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ISRAEL SECURITIES AUTHORITY

New Options for Financing Small and Medium Businesses through the Capital Market

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The importance of small- and medium-sized businesses to Israel's economy is enormous. These firms also constitute the vast majority of businesses in Israel, and employ the overwhelming majority of workers in the country's business sector. However, these organizations face severe financing difficulties, mainly because such financing relies almost exclusively on banking institutions, and the financing terms have been significantly toughened over the last few years. Bank financing is the main channel for raising funds because, on the one hand, these are businesses that are too small to generate much interest by institutional investors, and, on the other hand, the capital market is too big to be of relevance to such businesses.

In recent years, the Israel Securities Authority (ISA) has initiated and implemented, with the support of the Ministry of Finance and Ministry of Justice, more than 100 reliefs in regulation. These reliefs are intended to create balanced regulation for all supervised entities, based on protecting investors, encouraging competition, reducing investment costs, as well as the costs absorbed by these same supervised entities, and creating a supportive business environment. The reliefs were not randomly selected. Rather, they were developed - in an orderly and comprehensive manner - to remove regulatory barriers and incentivize every type and size of company that is considering financing its activities through the capital market.

However, upon examining the range of reliefs that have been implemented, as well as the current array of incentives available to companies to mobilize funding through the capital market, the gap is still apparent. Specifically, this chasm is noticeable with regards to the options of financing through the capital market available to companies that are neither small nor large.

The ISA's position is that these companies can potentially serve as a real engine for growth in the Israeli economy. Therefore, it is inappropriate to give up on the idea of these businesses being financed through the capital market, and at more attractive rates than those offered by the banks.

In this context, the ISA has promoted and continues to promote a variety of courses of action, including bringing small and medium (mainly) companies to the Tel Aviv Stock Exchange, or keeping them there - by easing the applicable rules; allowing small- (less) and medium-sized companies to avoid getting bogged down in regulation by using a 'crowd funding' model or P2P (Peer to Peer) lending; and launching new products on the Tel Aviv Stock Exchange that support investment in small- and medium-sized companies. The most innovative option of all is the creation of a new trading framework for small- and medium-sized companies that reduces regulation and changes the rules of the game, both in terms of disclosure obligations and corporate governance, so as to encourage small- and medium-sized companies to register for trading.

Background

The importance of small- and medium-sized businesses to Israel's economy is enormous. They are an important factor in increasing growth, production capacity and economic prosperity. These businesses also contribute to competition and are an important source of new jobs across diverse geographic areas.

There are about 520,000 businesses in Israel that are defined as tiny-, small- or medium-sized. They account for 99.5% of all businesses in Israel and employ about 61% of workers in the business sector. The contribution of small- and medium-sized businesses to Israel's GDP is 54%.

Yet despite these impressive data, small- and medium-sized businesses face financing difficulties, especially in recent years. The reason for this is probably that these companies tend to rely almost exclusively on bank financing. However, in the years following the global economic crisis (2008), bank financing became more rigid towards small- and medium-sized businesses. The data show that the costs of bank credit for small businesses are double that of credit to large businesses, although the credit losses of banks from small- and medium-sized businesses do not seem to justify this gap. Moreover, the Israeli banking system is very centralized. The two large banking groups hold about 57% of the country's total assets, and the five largest groups together possess about 94% of all banking assets. It should be noted that small- and medium-sized businesses have almost no possibility of receiving credit from non-banking sources, since, as stated above, institutional investors cannot justify such small investments in resources, while the barriers to entry into the capital market for small and medium businesses are prohibitively high.

The importance of small- and medium-sized businesses, on the one hand, and their financing difficulties or high financing costs, on the other, justify new and creative thinking about how to ease and remove barriers to financing. The intention, of course, is not to finance these businesses at all costs (literally), but rather to allow them to choose between a range of options, whereby the 'price' of their financing will be determined according to the principles of a free and competitive market and not according to desires, preferences or limitations such as those of the banking sector.

Of course, this is not just an Israeli issue. Many reports - for example, by the OECD – point to the importance of small- and medium-sized businesses to the economy, the difficulties they experience in obtaining financing and credit, the need to develop additional tools for their financing, and the most common ways in which governments intervene in this context – by establishing capital funds or granting capital investment benefits.

The ISA's Activities in Recent Years and their Effects on Small Business Financing

In recent years, the ISA initiated and implemented, with the support of the Ministry of Finance and the Ministry of Justice, more than 100 reliefs in regulation. These reliefs are designed to create a balanced regulation for all supervised entities, based on protecting investors, encouraging competition, reducing costs for investors and supervised entities, and creating a supportive business environment. A significant part of the reliefs in regulation is intended to restore the interest of quality companies in financing their economic activities via the capital market and Tel Aviv Stock Exchange.

These reliefs were not chosen by chance, but were specifically designed to remove, in an orderly and comprehensive manner, regulatory barriers and incentivize every type and size of company that is considering financing its operations via the capital market.

Examples of these regulatory reforms include:

- (1) Providing relief for Hi-Tech companies, which enables these firms companies to, among other things, file financial reports in English, in accordance with US GAAP, and receive analysis at subsidized costs as well as various tax incentives.
- (2) Promoting the 'crowd funding' and P2P (Peer to Peer) lending for financing small companies (detailed below).
- (3) Easements for small- and medium-sized companies, including: exemption from iSOX and cancellation of the requirement for quarterly reports.

- (4) Respite for companies that are considering initial public offering. These reforms apply to, among other things: approval of the terms of employment of a controlling shareholder and his/her relative/s as well as officers, exemption from appointment to the "balance committee", possibility of publishing a shelf prospectus at the time of initial issuance, exemption from requirement to file report about effective internal oversight, and allowing meetings with classified investors prior to commence before issuance proceedings have begun.

In this context, it is worth mentioning the recent demutualization of the Tel Aviv stock exchange that was approved by the Knesset, which deals with the separation between stock exchange owners (banks and institutional investors) and those who provide trading services, thereby strengthening the infrastructure of stock exchange activity as an important source of competition for capital resources. The amendment of the law regarding demutualization is expected to promote the status and efficiency of the stock exchange, and even allows for the establishment of a new secondary stock exchange.

In fact, the ISA has promoted and continues to promote solutions that will enable financing through the capital market, from the stage in which entrepreneurs start developing a product in their garage until the stage in which an established company goes public.

However, upon examining the range of reliefs that have been implemented, as well as the current array of incentives available to companies to mobilize funding through the capital market, the gap is still apparent. Specifically, this chasm is noticeable with regards to the options of financing through the capital market available to companies that are neither small nor large.

These companies may be too big for the 'crowd funding' model, but too small for institutional investors.

But we maintain that we should not give up on the idea of financing such companies through the capital market. Indeed, we believe that the most viable and equitable options for financing small and medium businesses are through the capital market.

For this purpose, we will present four courses of action, each of which may promote the financing of small businesses through the capital market. These are not alternative methods of action, but methods of action that can be implemented

simultaneously, so that their cumulative effect will achieve the desired goal. As will be shown, two of these methods of action have already been implemented or are in advanced stages of implementation. One course of action is in the advanced stages of implementation, while another approach is still in the development stage.

The underlying concept of the four methods of action is similar: recognition of the fact that one size does not fit all and that the existing regulatory framework is not sufficiently friendly towards small- and medium-sized companies. Therefore, in order to enable these companies to raise capital or debt through the capital market, new and creative ways must be found to make them accessible to the capital market, or the capital market to them, in such a way that the benefit of raising capital or debt from the public exceeds the cost involved.

The methods of action are as follows:

First Course of Action: Bring or Keep Small- and Medium-Sized Companies into the Tel Aviv Stock Exchange by Easing Relevant, Applicable Rules.

The goal of this process is to reduce the costs of listing on the Tel Aviv Stock Exchange to small- and medium-sized companies. In this context, the ISA initiated and recently implemented a number of significant amendments aimed at reducing regulatory costs, specifically to small- and medium-sized companies, in order to encourage these businesses to list for trade on the Tel Aviv Stock Exchange.

Public companies dedicate a significant portion of their time and money to the implementation of regulatory directives. But small- and medium-sized companies devote a much larger proportion than large firms. Research shows that in small companies (market value of up to NIS 300 million) regulatory costs can reach 9% of the company's value, while in large companies the regulatory costs are only 0.1% of the value of the company.

Therefore, in recent years the ISA has taken steps to reduce the scope of companies' regulatory burdens and to cancel certain disclosure requirements, in order to enable management to allocate significant portions of their companies' resources for business development.

For this purpose, the ISA initiated a series of concessions to 'small corporations,' defined as a corporation whose shares or participation units are held by the public

and whose value is less than NIS 300 million, is not included in one of the leading stock exchange indices and is an entity whose nominal bond value, held by the public, is less than NIS 200 million.

Within this framework, the ISA has promoted the following measures (which have already been implemented):

- (1) The ISA promoted legislation to eliminate the requirement of small companies (as defined above) to file quarterly financial reports in the first and third quarters of the year. This reform is relevant to more than 180 companies, out of about 530 companies reporting that their securities are traded on the stock exchange. As soon as it's implemented, quite a few companies will be eligible for this easement.

In this context, it is noteworthy that as of June 6, 2017, 123 companies and partnerships whose securities are traded on the stock exchange have announced the implementation of this change, with respect to the first quarter reports of 2017.

- (2) The ISA facilitated an exemption from publication of reports on the effectiveness of internal control (ISOX), so that small corporations will be required to include only a limited declaration by their managers.
- (3) The ISA promoted the granting of an exemption from filing a report regarding exposure to market risks and the way this risks are managed to small corporations whose exposure to market risks deriving from financial instruments is immaterial, in accordance with how materiality is determined.
- (4) The ISA made it easier to attach a valuation to reports by raising the threshold of materiality in connection with the inclusion of a valuation to 20% (instead of 10%).
- (5) The ISA streamlined the inclusion of reports of affiliated companies by raising the threshold in the interim financial statements of the companies included on the equity basis to 40% (by way of leaving the inclusion threshold for financial statements at 20%).

Second Course of Action: Allow Small and Medium Businesses to be Exempt from Regulation

As part of this process, the ISA promoted a legislative amendment allowing companies to remain nearly totally exempt from securities laws while raising

significant sums of money by means of 'crowd funding' or P2P. In fact, this is an arrangement that waives much of the regulation related to the raising of small capital or debt. The sums that were ultimately approved to raise as part of the arrangement (up to NIS 6 million per annum) may not only be attractive to only small companies.

The model of 'crowd funding' (on which the legislative process has acted) is a fundraising approach aimed at the general public and facilitated via an Internet platform. The idea is to raise small sums from a large number of people.

The regulations affecting 'crowd funding' activity have recently been approved. These include the possibility of corporations raising capital as well as issuing debt. The regulations cover the mechanism for 'crowd funding', including the maximum permitted investment volume for investors, maximum permitted amounts of funds to be issued to corporations, supervision by the ISA of the companies operating the Internet recruitment platforms (referred to as the "Offer Coordinator"), requirements for registration as a bid coordinator, and more.

According to the regulations, a company may raise capital from the public via this channel of up to NIS 4 million over the course of any 12 month period, or an additional NIS 1 million (up to a maximum of NIS 6 million) if the business has successfully passed certain examinations, or when the a venture capital fund or angel investor (called a 'leading investor') participates in an investment round of no less than 10 percent.

It should be noted that there is another business model for financing mass loans. According to this model, the investor only determines the amount he/she wants to invest and the level of risk he/she wants to assume. Meanwhile, the platform chooses and distributes to specific loans in its pool (Peer to Peer lending).

Currently, this model is in the advanced stages of the legislative process.

Third Course of Action: Bring New Products for Investing in Small and Medium Businesses to the Tel Aviv Stock Exchange

Within this framework, the ISA promotes and supports the establishment of high tech funds and of traded funds, as a means to finance small and medium businesses. These funds will provide accessibility for small- and medium-sized businesses to the capital market without them having to register for trading on the Stock Exchange

(with all that implies); enable interested investors to diversify their investment portfolio and be exposed to non-tradable investments; and facilitate a diversification of investment products on the stock exchange.

High-tech funds are designed to encourage investment of Israeli capital in fledgling high-tech companies, and enable Israeli investors to benefit from the success of these companies. Legislation has already been enacted so that high-tech funds specializing in investments in Israeli high-tech companies that are engaged in R & D, including those that are not traded on the stock exchange, can be established. These funds will be established as closed mutual funds that can be traded on the stock exchange, subject to various adjustments.

In addition, an interministerial committee established by the ISA and the Accountant General, which is currently concluding its work, has examined and recommended the establishment of designated commercial funds with the aim of creating additional sources of credit for small- and medium-sized businesses. In the first stage, the committee recommended that the funds be provided by a state guarantee for the debts that will be raised.

The committee's recommendations include many other arrangements regarding the duties of the fund manager, tax implications, types of securities that will be issued, rules for listing and trading on the Stock Exchange, and more. In general, the committee's recommendations seek to replicate and adapt the model that has already been successfully implemented with respect to REIT funds for investment in investment property in small- and medium-sized businesses.

Fourth Course of Action: Create a 'Stock Exchange' or a Designated List for Small- and Medium-Sized Companies

This is a completely different approach from what is described in the first course of action: "If Muhammad does not come to the mountain, the mountain should come to Muhammad." The aim of this method of action is to create a new, reduced regulatory framework for small- and medium-sized companies that could serve as an incubator for publicly traded companies, which will one day reach the big leagues. In this context, it will be possible to establish a new trade list or a dedicated stock exchange, with various rules - both in terms of disclosure obligations and corporate governance - that will encourage small- and medium-sized companies to register.

Public companies dedicate a significant portion of their time and money to the implementation of regulatory directives. As noted, small- and medium-sized companies devote a much higher proportion than large companies, so that listing the former in the current format is not worthwhile. As such, the existing rules described above can be remedied, in the hope that reducing regulatory costs will affect the conduct of these small and medium businesses.

However, there is another, completely different, way to keep small and medium-sized companies in the capital market or encourage them to register for trading. This could be done by establishing a separate stock exchange or designated list on the Tel Aviv Stock Exchange, whose rules would be "tailored" to the needs of small- and medium-sized companies. As a result, these businesses would be able to raise capital at low threshold requirements and lower regulation, without sacrificing the appropriate protections afforded the investor.

It should be noted that models for designated stock exchanges for small- and medium-sized companies already operate around the world. The data show a 92% increase in the number of companies traded on secondary markets worldwide since 2002, while the amount of businesses traded on main stock exchanges only grew by 13.5% during the same period.

Of course, the possibility of establishing a designated stock exchange naturally raises a large number of questions and issues:

- (1) Will this be a completely new stock exchange for small- and medium-sized companies with separate branding, or will it be a new list under the existing stock exchange?
- (2) What are the lessons that can be learned from the establishment and operation of stock exchanges for small businesses elsewhere in the world, and some that have not lived up to their expectations?
- (3) What should be the level of supervision of the designated stock exchange?

It will be necessary to design an effective, balanced monitoring model that will provide protection to investors in the capital market and at the same time not impose excessive costs on companies in a manner that will stifle the market. Some of the designated stock exchanges around the world adopted a model in which a nominated advisor (NOMAD) who reports to the local securities

authority or stock exchange performs the supervision. The advisor provides comprehensive business, legal, accounting and consulting services to companies: from registration to trade, up to current reporting and secondary listing of securities.

- (4) Who is authorized to invest in the designated stock exchange? Is it justified to impose restrictions on entry of investors as a result of the reduced supervision?

On the other hand, it may be justified to allow anyone to invest in companies that will be traded on the designated stock exchange, in order to increase demand. It may also be justified to give various incentives to investors on the designated stock exchange, while limiting the amount of investment allowed to each investor.

- (5) How will the securities issued on the designated stock exchange be offered to the public? Will it be by means of a prospectus? A 'thinner' document, to be signed by the company and whose approval will be predicated on an examination to be performed by the designated consultant?

- (6) What will be the disclosure and reporting obligations of the companies on the designated stock exchange? Will the financial reports be quarterly or semi-annual? And what will these reports will include? According to which accounting rules will they be conducted?

It may be justified to reduce the obligation to attach various documents to reports. It is also possible that in terms of the obligation to publish immediate reports, it makes sense to change today's accepted rules.

- (7) What about the rules of corporate governance?

It may also be justified to ease the rules of corporate governance that apply to companies that will be listed on the special list, specifically with regards to the definition and appointment of independent directors, approval of controlling shareholder transactions, number of independent committees, and the appointment of an internal auditor.

- (8) Are institutional investors expected to invest in the designated stock exchange?

If not, what is the liquidity level expected to be?

- (9) There may also be justification in making changes to the enforcement measures that the ISA will take against violations of the law perpetrated by these

companies. In this context, the question arises as to what will be the correct balancing point between the level of enforcement and risk that investors will be exposed to in view of the other easements offered.

All these will be examined within the framework of a committee set up by the Minister of Finance and Minister of Justice to examine possibilities for the establishment of an additional stock exchange.

