3-18-Final.pdf

[10] Bank of Israel report for 2017 published on March 28, 2018

industry, data[11] indicate that in 2017, the high-tech industry (goods and services) had 302.7 thousand salaried employees compared with 297.2 thousand in 2016, with 113.1 thousand salaried employees in the industrial sector and 189.6 thousand in the services sector. The number of salaried employees in the entire high-tech sector as a percentage of all salaried employees in the economy increased from 7.3% in 1997 to 9% in 2017 (compared with 9.1% in 2016).

2. Existing sources of financing for the Israeli high-tech industry

2.1 The Innovation Authority

In early 2016, the Chief Scientist's Office became an independent authority – the National Authority for Technological Innovation (the "**Innovation Authority**"). The Innovation Authority replaces both the Chief Scientist's Office in the Economic Ministry and the government-owned non-profit MATIMOP (the Israeli Industry Center for Research and Development) by virtue of Amendment No. 7 to the Encouragement of Research, Development and Technological Innovation in Industry Law, 5744-1984 (the "**Innovation Law**").

In 2018, the Innovation Authority invested a total of NIS 1.7 billion in 920 companies and 1,500 projects. In the **startup category, support granted to 213 start-up companies totaled 400 million**. The average grant to a company was NIS 1.9 million. 73 entrepreneurs received support in the Tnufa track. In the **growth category, grants totaling NIS 430 million from the R&D Fund were awarded to 177 companies,** and the average grant to a company was NIS 2.4 million. 22 companies received NIS 85 million in support from the generic R&D track for large companies.[12]

2.2 Local and foreign angels

Angels are one of the most important sources of financing for newly established high-tech companies at the seed stage. While there is no formal definition for the term "angel," angel investors seem to share the following features: they are affluent private investors who invest in private companies in the early stages of their development, mostly to generate a profit for themselves (making an investment against a holding in the target company's shares), without raising funds from institutional investors or the public.

[11] The data are based on the CBS Report for 2018.

[12] The data are taken from the Innovation Authority's Annual Report for 2017-2018.

Because angels invest in companies' early development, their investment is considered more risky, since uncertainty regarding the companies' future is highest at this stage, and a considerable percentage of all early-stage investments are lost.

For the angels, the appeals of investing in local high-tech companies at this stage include the "Angels Law"[13] and the benefits it confers on them (their investments are tax-deductible). According to Budgetary Division data, presented at a session of the Knesset Finance Committee held on December 29, 2015 – 122 investments totaling NIS 500 million were approved under the Angels Law between 2012 (the date the benefit was first granted under the Angels Law) and end 2015.

According to the IVC database, more than 300 Israeli angels made investments in startup companies between 2015 and 2019, including 80 angels who each made 5-20 investments in Israeli companies, 50 angels who each made 10-20 investments, and three angels[14] who each made 50-100 investments in Israeli startup companies.

Foreign angels also play an important role in the Israeli high-tech industry. According to the IVC database, more than 80 foreign angels actively invested in Israeli startup companies between 2015 and 2019. However, these investments clearly account for only a certain percentage of those foreign angels' portfolios: Other than 4 private foreign investors who made more than 10 investments in Israeli companies each in above period reviewed, all other foreign private investors made a significantly smaller number of investments in Israeli startup companies.

2.3 Venture capital funds

A venture capital fund may be considered a type of private equity fund, but the difference between a venture capital fund and a private equity fund mainly lies in the investment conditions and type of target companies. While private equity funds will typically seek to invest in more mature and well-established companies with stable cash flows, venture capital funds invest in startup companies and in small companies that have no access to the public capital market and/or have little or no access to alternative sources of financing.[15]

Typically, venture capital funds provide financing for startup companies in the seed stage, in which the funds identify a potential takeoff and exit. Their name indicates that venture capital funds are

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[13] Section 20 of the Economic Policy Law for 2011 and 2012 (Legislative Amendments) 5771-2011 (the "**Angels Law**").

[14] Gigi Levy Weiss, Yossi Vardi, and Zohar Gilon.

[15] https://www.investopedia.com/ask/answers/020415/what-difference-between-private-equity-and-venture-capital.asp

considered high-risk funds due to the low success rate of seed-stage companies and a high chance of losing their entire investment. Investors in a venture capital fund therefore expect to obtain a higher return on their investment and on the risk they assume. Most of the investors in venture capital funds are institutional investors or qualified investors.

According to joint publications of the IVC Research Center and the accounting firm of KPMG Somekh Chaikin,[16] local venture capital funds raised a total of USD 9 billion in 2007-2016, of which the venture capital funds had USD 3.5 billion in cash and available for investment as of early 2016.

Israeli and foreign venture capital funds operating in Israel lead investments in Israeli technology companies, in terms of the total volume of investments and the average amount raised per round. As of March 2019, 60 venture capital funds are in various stages of capital raising, including 25 funds that have completed a first closing. The remaining 35 have yet to make investments.

The figures presented above, which indicate that venture capital funds mainly invest in more advanced rounds or in companies with more significant capital requirements, can also be explained by the fact that significant inputs are required to assess each investment. Investment in larger, more mature companies also reduces related risks. Furthermore, in view of the fact that the number of new high-tech companies that commenced operations in each of the past few years has declined, similar changes have also affected the demand for money: the number of new companies declined while the older, more established companies continue their operations and need financing solutions in annually increasing amounts.

Based on the IVC-APM Most Active Funds report,[17] we can identify several additional features of the venture capital sector in Israel:

a. The number of foreign funds that invested in Israel increased in 2018 while the number of Israeli funds declined.

b. Between 2017 and 2018, the number of initial investments in portfolio companies by foreign ad Israeli venture capital funds declined (to 3.5% and 16.5%, respectively).

c. It is evident that the ratio of initial investments in Israeli high-tech companies by foreign and Israeli venture capital funds has remained stable at around 40%-60%, in favor of the foreign funds.

[16] http://www.ivc-online.com/Portals/0/RC/Survey/IVC_Q3-16%20Capital%20Raising_Survey-Final.pdf.

[17] https://www.ivc-online.com/High-tech-Insights/IVC-Publications/VC-Fund-Reports/Most-Active-Funds

d. On average, Israeli venture capital funds make more initial investments in local high-tech companies in comparison with the foreign venture capital funds.

e. The number of investments by venture capital funds in mid-stage companies increased from previous years, while venture capital fund investments in early-stage companies declined.[18]

f. In 2018, the number of initial investments in seed rounds was the lowest in 5 years. Venture capital funds' investment priorities have changed significantly in recent years. Currently funds show a clear preference for investments in software companies rather than Internet or biotech companies.

2.4 Israeli institutional investors[19]

In 2018, institutional investors managed long-term capital assets (pension and provident funds, and insurance policies) of more than NIS 1.7 trillion, and 1% of their managed assets are invested in local high-tech companies listed in Israel, as of end 2018.

Institutional investors' investments in local high-tech companies that are not listed are made mainly through investment funds.[20] The development that we have been witnessing in the past decade in the savings world—allocation of an increasing share of asset portfolios to alternative investments—is also evident in the asset portfolios of the Israeli public, which are managed by the institutional investors (although the phenomenon in Israel is more limited than in other OECD countries[21]). Nonetheless, an extremely small share of these portfolios is allocated to investment in Israeli venture capital funds. As of end 2018, only 0.16% of total managed assets were invested in Israeli venture capital funds. This has several reasons, including: the negative returns on venture capital investments, investment committees' apprehension about the venture capital sector, venture capital funds seek investments that are on a much smaller scale that pension fund managers' investment seek.

As noted above, the Israeli institutional investors invest only a small proportion of their managed assets in listed local high-tech companies. Moreover, their total investments in non-listed assets,

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[18] Early-stage companies are defined as seed companies and R&D companies, while mid stage companies are defined as having revenues of up to USD 10 million.

[19] The data in this section are based on data of the Bank of Israel and the Capital Market Authority.

[20] Some institutional investors make direct investments in local unlisted high-tech companies. Although ISA staff does not have detailed information on the scope of the institutional investors' holdings in these companies, we belief that these investments are negligible.

[21] The comparison is based on the OECD's annual pension fund survey for the year 2016, and Capital Market Authority data.

for example in venture capital funds whose capital can be used to finance new technologies, is also not high compared to global figures.[22]

2.5 Stock exchange listing – Raising capital from the public

As of end 2018, 448 companies that issued shares to the public were listed on the TASE, compared with 457 companies as of end 2017. As of end October 2019, 444 companies that issued shares to the public were listed on the TASE.

The relevant major sector in the TASE is "**High-Tech,**" which includes 117 companies (slightly more than one quarter of the joint-stock companies listed on the TASE). The Hi Tech sector is divided into two sub-sectors, **biomed and technology,** with 47 companies and 70 companies, respectively, constituting 11% and 16% respectively of the number of joint-stock companies listed on the TASE.

As of end October 2019, the market cap of the Global-Blue Tech Index, which offers a fair approximation of the market cap of the technology companies on the TASE, is NIS 200.9 billion. The value of these companies is 25.2% of the total TASE market cap, which was NIS 797 billion on that date. For comparison purposes, to assess the representation of Israel's public high-tech companies on the stock exchange in comparison to other leading exchanges, the following stock exchanges were examined:

NASDAQ

As of end August 2019,[23] 3,216 companies were trading on the Nasdaq. On the NASDAQ, classification of companies by sector/industry differs somewhat from the classification used in Israel. The market cap of all companies listed on the Nasdaq on that date was USD 14,503 billion.

The technology sector included 438 traded companies (that constitute 13.62% of all companies traded on the Nasdaq), whose market cap was USD 7,070 billion (approximately 48.75% of the total market cap of the companies trading on this exchange).

[22] The data in this section are not controlled by the designated bonds issued by the state. This arrangement is not a worldwide standard. It may be that controlling for this investment increases the investment rate compared with conventional global practice.

[23] The data was taken from the website https://www.nasdaq.com on September 01, 2019.

The healthcare sector[24] included 677 traded companies (that constitute 22.6% of all companies traded on the Nasdaq) with a market cap of USD 1,212 billion (or 8.35% of the market cap of the companies trading on this exchange).

NYSE

As of end August 2019, 2,429 companies were listed on the NYSE. The NYSE uses a similar classification system as the NASDAQ. The market value of all the companies on the NYSE, as of that date, was USD 28,516 billion.

There are 176 companies trading under the technology sector (and these account for 7.2% of all companies trading on this exchange), and their total market cap is USD 2,110 (or 7.4% of the total market cap of companies trading on this exchange).

There are 65 companies trading under the healthcare sector[25] (which constitute 2.7% of all the companies trading on this exchange) and their total market cap is USD 2,727 (or 9.56% of the total market cap of companies trading on this exchange).

A comparison of the NYSE and the Nasdaq reveals that the **TASE includes a substantial proportion of technology companies, which is similar to the proportion of technologies companies on the US stock exchanges,** yet these technology companies listed on the TASE represent significantly smaller trading volumes and market cap, especially compared to the Nasdaq. The above data show that Israel is a leading exporter of technology companies to foreign stock exchanges, especially the Nasdaq. The data suggest that many Israeli high-tech companies, like other companies in more traditional sectors, refrain from listing on the TASE. The factors underlying the **under-representation of technology companies on the TASE remain to be identified.**

Based on the number of IPOs performed in 2015-2018 on the TASE, the data paint a glum picture: **only 5 high-tech companies completed an IPO on the TASE first public issuance of their shares on the local stock exchange – or only 16%** of the 32 listed companies that completed an IPO in that period. **For comparison purposes, in the same period 621 IPOs were completed on Nasdaq, of which 290 IPOs (47%) were relevant to the technology sector—**67 companies in the technology sector and 223 in the medical sector. In the same period, of the **444 IPOs were**

[24] These data do not include companies in the following sectors: hospital/nursing management, industrial specialties, medical specialties, medical/nursing services sectors.

[25] The data do not include companies in the following sectors: hospital/nursing management, industrial specialties, medical specialties, medical/nursing services.

completed on the NYSE, 65 (15%) were associated with the technology sector—52 companies in the technology sector and 13 companies in the medical sector.

Moreover, according to Nasdaq website data,[26] 76 Israeli companies are listed on the Nasdaq (including 40 dual-listed companies), with an aggregate market value of USD 58 billion (0.4% of the total value of companies listed on the Nasdaq). In contrast 4 Israeli companies are listed on the NYSE, 3 of which are dual-listed companies.[27] The market value of those 4 companies is USD 16.6 billion, or 0.058% of the total value of the companies listed on the NYSE.

In addition, 20 Israeli companies are currently listed on the ASX Securities Exchange in Australia, with an aggregate market value of AUD 1.45 billion.

3. Public capital market financing in Israel – Challenges and opportunities

3.1 Challenges

The capital market in Israel plays a major role as the growth engine of the Israeli economy and constitutes the channel of public financing in Israel. The TASE plays a central role in the economy because it is the trading arena for private and institutional investors and for the companies that raise capital to finance their investments and business operations. Historically, public capital market financing has many advantages: high liquidity for investors, diversification of risk, the public directly benefits from the companies' success, promotion of long-term growth, etc.

Public capital market financing in Israel has many challenges compared to private financing alternatives (angels, venture capital funds, investment funds, private equity, etc.) and financing alternatives available on stock exchanges in other countries (e.g., the Nasdaq and NYSE in the United States, the stock exchanges in London, Australia, Hong Kong, Singapore, etc.). Public capital marketing financing in Israel faces the following difficulties and challenges:

a. **Low pricing** – Technology companies listed on the TASE are typically undervalued, and companies wishing to make an IPO will generally raise less capital and/or capital that reflects a lower company value. One of the main reasons for this is that institutional investors' lack the knowledge to price and assess the operations of early- and mid-stage companies with no revenues.

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[26] https://www.nasdaq.com/screening/companies-by-region.aspx?region=Middle+East&country=Israel&exchange=NYSE

[27] https://info.tase.co.il/Heb/MarketData/Stocks/MarketData/Pages/MarketData.aspx?action=2&dualTab=&SubAction=&Date=&issubmitted=1

b. **Lack of liquidity and low trading volumes** – The stock exchange in Israel has suffered from a lack of liquidity for many years. There are various reasons for this, including: institutional investors' lack of involvement in companies in their growth stages, a similar trend in other stock markets worldwide, the exit of foreign investors from the TASE, the conservative nature of individual investor in Israel, and the limited presence of market makers.

c. **TASE branding and public image** – One of the main challenges facing the TASE recent years is branding: The image of the Israeli stock exchange is not considered to be sufficiently appealing to entrepreneurs or private technology companies.

d. **Cheap money is available on private financing channels and/or other global exchanges** – As a result of the near-zero interest rate environment in most of the western world, cheap money has flowed to the private financing entities that have preferred to invested it in the venture capital industry. Moreover, cheap money has also flowed into the world's other stock exchanges, and investors seeking attractive investments in those stock exchanges have, in many cases, contributed to the high pricing of technology companies.

e. **Active assistance and sustained involvement of the VCs** – In addition to financing, venture capitalists also offer high-tech companies a broad infrastructure of resources including knowhow, expertise, experience and business contacts.

f. **Regulation (disclosure requirements and ongoing reporting requirements)** – The regulation in Israel as elsewhere poses a challenge in view of two concerns: One, companies prefer to avoid publishing business information such as trade secrets, patents, business plans, and trading terms with customers/suppliers, etc. Two, ongoing reporting requirements for listed companies are generally costly or procedurally intensive, and many times have not been adjusted to the size or the growth stage of many high-tech companies.

g. **The underwriters' expertise and analytical challenges** – One of the arguments raised in connection with the obstacles preventing companies from raising capital from the public is that the underwriters' market in Israel lacks expertise in the area of technology companies.

h. **The market has limited exposure to foreign investors** – On June 15, 2009, Morgan Stanley Capital International (MSCI), the global index firm, announced its decision to reclassify the Israeli capital market from the Emerging Markets to the Developed Markets category, beginning from May 2010. Although this decision reflects the local capital market's development and openness, one of the major implications of this move was a drop in the scope of investments in the Israeli capital market by foreign investors. For example, while Israel accounted for 2.87% of the Emerging Countries Index, it accounted for less than 0.4% in the Developed Markets Index. Against this background, foreign investors who invested in the

Emerging Markets Index sold their investments in the Israeli capital market, and as a result, the scope of foreign investments in the TASE dropped significantly in 2010. While foreign investments in the TASE recovered over time, according to OECD data for 2017 foreign holdings in public companies in Israel was lower than the OECD average. That is to say that the local capital market is relatively under-exposed to foreign investors compared to leading capital markets in Europe and the US.[28]

See Section 5 for regulatory restrictions and global tax barriers to investment.

3.2 The opportunity for public capital market financing in Israel

Along with the challenges set out in detail above, we identified several elements that present opportunities, which can be used to develop thinking on financing by the capital market or an appropriate financing model for the high-tech sector, which might be a viable alternative to private financing and financing on other global exchanges. The following opportunities have been identified:

a. **Creating regulatory certainty (standardization)** – Creating regulatory certainty by developing a financing and capital raising model appropriate for small, growing technology companies may provide an advantage for entrepreneurs and private high-tech companies that are sometimes compelled to deal with ambiguity in their environment in view of the multiple, changing demands of various private investors.

b. **The time required to raise capital using alternative private investments** – The time to completion of a capital raising and investment round for technology companies is very long, especially for early-stage companies (in the seed and round A stages). A platform for expedited capital raising from the public may constitute a genuine alternative to private financing.

c. **Dilution and representation on the board of directors** – Entrepreneurs may sometimes be forced to cede a large portion of their equity rights in the companies they established in exchange for the financing they need to continue operating. Thus, "dilution" is a major concern. In some cases, entrepreneurs are also forced to cede significant representation of their company's board.

d. **The agency problem** – the venture capital fund's representation on the board may drive some portfolio companies to a rapid exit in order to liquidate the fund's investment. This problem

[28] De La Cruz, A., A. Medina and Y. Tang (2019), "Owners of the World's Listed Companies", OECD Capital Market Series, Paris.

generally arises in companies which the venture capital funds consider as having limited growth potential; Consequently, venture capital funds have an interest in liquidating its investment and locking in a return for its investors.

e. **Ongoing reporting requirements** – In return for their investment, private investors and venture capital funds occasionally pose what may be extensive reporting requirements.

f. **Employee compensation** – The absence of sale/exit alternatives in the private financing channel – In recent years there has been a marked decline in the number of buyouts[29] and an increase in the number of unicorns.[30] In the resulting trend, many private companies grow and occasionally becoming unicorns through multiple private financing rounds of considerable amounts. Consequently, these companies are less dependent on liquidity events such as IPOs or buyouts. As liquidity events (IPOs/sales) /sale) become less frequent, entrepreneurs and employees are unable to exercise their warrants, which lose their effectiveness as an employee retention tool. A public capital market platform could increase the liquidity of employee warrants and increase the attractiveness of equity compensation.

g. **M&A platform** – A listing on the stock exchange allows companies to grow through acquisitions of or mergers with other companies based on stock swaps rather than cash payments. Consideration may also be tied to retention of key personnel in the acquired company.

3.3 Threats to the Israeli high-tech industry

The ISA believes that financial crises must be addressed through preventive action, and the Israeli capital market must be prepared for a future crisis in the local high-tech industry. From the data set out above it is evident that this industry is dependent on foreign capital, largely from the US, which is invested through Israeli and foreign venture capital funds. This situation poses potential risks and challenges that emphasize the need of Israel's high-tech industry to diversify the sources of its capital.

3.3.1 Economic crisis

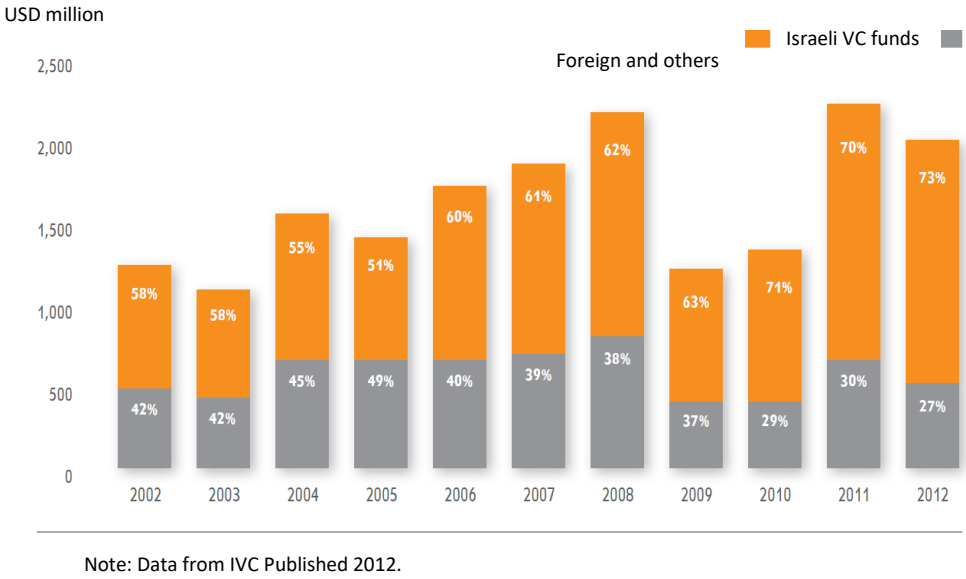
During a crisis, foreign investors are inclined to scale down their investments in remote markets, and prefer to focus on domestic investments. Until 2008, there was a continuous increase in the volume of capital raisings by Israeli high-tech companies, but the global financial crisis affected

[29] Exits Report by PwC Israel 2018 - file:///C:/Users/amitn/Downloads/pwc-exit-report-heb-2018.pdf

[30] - Unicorn Stock Options - Golden Goose or Trojan Horse?

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3228400

the capital raisings in 2009-2010. In 2011-2012, local high-tech companies returned to the volume of capital raisings of 2008:[31]



Note: Data from IVC Published 2012.

Figure 1. *Total venture capital fund investments in the Israeli high-tech industry, 2002-2012*

In Figure 1, the ratio between foreign and local capital remained similar after the 2008 financial crisis, total investments dropped significantly in 2009 and 2010. When investments recovered in 2011 and 2012, foreign investments accounted for an increasing share of total investments in the high-tech industry.

3.3.2 US tax reforms

In 2018, the tax reform known as the Tax Cuts and Jobs Act ("the Trump Reform") was signed into law. Its aim was to encourage the creation of jobs and investment in the United States. The reform included changes in the American taxation system designed to repatriate the operations of US multi-national companies. The measures most impacting those companies were the dramatic reduction in the corporate income tax rate to 27%[32] and the imposition of BEAT tax, which imposed on US companies a minimum tax on payments to associated foreign companies for various services, and the GILTI2, as a result of which controlling shareholders (a company or an individual holding more than 10 percent) become liable for tax on income from intangible assets in associated foreign companies they controlled, pro rata to their holding.

[31] R&D Committee Report, p. 19.

[32] Federal corporate tax was reduced significant from a gradual rate ranging from 15% to 35%, to a fixed rate of 21%. Including state and local taxes, the effective total corporate rate is 27%.

It should be noted that the United States is not the only country that has been working on tax reform in recent years, and China followed it by reducing the VAT rates by various percentages for various products, including technology products (the Chinese tax rate is differential and sector dependent[33]), and simultaneously reducing corporate tax and personal tax rates.[34,35] Massive government subsidies are granted to essential tech industries (mainly the electronic chip industry) in China, in response to the trade war.

Furthermore, in response to the US tax reform, China announced that it would temporarily not tax foreign companies' profits provided they re-invest these profits in China.[36] China is apparently making an effort to improve its global competitiveness and to improve business conditions for technology companies operating in China.

3.3.3 The trade war between the United States and China

According to estimates, Chinese investors are involved in 25% of venture capital investments in local technology companies, mainly through investments in local venture capital funds. The American administration is extremely concerned that Chinese involvement in specific industries may constitute a national security risk for the United States. This fact may deter American investors from investing in companies in which Chinese investments are involved and/or substantially reduce the chances of Israeli technology companies to operate in the American market.

Israeli companies and funds take the rivalry between the superpowers into account and it is especially relevant when companies select investors (for example, a fund that raises capital from a Chinese investor may not necessarily be successful in subsequently raising capital in the United States, and vice versa), customers, and collaborations of various kinds. At the same time, the trade war between the two superpowers may be considered an opportunity for the local economy: The superpowers may invest in Israeli high-tech companies in order to prevent the other from making investments in this market. Therefore, it is uncertain how the US-Chinese trade war will affect Israeli high-tech companies, if at all.

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[33] http://www.chinatax.gov.cn/eng/n2367731/index.html

[34] https://home.kpmg/xx/en/home/insights/2019/01/flash-alert-2019-010.html

[35] https://www.grantthornton.global/en/insights/articles/china-individual-income-tax-reform--finalising-developments/

[36] https://www.themarker.com/wallstreet/1.5526523

4. The R&D Committee

4.1 Background to its establishment

The R&D Committee was established in 2012 by then Chair of the ISA, Prof. Shmuel Hauser, with the intention of exploring why high-tech companies were not going public on TASE as might have been expected in view of their share in Israel's business activity. The committee was therefore tasked with examining the measures and incentives required to create a supportive infrastructure that would facilitate those companies' path to the TASE, allowing them to grow and develop in Israel instead of being sold to international corporations in the relatively early stages of their life cycle.

4.2 **Main recommendations and implementation status**

The R&D Committee proposed four main recommendations: making the TASE accessible to high-tech companies through regulatory relaxation and benefits; establishing listed high-tech funds; off-exchange financing solutions such as crowdfunding and sophisticated investors clubs; and encouraging institutional investors to invest in listed high-tech companies. In view of the time that has elapsed since the recommendations were implemented, the time is ripe to examine their implementation and success.

4.2.1 Enhancing high-tech companies' access to the TASE

4.2.1.1 Creating a Tech-Elite index

The Tech-Elite Index was launched in May 2014 and included the shares of companies listed on the TASE that are classified under the high-tech sector (technology and biomed companies). In effect, this index includes all the stocks in the T.A. Global Blue Tech Index with a minimum market cap of NIS 75 million. There are currently 57 such companies, whose aggregate market value is NIS 143 billion (correct as at end October 2019). That is to say, the Tech-Elite Index is a derivative index. **A retrospective examination of the Tech-Elite Index indicates partial success**, considering that only a single ETN[37] that tracks its performance has been established to date.

[37] MTF (A4) T.A. Tech-Elite, which has NIS 21.5 million in managed assets.

4.2.1.2 Encouraging independent analyses of high-tech companies

As part of its high-tech analysis program, the TASE contracted with two international firms to perform analyses of the public companies that have elected to participate in the program.[38]

As of end October 2019, 27 companies have joined the analysis program, including one that joined during its efforts to perform an IPO[39] (which subsequently failed). The two international firms have published 235 analyses of companies to date, and 15 companies have already completed a two-year period in the program, and therefore their review period has ended. 8 companies are still being reviewed in the analysis program. **A retrospective examination of the success of the program indicates partial success**.[40]

**** See the Complete Report for details and further information on the success of the analysis program.***

4.2.1.3 Tax benefits for issuing companies and their controlling shareholders

In March 2016, the Law to Amend the Income Tax Ordinance (No. 220 and Temporary Order) 5776-2016[41] (the "**Temporary Order**") was published in Reshumot, the official Government Gazette. Under the Temporary Order, tax benefits were given for a limited time, to investors in R&D companies that launch an IPO on the TASE between July 1, 2016 and June 30, 2019, as well as to controlling shareholders who also work in those companies.

It should be noted that until the Temporary Order expired, **not a single high-tech company that completed an IPO during the relevant period or their controlling shareholders took advantage of that tax benefit, despite the fact that several IPOs were performed on the TASE during that period and might have benefit from the tax relief.**

To the best of our knowledge, the main reason that these companies did not take advantage of the benefit was their concern that the tax authorities might demand that the company or its investors return the tax benefit if the company fails within a 1-2 year period from the issuance. Therefore, **this tax benefit measure has apparently failed.**

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[38] Analysts' reports are published on the Magna Authority distribution site and on the TASE Maya site, and are available to the public.

[39] Celltick Technologies and Media Ltd.

[40] 4 companies has joined the project and didn't finished the two year period: 3 companies delisted from TASE; 1 company has joined the project prior to an IPO that has failed.

[41] The order was published in the Book of Laws 2540, 18 Adar II 5776, March 28, 2016.

4.2.1.4 Relaxation of and adjustments to ongoing and prospectus disclosure requirements

In implementing its recommendations, the R&D Committee approved specific regulatory relief for companies whose shares were included in the Tech-Elite Index. Among other things, these companies were permitted to report in English and to draft their financial statements according to US GAAP; the period for which comparison data had to be included in the financial statements was reduced to two years; relief was given regarding the quarterly reports (a board of directors' report is not required); and a limited time exemption was given from attaching an annual report on board of directors and management assessment of the effectiveness of the internal control over financial reporting.

It should be noted that with regard to **only one high-tech corporation—Exalenz Bioscience Ltd[42]—elected** to implement the relief concerning the use of English. To date, **not a single Tech-Elite Index company has requested to apply the special regulations and report according to US GAAP. .**

4.2.1.5 Relaxation of corporate governance rules

In 2015, the ISA and the Ministry of Justice jointly initiated a number of relaxations pertaining to corporate governance rules that apply to all listed companies. These include relief on the procedures to approve officers' remuneration, appointment of board of director committees, approval of dual COB-CEO appointments, and other issues. In general, relaxation of **corporate governance rules seems to have had complete success among public companies—especially small- and medium-sized companies—that elected to adopt the relaxed rules.**

4.2.2 Setting up elite technology funds

An elite technology fund is a special mutual fund specializing in investments in Israeli high-tech companies engaged in research and development, including those that are not listed on the TASE. Such funds have a special structure that includes regulatory relief, tax benefits, relaxation on management fees charged to institutional bodies, and mainly loss protection that reduces risks for institutional investors and the public.

The following principles apply to an elite technology fund are: elite technology funds are set up as closed-end mutual funds whose units can be traded on the TASE; the elite technology fund manager is required to purchase for the fund shares of Israeli companies engaged in research and development that are not listed on the TASE and that other mutual fund managers are not permitted

[42] The general meeting of Exalenz Bioscience Ltd. approved the transition to an English reporting format in March 2018.

to purchase for their funds; an elite technology fund manager must hold at least 5% of the fund's units; an elite technology fund manager can be assisted by an investment adviser or investments manager specializing in high tech; an elite technology fund manager can take a salary as a percentage of the profit that the fund generated; the minimum public float of an elite technology fund is NIS 400 million.

Notably, in July 2017 the Accountant General Division in the Ministry of Finance published a tender to choose managers for elite technology funds to be listed on the TASE, which will qualify for loss protection from the state for investors in the elite technology funds, as well as government guarantees.

It should be stressed that due to the inherent risk in investing in R&D companies—which is not necessarily compatible with the public's risk profile— whether these are direct investments or through an elite technology fund, and in view of the fact that the companies in which the elite technology funds will invest are subject to certain disclosure and transparency requirements, **only a single elite technology fund finally succeeded in raising the amount of capital required to meet the conditions of the tender IBI (5D) Tech Fund – Elite Technology**[43] (the "**High-Tech Fund**"): It raised NIS 403 million, most of which (over 80%) came from institutional investors.

At this time, it can be said that the High-Tech Fund has had only partial success among the institutional investors and the general public. This may be attributed to the inherent risk in investments in private R&D companies and the fact that no other funds of this type exist, especially not funds with years of operations, which makes it impossible to compare the high-tech fund's performance with their past performance. To date (end October 2019), the High-Tech Fund has made six investments in private high-tech companies in Israel[44] for an aggregate sum of NIS 32-33 million.

4.2.3 Off-exchange financing solutions

Among its recommendation to encourage investment in startups and in high-tech projects in the seed stage, which are not suitable for listing on the TASE, the R&D Committee recommended the adoption of a crowd-funding mechanism using the Internet to raise small sums of money from a large number of investors, as well as sophisticated investors clubs.

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[43] Fund number 1142538.

[44] Investments of NIS 3.5 million in Nailomatic Ltd, NIS 11 million in Songo Group, NIS 7.2 million in RightBound Inc, NIS 1.5 million in Xperiti Inc, NIS 2.7 million in Manto AI Ltd and NIS 7 million in Scalez.

4.2.3.1 Crowdfunding

It is important to distinguish between two types of crowdfunding—classic crowdfunding, in which investors receive nothing for their investment or receive consideration in the form of a product or service, and crowd-investing, in which investors receive the securities of the company in which they have invested in return for their investment.

Israeli legislation also regulates the activities of the Internet platforms on which the social lending sector operates. Thus, legislature determined that the Capital Market Authority should oversee this sector, and that public offerings of bonds only, of up to NIS 1 million, may be made according to the regulation that applies to social lending.

In 2018 and in the first quarter of 2019, 5 registered offer coordinators (crowdfunding intermediaries) were registered in the Securities Authority coordinators register. In this period, two offer coordinators commenced crowdfunding activities pursuant to the Crowdfunding Regulations, in which they raised NIS 11.1 million from the public for 7 technology companies. It should be noted that according to information the Securities Authority has, more than 2,800 investors participated in those funds raising campaigns. Additional registered offer coordinators are expected to participate in crowdfunding campaigns in the near future, which will lead to increased activity in this sector.

4.2.3.2 Sophisticated investor clubs

While the crowdfunding model is designed to raise small amounts from the general public, sophisticated investor clubs are designed to raise larger amounts from a small number of more sophisticated investors.

It is more difficult for a startup seeking to attract buyers for its securities to identify individual smart investors than sophisticated investors that are institutions or other entities. Sophisticated investor clubs give startups access to a large number of investors who can provide a solution to their financing needs. The ISA's measures to removal barriers and facilitate the identification of such investors facilitates and simplifies high-tech companies' access to this potential group of investors.

4.2.4 Encouraging institutional investors' investments in listed high-tech companies

The R&D Committee's recommendations to encourage institutional investors to invest in listed high-tech companies include a recommendation to allow, for a limited time, to consider the direct costs of an investment in listed high-tech funds and index products as direct tax-deductible expenses, provided that the fund manager is not a related party of the institutional investor.

In the only high-tech fund stablished to date,[45] institutional investors made an enormous investment, accounting for more than 80% of the capital raised in the IPO, due to implementation of the above recommendation to consider the costs of investments in listed high-tech companies as tax-deductible expenses.

[45] I.B.I. (5D) Tech Fund-High Technology.

5. Why is the capital market (institutional investors) not aligned with the Israeli high-tech industry

5.1 Regulatory obstacles – the Hodek Committee

Based on discussions with investment managers in institutional investors, the investment committees of these entities restrict their investment managers and prevent potential investments in high tech companies. In general, institutional investors' investments in venture capital funds are extremely limited, and the ISA does not have information on their direct investments in local high-tech companies (it is also possible that the absence of public information on institutional investors' direct investments in unlisted companies constitutes a barrier in itself), yet the assumption is that the scope of their investments is negligible. It is unclear whether the investment committees' caution stems from their application of the Hodek Committee recommendations (affecting bonds, regarding the preparation of written analyses and the purchase of bonds of private companies) to venture capital investments, or whether they reflect other (internal) committee restrictions.

5.2 Geopolitical risks of investments in Israeli high tech companies

Institutional investors are not interested in having their portfolios depend solely on the Israeli economy, which represents a non-negligible geopolitical risk. The trend toward significant growth in institutional investors' assets has created a need to invest an ever-increasing percentage of the public's financial savings outside Israel. Today almost one third of their managed assets are invested outside Israel, and this percentage is expected to grow.

5.3 Tax restrictions

5.3.1 Special tax arrangements for venture capital funds and private investment funds

The tax benefits granted to capital funds may not be an obstacle for the high-tech industry, but they are certainly significantly reduce the motivation of funds that benefit from these tax arrangements to raise capital through the TASE or from institutional investors and consequently forgo these tax benefits.

5.3.2 The VAT restriction

Foreign investors enjoy an exemption from capital gains tax on investments in venture capital funds. The tax laws in Israel determine that, in contrast, that institutional investors pay the full VAT rate of 17% on their annual management fees, as do all other Israeli investors. The implication is that Israeli venture capital funds prefer to raise money from foreign sources, as in this manner their net cash flow from capital raising is greater.

5.4 The restriction on direct expenses attributable to members

The direct expenses regulations determine which transaction-related expenses an institutional investor may collect directly from the provident fund assets or other money that backs their yield-dependent liabilities, as the case may be. The regulations restrict double management fees. As a result, institutional investors may deduct direct expenses of up to 0.25% of a fund's assets. Investment funds, however incur additional expenses because they are less accessible, and investments in these funds require expertise: Both factors have significant financial implications.

Institutional investors are concerned about exceeding the direct expense restriction, because in such a case the expenses will be deducted directly from the fund manager. Institutional investors therefore carefully track their expenses and exit from certain investments to avoid reaching the restriction. The Bank of Israel attributes the difference between Israeli institutional investors and their global counterparts in their investment volume in investment funds to the unique regulation that applies in Israel concerning double management fees.

5.5 Venture capital funds' probability of success and alignment with funds' risk profiles

Data on the returns of Israeli venture capital funds are not public, but it is known that the probability of success of Israeli high-tech companies is low.

To determine whether Israeli high-tech companies represent a legitimate investment for public savings, the returns of those funds should be compared with the returns relevant TASE indices. It is generally argued that venture capital funds do not beat the TASE indices. Still, we are witnessing the maturation of the high-tech industry in Israel, and this sector seems to be thirsty for larger investments at more advanced stages.

5.6 The negative effect of the requirement to publish institutional investors' returns

Venture capital funds' significant contribution to pension fund or provident fund returns is expected to be manifest at the time of a sale or issuance, and until then, the funds do not accrue profit and consequently have a negative impact on institutional investors' turns (J-Curve).

Venture capital funds are characterized by high volatility: A "bad" period can wipe out the returns in an entire investment track. As a result, the effectiveness of investments in venture capital funds has a negative image, since they are compared to assets that have a positive impact on returns. Provident fund and pension fund members have continuous access to digitized data on a website to view monthly returns by asset class. If the data on venture capital funds and their performance are included in these data, the effectiveness of the investment is likely to be interpreted as negative, and institutional investors will be deterred from investments of this type.

5.7 Lack of incentives for success – restriction on remuneration in the financial sector

Existing legal restriction prohibit fund managers, portfolio managers, and provident and pension fund managers from charging investors a success fee. Only ongoing management fees may be charged, independent of performance. Hedge funds and venture capital funds are unregulated and are not subject to this restriction. In practice, incentives appear to improve the quality of fund management, so that savers and investors in those funds consistently enjoy higher risk-adjusted returns compared to funds whose management fees are based on asset value.

5.8 Lack of knowhow, financial capabilities, and economic feasibility of analyzing technology companies or startups

Investment in high-tech companies demands special expertise. Institutional investors currently lack analysts qualified to review companies of this type. Israeli institutional investors typically collaborate with familiar partners, invest in follow-on funds rather than new ones, and team up with executives who are well known to them. Due to the fact that most high-tech companies that are a potential investment targets are relatively small, investing a small amount of capital is inconsistent with the efficient use of institutional investors' resources.

6. How to guarantee continued growth and prosperity

From an economic and national perspective, it is important to maintain the growth of the local high-tech industry. To do so, it would appear to be important to create an eco-system that allows high-tech companies to grow rather than choose an exit strategy, because this way, the contribution to the Israeli economy will be greater. Diversification of high-tech companies' sources of capital is necessary to eliminate their dependence on foreign capital. Furthermore, a local, global, economic, security or other crisis, or change in tax policy is liable to have a dramatic negative impact on local companies.

Obstacles and barriers must be resolved in order to create the desired eco-system and introduce innovations in the Israeli capital market that offer investors a diverse range of investment options, and that diversify the financing sources of high-tech companies. The best way, in our opinion, to achieve that task, is by setting up a team of representatives of the relevant financial regulators (the ISA, the Capital Market Authority, the Tax Authority, the Innovation Authority, the National Economic Council, and the Budgetary Division in the Ministry of Finance), the high-tech sector (including representatives of venture capital funds and private equity funds), and local institutional investors, to work together to provide solutions to those issues and obstacles.

6.1 Establishing a secondary stock exchange

In June 2018, the final 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 was published. A review of growth companies and small and medium-sized companies in the local capital market leads to the conclusion that the TASE has not been an effective alternative for those companies to raise funds, mainly for the following reasons: their size and the scope of their operations; prohibitively high listing requirements; lack of correspondence between current regulatory costs and their size, and; the availability of attractive alternatives for raising capital.[46]

A secondary stock exchange has not yet been established in Israel to date, which makes it difficult to provide an answer to the question of whether such a step might solve these companies' financing challenges. The process of establishing a secondary stock exchange in Israel is under economic evaluation.[47] However, even if listing on the stock exchange is deemed to solve these companies'

[46] From the final 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.

[47] Notably, on July 9-11, 2019, several articles appeared in the financial media in Israel on the interest expressed by the NYSE to an Israeli delegation led by the Minister of Finance, Moshe Kahlon, which was visiting the United States

financing challenges, it would not resolve the problem of institutional investors' access to high-tech companies (due to the size of the companies, the difficulty of analyzing them, and the resources required to do so).

6.1.1 Incentives for issuers and investors

In the course of its deliberations, described in paragraph 6.1 above, various types of incentives were reviewed, including incentives to the companies, institutional investors, government support, encouragement of market makers, and tax incentives. The team specifically discussed the possibility of offering a wide range of tax incentives to companies and investors, but due to lack of agreement between committee members, only few of these found their way into the recommendations in the committee's final report that was submitted to the Minister of Finance and the Minister of Justice.

Numerous studies lead to the conclusion that tax benefits help to promote investments in SMEs. Empirical findings show that many countries have introduced tax incentives as an important element in aid to SMEs, either as direct incentives to those companies or as incentives to investors in those companies, with the tax benefits varying from place to place. This approach can be implemented with respect to technology companies.

Tax incentives to individuals that were reviewed by the committee

1. Recognition of an investment as a capital loss – The relevant model for review is the model of the Temporary Order pursuant to Section 92A of the Income Tax Ordinance (hereinafter – the "**Ordinance**"). Under the provisions of the Section, the amount of an "qualified investment" (a cash investment in an R&D company, in return for which the investor was allocated shares in that company in the same year) of up to USD 5 million, will be recognized (for the investor) as a **capital loss** in the tax year in which the investment was made or in the consecutive tax year, and the loss may also be set off against capital gains from other sources. In calculating the capital gain from an eligible investment, the amount recognized as a capital loss is deducted from the original price.[48] **This recommendation was included in the Committee's final report and is also relevant in this context**.

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at the time, concerning the establishment of a secondary stock exchange for high-tech companies in Israel. https://www.maariv.co.il/landedpages/printarticle.aspx?id=707681

[48] The original price is defined in the Ordinance, among other sources as "the amount an investor paid for the purchase of that asset."

2. Reduced tax rate/tax exemption for investors – Capital gains tax, tax dividends, and tax on interest (in respect of interest on bonds, etc.). Several questions arise with respect to these issues. First, how much should the tax rate be reduced? Second, should such benefits also be made available to a substantive shareholder as defined in the Ordinance (including controlling shareholders), and if so, to what extent?[49] Tax benefits to substantive shareholders, and in particular to controlling shareholders, could encourage companies to perform IPOs on a dedicated special stock exchange as an alternative to raising funds from private sources. In summary, such benefits range from a full exemption to two classes of shareholders (substantive and non-substantive) to a reduced tax rate to only one class. **This recommendation was not included in the Committee's final report.**

3. A reduced tax rate (capital gains, dividend, and interest) for investments in "growth companies and markets" – Similarly to the tax incentive adopted in England and designed so support incentives for investments in growth companies and AIM-listed companies, it was proposed to a tax benefit to incentivize investors who invest in companies (and markets) that meet a certain definition. In England, investors in companies listed in "growth markets" are exempt from stamp duty.[50] Similarly, it was proposed to grant a reduced tax rate on investments in companies listed on the dedicated stock exchange and are defined as growth companies, since no other taxes are levied in Israel for the purchase of securities. It is possible to define technology firms using the definition of a growth market used in England.

4. "Investment account" (standard in several countries) – It was proposed to define tax benefits that also apply to trading on the dedicated stock exchange. Like in other cases the range of potential tax benefits is large, from an alternative according to which the investments in such an account would be tax exempt without imposing any limit on the amount of the investment, to alternatives based on partial tax benefits, such as:

    a. A full exemption on earnings in the account with no limit on the amount that can be deposited in the investment account, provided there are no withdrawals from the account

[49] The Ordinance determines different tax rates for substantive shareholder and for others who do not fit that definition.

[50] To be considered a growth market, one of the two following definitions must be met:

a. A market value of less than GBP 170 million (a condition intended to bring the AIM under the definition).

b. A two-year growth rate of at least 20% in income or in the number of employees who have been employed for over three years before submitting the application.

are made before retirement age.[51] Any withdrawals before the statutory age of retirement are taxed at the standard tax rates.

b. A full exemption on earnings in the investment account, with a limit on the maximum (annual or total) amount of deposits in the investment account. This is similar to individual savings accounts (ISA) conventionally used in England.

c. The tax event is deferred to the date of withdrawal from the account and the investment amount is unlimited – On the withdrawal, the total net earnings will be taxable. This means the total earnings less total losses accruing to that date. This effectively allows losses to set off gains that accrue after the original tax event, as long as no withdrawals are made.[52] No limit on the amount of the investments is imposed, yet the annual income or tax-exempt earnings will be capped, and any amount in excess of the cap is taxable immediately and non-deferrable.

d. There should be discussion of a condition for minimum investments in companies included in the list of "investment accounts" or companies of a certain type. Such a condition was determined in Italy, but in our opinion, a requirement to make a minimum investment is not necessarily of any benefit to the public of investors. On the other hand, a loss protection mechanism could encourage the public to invest in those companies.

The advantage in this incentive is that an investment account encourages the public to invest in companies of a certain type and to save, without being concerned about selling assets that are not worth holding and are usually held solely for tax considerations. Moreover, there is an operating advantage in creating such a mechanism – this is a separate investment account that allows the movements in it to be easily monitored. Nonetheless, any solution that encourages long-term investing diminishes the negotiability of the securities or the product in question.

6.2 Listed R&D partnerships

ISA staff requested that the TASE amend its articles of association to allow listed partnerships to operate in the R&D sector. On April 11, 2019, the TASE board of directors approved an

[51] Similarly to the arrangement that applies to provident investment funds.

[52] 401(k) in the United States – a retirement plan that was signed into law in 1978, in which employees are entitled to deferred tax on their investment earnings. Contributions to the plan are made from pre-tax salary. Employers can also contribute to the plan. Tax on earnings from the plan are deferred until the taxpayer withdrawers he money from the plan. The amounts invested in the plan are limited as is the timing and manner of withdrawal.

amendment to the TASE articles of association, and on May 2, 2019, the ISA Secondary Market Committee approved the R&D Partnership Amendment, which went into effect in May 2019.

Pursuant to the R&D Partnership Amendment, an R&D partnership trading on the TASE is now able to invest solely in R&D projects approved by the Innovation Authority. Where relevant, the Innovation Authority is now required to respond within 30 days of a partnership's request. The R&D Partnership Amendment also determines that an issuing partnership must limit its initial investment in any single project to 40% of the partnership's total assets according to its most recent financial statements known on the date of the relevant investment.

ISA staff worked with the Tax Authority to publish an order that applies the same tax regime to public companies and to R&D partnerships (the "**Order**"). On publication of the Order in Reshumot, R&D partnerships may be listed on the TASE (as of the end of October 2019, publication of the Order is pending).

It should be emphasized that to date, several private entities have expressed interest listing as R&D partnerships on the TASE based on an IPO prospectus, **and the ISA staff is currently reviewed several IPO prospectuses of R&D partnerships, estimating that by the end of 2019, at least one R&D partnership will be listed on the TASE.**

6.3 Investment instruments abroad

In view of the problems presented above, the team studied several investment instruments available outside Israel that might resolve the problems described above, specifically the problem of institutional investors. The data presented below on global investment instruments are not necessarily compatible with the nature of the market and regulation in Israel and would require adjustment.

6.3.1 England: Venture Capital Trust - VCT

What is VCT?

A VCT is an investment fund listed on the LSE (London Stock Exchange), first introduced in 1995 to encourage investments in small companies in England. The value of VCTs in England was GBP 6 billion in 2016.[53] These funds were designed to encourage investment in small- and medium-sized enterprises (SME) through tax incentives:[54] Investors in these funds receive tax benefits in the form of income tax relief and tax exemptions on dividends.

[53] The fund is regulated under the UK Finance Act 1995.

[54] The tax benefits: a. Income tax relief: (a) an investor is entitled to relief of up to 30% according to the investment amount (30% for investments of up to GBP 200,000 pounds, above which the rate of tax relief diminishes), provided

In 2017-2018, 43 VCTs raised capital. As of January 2019, the total number of existing VCTs (including those that did not raise funds in 2018) was 61 (42 general VCTs, 11 specialist VCTs, and 8 listed on the AIM). Since their introduction in 1995, VCTs have raised GBP 7.7 billion in England.

Overall, VCTs do not appear to be materially different from an elite technology fund. Both instruments have identical aims, are traded, and their investors receive benefits. Tax benefits, which are the main difference between the instruments, are the factor that explains VCTs' success in England, compared with the partial success of the elite technology fund in Israel, however, this difference does not justify the design and introduction of a new investment instrument.

6.3.2 England: Enterprise Investment Scheme (EIS)

This program was launched in 1994 alongside VCTs to encourage investment in small companies in England. In contrast with VCTs, EIS funds are not listed and have a distinct legal structure. As a result, this instrument appeals to sophisticated investors. Both instruments offer identical tax benefits but in an EIS these benefits apply to larger investment amounts. There is a tendency to link this instrument with VCTs since both offer the same tax benefits: tax exemption on a dividend and capital gains and tax deduction is limited to 30% of the investment amount. However, the EIS is not listed and the tax benefits are not immediately available as they are in VCTs.

6.3.3 England: Fund of Funds[55]

A unique aspect of this investment vehicle is that the "parent" fund is a regulated entity. That is to say, it is listed, while the remaining funds are neither regulated nor listed. Funds of funds exist in Israel and worldwide, but in Israel these funds are not listed.[56] This is investment vehicle is relevant for investors seeking exposure to the Israeli high-tech sector and for institutional investors able to invest in multiple funds (for diversification), and for foreign investors seeking exposure to a quasi-index of Israel's venture capital sector.

The rules of a fund of funds must allow a certain degree of "confidentiality" concerning the performance of each of the funds in which the fund of fund invests. In other words, a public trust

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that the shares are held for at least five years and the shares are purchased in an IPO. The relief rate is subject to annual income. The relief may be applied to other income, such as income from rents or dividends; (b) VCT investors are not subject to capital gains tax or tax on dividends. Tax benefits on VCT investments are granted only to British investors over age 18 who are UK taxpayers, and for units purchased in an IPO. In order to enjoy VCT tax benefits, the holding in the VCT must be for five years.

[55] This is a syndication of funds, a fund that invests in other funds.

[56] https://vintage-ip.com/

can publicly disclose the names of its target funds, the amount and value of its investment in each, and the fund's total asset value, and other information, but a creative solution is required for disclosing information about the individual performance of each fund. The non-disclosure of the venture capital funds' data may be the key to the success of funds of funds.

6.3.4 Australia: Australian Venture Capital Fund of Funds (AFOF)[57]

AFOFs are non-listed funds that invest in venture capital funds and are governed by the Venture Capital Act 2002 and the Income Tax Act 1997.[58] AFOFs are not currently listed on the Australian stock exchange but are approved and registered by Innovation and Science Australia.[59] As far as tax concessions are concerned, the fund is exempt from tax – the AFOF itself is not taxed and the revenues flow directly to its investors. Investors outside of Australia are not subject to capital gains tax.

6.3.5 Canada: Labor-Sponsored Investment Funds (LSIF)

Labor-sponsored investment funds (LSIF) are funds that invest in small- and medium-sized companies in Canada. The Canadian government granted investors in LSIFs tax benefits to promote investments through such funds.[60] LSIFs are required to obtain support from a labor union, which is also entitled to appoint representatives to the fund's board. LSIFs invest in early-stage companies that are typically not listed on the stock exchange but have considerable growth potential to produce high yields if they succeed.

To qualify for the tax benefit, LSIF units must be purchased in an IPO, and must be held for eight years, for considerations of stability of the Canadian economy. This instrument is therefore suited for long-term investments.[61] In view of the long holding period to which investors are committed, the instrument is problematic from the perspective of investors' liquidity. Moreover, owing to the fact that the companies are not listed on the stock exchange, the value of LSIF investments are difficult to assess.

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[57] https://www.business.gov.au/assistance/venture-capital/australian-venture-capital-fund-of-funds

[58] The Venture Capital Act 2002 (VCA) and the Income Tax Assessment Act 1997 (ITAA 1097)

[59] A list of the funds listed in Australia: https://www.business.gov.au/Assistance/Venture-Capital/Australian-Venture-Capital-Fund-of-Funds/List-of-Australian-Venture-Capital-Fund-of-Funds

[60] https://www.td.com/ca/products-services/investing/td-direct-investing/mutual-funds/labour-funds.jsp

[61] https://www.td.com/ca/products-services/investing/td-direct-investing/mutual-funds/labour-funds.jsp

6.3.6 SPAC-type sector-specialist funds

To support young, small- or medium-sized high-tech companies operating in the high tech industry that needing significant investments, the SPAC (Special Purpose Acquisition Company) model[62] may be implemented in this sector, allowing reputable entrepreneurs to issue a sector-specialist fund on the stock exchange (either a company or a partnership; the "**Sector-Specialist Fund**"), which will raise capital from the public to be invested in target companies operating in a specific sector, such as biomed or auto-tech.

According to the proposed model, similarly to the SPAC model, at its issue the sector-specialist fund has no operations, and investors invest in it on the basis of a prospectus that defines its future investment policy—investments in target companies in a specific field. The incentive for investors, including institutional investors, is that the fund is being managed by an experienced entrepreneur.

In summary, it appears that a tax benefit cannot be the main feature around which an investment model is to be designed, and the Israeli public of investors must have some interest in investing in a certain investment instrument, apart from tax benefits, which is the case in vehicles such as EIS, fund of funds, or R&D partnerships. Any other model that is selected requires adaptation to the features of the local market, and to the following goals: to create an additional source of financing for high-tech companies, to increase the public's exposure to investments in the high-tech sector by listing companies on the TASE, and to increase institutional investors' investments in such companies. At this time, there does not seem to be any justification in adopting additional investment vehicles from other countries.

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[62] A SPAC is a type of blank check company—a company with no commercial operations, created only for the purpose of a merger, acquisition of assets, or integration of existing commercial operations. This investment vehicle is designed to raise capital on public capital markets for the purpose of acquisition. Although not all SPACs have the same structure, they share many features. Generally, SPAC companies can be considered a kind of "shell company" (listed on an exchange) that raises money through an IPO, with a promise to acquire an acquisition target within a predetermined time period. This structure provides the acquisition target company with immediate capital, raised in the IPO, which offers an advantage over the acquisition of a shell company. Unlike conventional companies that raise capital from the public, SPACs have no history of operations, income, or profit. In effect, while capital is being raised from the public, these companies have only a management team that works toward making acquisitions in the limited period allotted. SPACs typically have an experienced entrepreneur behind them, by virtue of whom the SPAC is able to raise capital immediately. As a result the search for an appropriate acquisition target is unfettered by uncertainty concerning the success of the capital raising round.

6.4 Designated bonds as an investment incentive for institutional investors

The State of Israel issues bonds to the institutional bodies with a guaranteed real interest rate, in order to increase institutional investors' ability to meet its pension payout liabilities. These bonds are called designated bonds. They are non-negotiable, index-linked, fixed-interest government bonds. Designated bonds have a real interest rate of 4.86%.[63] Designated bonds constitute a moderating factor in interest rate fluctuations, because they provide a positive fixed interest every year, irrespective of the markets or interest rate changes. These bonds are a state budget expenditure item.

Designated bonds may be used to design an incentive package for institutional investors, to promote their investments in high-tech companies that are contributing to the growth of the Israeli economy. For this purpose, two series of designated can be issued: the first is a fixed-interest series, and the second has a fixed yet higher interest rate, designed for investments in early-stage high-tech companies. Institutional investors will use the spread to create a safety net for themselves. The advantage of such a scheme is that it does not constitute an additional budget expenditure.

Such a scheme would represent a significant change in the State's approach to encourage investments to be direct to a specific sector.

6.5 Collaboration with the Innovation Authority – subsidizing analysts' reports for institutional investors

In 2018, the ISA and the Innovation Authority commenced work to kick-start an initiative to address one of the barriers that prevent institutional investors from investing in private R&D companies: institutional investors' inability price these companies, in view of their lack of analysts who specialize in the review of high-tech companies. According to one suggestion, the Innovation Authority would help by funding analysts in the high-tech sector for the local institutional bodies.

In September 2019, the Innovation Authority Council approved Benefit Track No. 40, designed to promote the ability of institutional investors active in the capital market to invest in the high-tech industry. The track formally establishes the idea set out above (the "**Benefit Track**"). In light of approval of the Benefit Track, that came into effect on October 29, 2019, a call to local institutional investors to join that track is expected to be issued in the final quarter of 2019.

[63] Sound Pension Savings – report of the Task Force for Increasing Certainty of Pension Savings, December 2015.

6.6 Collaboration with the Innovation Authority – Harnessing the European Investment Fund (EIF) on behalf of local high-tech companies

Over the past 18 months, the ISA and the Innovation Authority have examined the possibility of involve the European Investment Fund (EIF) as a source of guarantees and/or financing for local small- and medium-sized high-tech companies defined as innovative according to the EIF definition. As part of this collaboration, the ISA and the Innovation Authority are working to promote two possible tracks—a guarantees track for high-tech companies issuing bonds on the TASE and a guarantees track for a loan fund, to be issued on the TASE, that provides loans to small- and medium-sized companies**.**

7. Conclusion

This abridged version of the complete document contains the section headings of the complete document and the highlights of the issues described in detail in the complete document. In this abbreviated version we address solutions that have already been tested and future potential solutions. Thinking on potential solutions for promoting the local high-tech industry and enhancing its access to the Israeli capital market entails two main challenges:

One, why do many local technology companies choose to raise capital, mainly from foreign investors and not from Israeli investors, and whether the local capital market can be relevant for growing technology companies?

Two, why do local institutional investors have few or no investments in Israeli high-tech companies and/or in venture risk capital funds?

We invite the general public to send their comments on these questions of principle, potential solutions, and on the series of ideas mentioned in this document including:

- Is it important to expose the Israeli public to the success of the local High-tech industry?
- Should a secondary exchange or additional exchanges for local high-tech companies be established?
- Should incentives (including tax incentives) be given to investors in small and middle-sized high-tech companies?
- Should investment instruments such as those available in England, Australia, or Canada, be promoted in Israel, or should existing instruments be adjusted in view of the experience accumulated over time?
- Should we allow the operations of tradeable debt funds whose aim is to provide credit to high-tech companies in general, or high-tech companies in the sale stage?
- Would a public fund of funds should be established in Israel?
- What barriers should be removed in order to enhance the capital market's access to the local high-tech industry?

We invite the public to express its opinion and comment on the contents of this document, until January 7th , 2019.

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