

COMMTOUCH SOFTWARE LTD  
Form 20-F  
March 26, 2010

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the fiscal year ended December 31, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report.....

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-26495

COMMTOUCH SOFTWARE LTD.  
(Exact name of Registrant as specified in its charter and translation of Registrant's name into English)

Israel  
(Jurisdiction of incorporation or organization)

4A Hazoran Street  
Poleg Industrial Park,  
P.O. Box 8511  
Netanya 42504, Israel  
011-972-9-863-6888  
(Address of principal executive offices)

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Ron Ela, CFO, Fax: 011-972-9-8636863. Same address as above.  
(Name, Telephone, Email and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

| Title of each class                           | Name of each exchange on which registered |
|-----------------------------------------------|-------------------------------------------|
| Ordinary Shares, par value NIS 0.15 per share | NASDAQ Capital Market                     |

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report (December 31, 2009).

|                                     |            |
|-------------------------------------|------------|
| Ordinary Shares, par value NIS 0.15 | 23,958,761 |
|-------------------------------------|------------|

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes  No

Note: Checking the above box will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. Check one:

|                                               |                                         |                                                        |
|-----------------------------------------------|-----------------------------------------|--------------------------------------------------------|
| Large accelerated filer <input type="radio"/> | Accelerated filer <input type="radio"/> | Non-accelerated filer <input checked="" type="radio"/> |
|-----------------------------------------------|-----------------------------------------|--------------------------------------------------------|

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing.

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|                                            |                                                                                                                             |                             |
|--------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|-----------------------------|
| U.S. GAAP <input checked="" type="radio"/> | International Financial Reporting Standards as issued by the International Accounting Standards Board <input type="radio"/> | Other <input type="radio"/> |
|--------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|-----------------------------|

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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1 Boxes to remain unchecked.

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## PART I

## Item 1. Identity of Directors, Senior Management and Advisers.

Not applicable.

## Item 2. Offer Statistics and Expected Timetable.

Not Applicable

## Item 3. Key Information.

Unless otherwise indicated, all references in this document to “Commtouch,” “the Company,” “we,” “us” or “our” are Commtouch Software Ltd. or its wholly-owned subsidiary, Commtouch Inc., as relating to consolidated financial information contained herein.

The selected consolidated statements of operations data for the years ended December 31, 2007, 2008 and 2009 and the selected consolidated balance sheet data as of December 31, 2008 and 2009 have been derived from the Consolidated Financial Statements of Commtouch included elsewhere in this report. The selected consolidated statements of operations data for the years ended December 31, 2005 and 2006 and the selected consolidated balance sheet data as of December 31, 2005, 2006 and 2007 have been derived from the Consolidated Financial Statements of Commtouch not included elsewhere in this report. Our historical results are not necessarily indicative of results to be expected for any future period. The data set forth below should be read in conjunction with “Item 5. Operating and Financial Review and Prospects” and the Consolidated Financial Statements and the Notes thereto included elsewhere herein:

|                                                                                           | Year Ended December 31,                   |           |           |           |           |
|-------------------------------------------------------------------------------------------|-------------------------------------------|-----------|-----------|-----------|-----------|
|                                                                                           | 2005                                      | 2006      | 2007      | 2008      | 2009      |
|                                                                                           | (USD in thousands, except per share data) |           |           |           |           |
| <b>Selected Data:</b>                                                                     |                                           |           |           |           |           |
| Revenues                                                                                  | \$ 3,925                                  | \$ 7,234  | \$ 11,250 | \$ 14,092 | \$ 15,189 |
| Operating profit (loss)                                                                   | \$ (2,656)                                | \$ (415)  | \$ 1,610  | \$ 1,931  | \$ 2,696  |
| Net income (loss) attributable to ordinary and equivalently participating shareholders    | \$ (2,690)                                | \$ (190)  | \$ 2,109  | \$ 2,270  | \$ 5,160  |
| Basic net earnings (loss) per share                                                       | \$ (0.28)                                 | \$ (0.01) | \$ 0.08   | \$ 0.09   | \$ 0.21   |
| Diluted net earnings (loss) per share                                                     | \$ (0.28)                                 | \$ (0.01) | \$ 0.08   | \$ 0.08   | \$ 0.20   |
| Weighted average number of shares used in computing basic net earnings (loss) per share   | 15,802                                    | 22,113    | 24,847    | 25,619    | 24,532    |
| Weighted average number of shares used in computing diluted net earnings (loss) per share | 15,802                                    | 22,113    | 27,591    | 26,929    | 25,292    |
| Total Assets                                                                              | \$ 7,995                                  | \$ 11,999 | \$ 18,210 | \$ 20,709 | \$ 25,190 |

## FORWARD LOOKING STATEMENTS

Except for the historical information contained in this Annual Report, the statements contained in this Annual Report are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, as amended, and other federal securities laws with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial

results.

We urge you to consider that statements which use the terms “anticipate,” “believe,” “expect,” “plan,” “intend,” “estimate” similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements, or industry results, expressed or implied by such forward-looking statements. Such forward-looking statements appear in Item 4 – “Information on the Company” and Item 5 – “Operating and Financial Review and Prospects,” as well as elsewhere in this Annual Report. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to update or revise any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears below.

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## RISK FACTORS

You should carefully consider the following risk factors before you decide to buy our Ordinary Shares. You should also consider the other information in this report. If any of the following risks actually occur, our business, financial condition, operating results or cash flows could be materially adversely affected. This could cause the trading price of our Ordinary Shares to decline, and you could lose part or all of your investment. The risks described below are not the only ones facing us. Additional risks not presently known to us, or that we currently deem immaterial, may also impair our business operations.

### Business Risks

If the market does not continue to respond favorably to our current messaging and Web security solutions, including our anti-spam, email anti-virus and Uniform Resource Locator or URL filtering solutions, or our future solutions do not gain acceptance, we will fail to generate sufficient revenues.

Our success depends on the continued acceptance and use of our messaging and Web security solutions by current and new enterprise, Original Equipment Manufacturer or OEM, and Service Provider customers. We have been selling our anti-spam products for over six years, Zero-Hour™ virus outbreak detection product for approximately five years, our GlobalView™ Mail Reputation perimeter defense solution for approximately four years and our URL filtering solutions for over one year.

As the markets for messaging and Web security products continue to mature and consolidate, we are seeing increasing competitive pressures and demands for even higher quality products at lower prices. This increasing demand comes at a time when email and Web-based threats are more varied and intensive, challenging even the top end solutions to keep their performance at an industry acceptable high level of accuracy. If our solutions do not continue to evolve to meet market demand, or newer products on the market prove more effective, our business could fail. Also, if growth in the markets for messaging and Web-based security solutions begins to slow, our business will suffer dramatically.

Continuing unfavorable national and global economic conditions could have a material adverse effect on our business, operating results and financial condition

It is not yet clear if the recent crisis in the financial and credit markets in the United States, Europe and Asia, that led to a global economic slowdown, has passed completely. If the economies of countries in which our customers and potential customers are located continue to be weak or weaken further, our customers may reduce or postpone their spending significantly. This could result in reductions in sales of our services and longer sales cycles, slower adoption of new technologies and increased price competition. In addition, weakness in the end-user market could negatively affect the cash flow of our OEM partners, distributors and resellers who could, in turn, delay paying their obligations to us. This would increase our credit risk exposure and cause delays in our recognition of revenues on future sales to these customers. While our OEM business remained strong during 2009, we did see instances of financial weakness with a few non-key OEM partners during 2009. Specific economic trends, such as declines in the demand for PCs, servers, and other computing devices, or weakness in corporate information technology spending, could have a more direct impact on our business. Any of these events would likely harm our business, operating results and financial condition.

If global economic and market conditions, or economic conditions in the United States or other key markets do not continue to improve, or revert to a recessionary state, our business, operating results and financial condition may be adversely impacted in a material way.

Tighter governmental enforcement of regulations could decrease the distribution of unsolicited bulk (spam) email and malicious software and decrease demand for our solutions, or increase our cost of doing business.

The Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act) established a framework of administrative, civil, and criminal tools to combat spam. The law establishes both civil and criminal prohibitions to assist in deterring the most offensive forms of spam, including unmarked sexually-oriented messages and emails containing fraudulent headers. Under the law, senders of email are required to honor a request by a consumer not to receive any further unsolicited messages. While past high profile prosecutions of direct marketers seemingly have not had much of a deterrent effect on marketers of unsolicited email, it is not known whether or not future enforcement actions will prove effective.

In addition, various state legislatures have enacted laws aimed at regulating the distribution of unsolicited email.

These and similar legal measures may have the effect of reducing the amount of unsolicited email and malicious software that is distributed and hence diminish the need for our email defense solutions. Any such developments would have an adverse impact on our revenues.

We depend upon OEM partners and resellers and we have a limited concentration of products.

We expect to continue to be dependent upon resellers and OEM partners for a significant portion of our revenues, which will be derived from sales of our messaging and Web security solutions. Our operating results and financial condition may be materially adversely affected if:

- Our limited product suite fails to remain attractive to current or prospective partners;
- Anticipated orders or payments from these resellers and OEM partners fail to materialize;
- We are unable to locate and or sign additional OEM partners (given the limited pool of available candidates for our technology); or
  - Some of the key resellers or OEM partners cease the promotion of our business or begin to promote additional solutions in a layered approach to email defense and URL filtering management.
  - Some of our key OEM partners' businesses fail as a result of a deepening global economic crisis.

Our quarterly operating results may fluctuate, which could adversely affect the value of your investment.

A number of factors, many of which are enumerated in this "Risk Factors" section, are likely to cause fluctuations in our operating results or cause our share price to decline. These factors include:

• Our ability to successfully market our messaging and Web security solutions in new markets, both domestic and international;

- Our ability to successfully develop and market new, modified or upgraded solutions, as may be needed;
  - The continued acceptance of our solutions by our current customer base;
  - Our ability to expand our workforce with qualified personnel, as may be needed;
- Unanticipated bugs or other problems affecting the delivery of our solutions to customers;

- The success of our resellers' and OEM partners' sales efforts to potential customers;
- The solvency of our resellers and OEM partners and their ability to allocate sufficient resources towards the marketing of our solutions to potential customers;
- Our OEM partners' ability to effectively integrate our solutions into their product offerings;
  - The substantial decrease in information technology spending;
  - The pricing of our solutions;
  - Our ability to timely collect fees owed by resellers and OEM partners;
  - A renewed global slowdown;



• Sudden, dramatic fluctuations in exchange rates of currencies covering the fees we collect from our foreign customers versus the currencies utilized in our business (namely, the New Israeli Shekel, U.S. Dollar and EURO);

• Our ability to add cost-effective space and equipment to our current detection centers in a timely and effective manner to match the rate of growth in our business, plus our ability to build new, cost-effective detection centers as worldwide demand for our products may require; and

• The effectiveness of our customer support, whether provided by our resellers and OEM partners, or directly by Commtouch.

Our products and services have changed many times since we commenced operations in 1991. For example, in late 2006, we announced the availability of our IP reputation service, now known as GlobalView Mail Reputation and in late 2008, we released the initial version of our URL filtering, or Web security, solutions. Future changes in our product offerings may require that we adjust our business processes and workforce, which can cause fluctuations in our results from operations.

We have many established competitors who are offering a multitude of solutions to the problems of spam/virus distribution and Web-related security threats.

The market for messaging security products remains intensely competitive. This has resulted in pricing pressures and lower operating margins, which has been a cause in the slowing of our business' rate of growth.

In the market for messaging security solutions, there are fewer providers offering somewhat ineffectual "content filtering" solutions (solutions focusing solely on the content of potential spam email) than in the past, and more sophisticated offerings that compete with our solutions. Messaging security providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include Symantec (Brightmail), TrendMicro, McAfee (including products of the previously acquired Secure Computing) and Cisco (IronPort). Messaging security providers offering solutions on an OEM basis similar to Commtouch's business model, and which may be viewed as direct competitors, include Cloudmark, Mailshell and Mail-Filters. As this market continues to develop, it is likely that companies will attempt to either enter or increase their presence in this market, or expand into ancillary markets, by acquiring or forming strategic alliances with our competitors or business partners. Some examples of this are the acquisitions of IronPort by Cisco, Secure Computing by McAfee, CipherTrust by Secure Computing, Brightmail by Symantec Corp., Microsoft of both Frontbridge Technologies and Sybari Software and, more recently, Bizanga by Cloudmark.

In the market for Web security solutions, there are fewer providers offering somewhat ineffectual "content filtering" solutions (solutions focusing solely on "Black & White" lists) than in the past, and more advanced offerings that compete with our URL filtering solutions. Web security providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include McAfee (Secure Computing), WebSense and IBM (ISS/Cobion). Web security providers offering solutions on an OEM basis similar to Commtouch's business model, and which may be viewed as direct competitors, include BrightCloud, eSoft, RuleSpace and Puresight. As this market continues to develop, it is likely that companies with greater resources than ours will attempt to either enter or increase their presence in this market by acquiring or forming strategic alliances with our competitors or business partners. Some examples of this are the acquisitions of Fastdata by Cisco, SurfControl by WebSense and Secure Computing by McAfee.

Also, there are companies that develop and maintain in-house email defense and web security solutions, such as Google and Yahoo. These and other companies could potentially leverage their existing capabilities and relationships to enter the messaging and/or Web security markets.

Competitors could introduce products with superior features, scalability and functionality at lower prices than our products and could also bundle existing or new products with other more established products that discourage users from purchasing our products. Our market's level of competition has increased as current competitors have improved the sophistication and effectiveness of their offerings and as new participants have entered the market. Some of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and greater financial, technical, sales, marketing and other resources than we do and may enter into strategic or commercial relationships on more favorable terms. New technologies and the expansion of existing technologies may increase competitive pressures on us, and we may not be able to compete successfully against current and future competitors.

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Our ability to continue to increase our revenues will depend on our ability to successfully execute our sales and business development plan.

The complexity of the underlying technological base of messaging and Web security solutions, and the current landscape of the markets, require highly trained sales and business development personnel to educate prospective resellers, OEM partners and customers regarding the use and benefits of our solutions. Recently, we have added new vice presidents of business development for our U.S. and international operations. It may take time for our current and future employees to convey to potential, as well as current, OEM partners and resellers how to most effectively market and utilize our solutions. As a result, our sales and business development personnel may not be able to compete successfully against larger, more heavily financed and more experienced sales and business development departments of our competitors.

The loss of our key employees would adversely affect our ability to manage our business, therefore causing our operating results to suffer and the value of your investment to decline.

Our success depends on the skills, experience and performance of our senior management and other key personnel. The loss of the services of any of our senior management or other key personnel could materially and adversely affect our business. The loss of our software developers or senior operations personnel may also adversely affect the continued development and support of our messaging and Web security solutions, thereby causing our operating results to suffer and the value of your investment to decline.

We do not have employment agreements inclusive of set periods of employment with any of our key personnel. We cannot prevent them from leaving at any time. We do not maintain key-person life insurance policies, listing us as a beneficiary, on any of our employees.

Our business and operating results could suffer if we do not successfully address potential risks inherent in doing business overseas.

As of December 31, 2009, we had sales offices in Israel and the United States. We also are marketing our messaging and Web security solutions in international markets by utilizing appropriate distribution channels. However, we may not be able to compete effectively in international markets due to various risks inherent in conducting business internationally, such as:

- Differing technology standards;
- Inability of distribution channels to successfully market our solutions;
  - Export restrictions;
- Difficulties in collecting accounts receivable and longer collection periods;
  - Unexpected changes in regulatory requirements;
  - Political and economic instability;
  - Potentially adverse tax consequences;

• The adoption of new legislation-backed penalties, which may discourage the distribution of unsolicited email messages and Web security threats; and

- Limited enforcement mechanisms for protecting intellectual property rights.

Any of these factors could adversely affect the Company's prospective international sales and, consequently, business and operating results.

Our Web security solution may be adversely affected if we are not able to receive sufficient components from third party suppliers.

Our Web security solution relies in part on certain components supplied by third parties pursuant to contractual relationships. If these third parties breach their agreements with us, we may have difficulty in securing alternative sources for these components in a timely manner and thus our Web security solution may not perform at the level we expect. If this were to occur, the effectiveness of this solution would drop, it would become less attractive to customers/potential customers and anticipated revenues could decline.

## Technology Risks

We have recently entered a new market with our URL filtering solutions, and may not fully appreciate the needs of customers and risks inherent in this new market

Historically, Commtouch has focused its products solely on email based messaging security solutions. The recent move into the Web security industry in late 2008 represents our first effort at expansion into a totally new market. While we have expended resources in educating ourselves about this new market, and we showed tangible traction in this new market during 2009, nevertheless we cannot be totally certain that we have anticipated all possible issues that might arise with our “in the cloud” technology infrastructure and trends affecting Web-based threats. Should unanticipated issues arise, sales of our URL filtering solutions likely will slow and our business will suffer.

We may not have the resources or skills required to adapt to the changing technological requirements and shifting preferences of our customers and their users.

Both the messaging and Web security industries are characterized by difficult technological challenges, sophisticated distributors of email and Web threats, multiple-variant viruses, unique phishing scams and constantly evolving malevolent software distribution practices and targets that could render our solutions and proprietary technology ineffective. Our success depends, in part, on our ability to continually enhance our existing messaging and Web security solutions and to develop new solutions, functions and technology that address the potential needs of prospective and current customers and their users. The development of proprietary technology and necessary enhancements entails significant technical and business risks and requires substantial expenditures and lead-time. We may not be able to keep pace with the latest technological developments. We may not be able to use new technologies effectively or adapt to OEM, customer or end user requirements or emerging industry standards. Also, we must be able to act more quickly than our competition, and may not be able to do so.

Our solutions may be adversely affected by defects or denial of service attacks, which could cause our OEM partners, customers or end users to stop using our solutions.

Our messaging and Web security solutions are based in part upon new and complex software and highly advanced computer systems. Complex software and computer systems can contain defects, particularly when first introduced or when new versions are released, and are possible targets for denial of service attacks instigated by “hackers”. Although we conduct extensive testing and implement Internet security processes, we may not discover defects to or vulnerabilities in our software or systems that affect our new or current solutions or enhancements until after they are delivered. Although we have not experienced any material defects or vulnerabilities to date in our messaging and Web security offerings, it is possible that, despite testing by us, defects or vulnerabilities may exist in the solutions we provide. These defects or vulnerabilities could cause or lead to interruptions for customers of our solutions, resulting in damage to our reputation, legal risks, loss of revenue, delays in market acceptance and diversion of our development resources, any of which could cause our business to suffer.

Our solutions may be adversely affected if we are not able to receive a sufficient sampling of Internet traffic or deliver our services to customers.

Our messaging and Web security solutions are dependent, in part, on the ability of our Detection Centers to analyze, in an automated fashion, live feeds of Internet and Web related traffic received through our services to customers and other contractual arrangements. If we were to suffer an unanticipated, substantial decrease in such traffic or our Detection Centers become unavailable for any significant period, the effectiveness of our technologies would drop, our product offerings would become less attractive to customers/potential customers and revenues could decline.

Our Web security solution may be adversely affected if we are not able to receive sufficient components from third party suppliers.

Our Web security solution relies in part on certain components supplied by third parties pursuant to contractual relationships. If these third parties breach their agreements with us, we may have difficulty in securing alternative sources for these components in a timely manner and thus our Web security solution may not perform at the level we expect. If this were to occur, the effectiveness of this solution would drop, it would become less attractive to customers/potential customers and anticipated revenues could decline.

## Investment Risks

If we will be in need of additional capital, we may not be able to secure additional funds on acceptable terms, or at all, and the Company could fail.

We have invested heavily in technology development. We expect to continue to spend financial and other resources on developing and introducing new offerings and maintaining our corporate organizations and strategic relationships. We also expect to invest resources in research and development projects to further enhance our URL categorization and blocking, anti-spam and anti-virus solutions.

Notwithstanding the Company's current, solid financial condition and the fact that recently the Office of the Chief Scientist for the State of Israel, or the OCS, has approved the allocation of research and development funding for the Company, should additional funding become necessary we may be unable to secure capital on acceptable terms, or at all, due to, among other things, difficulties in the capital and credit markets. In such case, the Company's business could suffer.

Our directors, executive officers and principal shareholders will be able to exert significant influence over matters requiring shareholder approval and could delay or prevent a change of control.

Our directors and affiliates of our directors, our executive officers and our shareholders who currently individually beneficially own over five percent of the voting power in the Company (together known as "affiliated entities"), beneficially own, in the aggregate, approximately 36.3% of our outstanding Ordinary Shares as of December 31, 2009. Included in the calculation of voting power are warrants and options exercisable by the affiliated entities within 60 days thereof (the exercise price of some of which was more than the price of our shares as of December 31, 2009). If they vote together (especially if they were to convert all beneficial holdings into shares entitled to voting rights in the Company), these shareholders will be able to exercise significant influence over all matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. This concentration of ownership could also delay or prevent a change in control of Commtouch. In addition, conflicts of interest may arise as a consequence of the significant shareholders control relationship with us, including:

• Conflicts between significant shareholders, and our other shareholders whose interests may differ with respect to, among other things, our strategic direction or significant corporate transactions;

• Conflicts related to corporate opportunities that could be pursued by us, on the one hand, or by these shareholders, on the other hand; or

• Conflicts related to existing or new contractual relationships between us, on the one hand, and these shareholders, on the other hand.

Our ordinary shares are traded on more than one market and this may result in price variations.

Our ordinary shares are traded primarily on the NASDAQ Capital Market and also on the Tel Aviv Stock Exchange. Trading in our ordinary shares on these markets is made in different currencies (U.S. dollars on the NASDAQ Capital Market, and New Israeli Shekels, or NIS, on the Tel Aviv Stock Exchange), and at different times (resulting from different time zones, different trading days and different public holidays in the United States and Israel). Consequently, the trading prices of our ordinary shares on these two markets often differ. Any decrease in the trading price of our ordinary shares on one of these markets could cause a decrease in the trading price of our ordinary shares on the other market.





## Intellectual Property Risks

If we fail to adequately protect our intellectual property rights or face a claim of intellectual property infringement by a third party, we could lose our intellectual property rights or be liable for significant damages.

We regard our patented and patent pending technology, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality or license agreements with our employees and customers to protect our proprietary rights.

During 2004, we purchased a United States patent, U.S. Patent No. 6,330,590. During 2005, we filed in the United States an anti-spam related patent application, claiming priority for a prior period based on the filing of U.S. Provisional Patent Application. This application remains outstanding. During 2006, we filed in the United States a patent application relating to the prevention of spam in streaming systems or, in other words, unwanted conversational media sessions (i.e. voice and video related). This provisional application was converted to a formal patent application, which we continue to prosecute with the United States Patent and Trademark Office. During 2008, we filed a U.S. Provisional Patent Application for anti-malware data center aggregate, the subject of which remains unpublished and thus confidential. During 2009, it too converted into a formal patent application. We may seek to patent certain additional software or other technology in the future. Any such patent applications might not result in patents issued within the scope of the claims we seek, or at all.

Despite our precautions, unauthorized third parties may copy certain portions of our technology, reverse engineer or obtain and use information that we regard as proprietary or otherwise infringe or misappropriate our patent or our patent pending technology, trade secrets, copyrights, trademarks and similar proprietary rights. We may not have the proper resources in order to adequately protect our intellectual property. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as do the laws of the United States. Our means of protecting our proprietary rights in the United States or abroad may not be adequate and competitors may independently develop similar technology.

We cannot be certain that our messaging and Web security solutions do not infringe issued patents in certain parts of the world. In addition, because patent applications in the United States are not publicly disclosed until eighteen months after the application is filed, applications previously may have been filed which relate to our solutions. Therefore, other parties, whether in the United States or elsewhere, may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement of copyrights, trademarks and other intellectual property rights of third parties by ourselves and our customers. Our customer agreements typically include indemnity provisions, so we may be obligated to defend against third party intellectual property rights infringement claims on behalf of our customers. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. We may not have the proper resources in order to adequately defend against such claims.

## Risks Relating to Operations in Israel

We have important facilities and resources located in Israel, which has historically experienced military and political unrest.

We are incorporated under the laws of the State of Israel. Our principal research and development facilities are located in Israel. Although the majority of our past sales were made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Any major hostilities involving Israel, or the interruption or curtailment of trade between Israel and its present trading partners, could significantly harm our business, operating results and financial condition.

Since the State of Israel was established in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. Since October 2000, terrorist violence in Israel has increased significantly. Recently, there has been an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities in December 2008 and January 2009 along Israel's border with the Gaza Strip, which resulted in missiles being fired from the Gaza Strip into Southern Israel. There were also extensive hostilities along Israel's northern border with Lebanon in the summer of 2006. Ongoing and revived hostilities or other Israeli political or economic factors could harm our operations and cause our revenues to decrease.

In addition, Israel and some companies doing business with Israel have been the subject of an economic boycott by Arab countries and their close allies since Israel's establishment. These restrictive laws and policies may have an adverse impact on our operating results, financial condition and expansion of our business.

Our results of operations may be negatively affected by the obligation of key personnel to perform military service.

Certain of our officers and employees are currently obligated to perform annual reserve duty in the Israel Defense Forces and are subject to being called for active military duty at any time in the event of a national emergency, such as in connection with the hostilities along Israel's border with the Gaza Strip in December 2008 and January 2009. Although Commtouch has operated effectively under these requirements since its inception, we cannot predict the effect of these obligations on Commtouch in the future. Our operations could be disrupted by the absence for a significant period of one or more of our officers or key employees due to military service. Any disruption in our operations would harm our business.

Because a substantial portion of our revenues historically have been generated in U.S. dollars and the Euro, and a portion of our expenses have been incurred in New Israeli Shekels, our results of operations may be adversely affected by currency fluctuations.

We have generated a substantial portion of our revenues in U.S. dollars and Euro, and incurred a portion of our expenses, principally salaries and related personnel expenses in Israel, in New Israeli Shekels, or NIS. We anticipate that a significant portion of our expenses will continue to be denominated in Israeli shekels. As a result, we are exposed to risk to the extent that the value of the U.S. dollar decreases against the NIS and the Euro. In that event, the U.S. dollar cost of our operations will increase and our U.S. dollar-measured results of operations will be adversely affected, as occurred during portions of 2006 - 2008, when the NIS and the Euro appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operational expenses and revenues. We cannot predict the trend for future years. Our operations also could be adversely affected if we are unable to guard against currency fluctuations in the future. To date, we have not engaged in hedging transactions. In the future, we may enter into currency hedging transactions to decrease the risk of financial exposure from fluctuations in the exchange rate of the dollar against the NIS. These measures, however, may not adequately protect us from material adverse effects if inflation in Israel accelerates.

The government programs and benefits which we previously received require us to meet several conditions and may be terminated or reduced in the future.

Prior to 1998, we received grants from the Government of Israel, through the OCS, for the financing of a significant portion of our research and development expenditures in Israel. These grants totaled \$0.6 million. In 2001, we received \$0.6 million and in 2002 we received \$0.2 million. We did not submit an application for funding during the period 2004 - 2008. In 2009, our application for funding was approved in an amount of approximately \$0.5 million. We currently intend to apply for an additional grant during 2010. In the past, the OCS budget has been subject to reductions which may affect the availability of funds for possible future grants. Therefore, we cannot be certain that we will be able to receive future grants in similar amounts, or at all. In addition, the terms of any future OCS grants may be less favorable than our past grants.

In order to meet specified conditions in connection with the grants and programs of the OCS, we have made representations to the Israel government about our Israeli operations. From time to time the conduct of our Israeli operations has deviated from our forecasts. If we fail to meet the conditions of the grants, including the maintenance of a material presence in Israel, or if there is any material deviation from the representations made by us to the Israeli government, we could be required to refund the grants previously received (together with an adjustment based on the Israeli consumer price index and an interest factor) and would likely be ineligible to receive OCS grants in the future.

Under the Law for the Encouragement of Industrial Research and Development, 5744-1984 and the related regulations, the discretionary approval of an OCS committee is required for any transfer of technology developed with OCS funding or for the transfer of manufacturing rights outside of Israel. OCS approval is not required for the export of any products resulting from the research and development. There is no assurance that we will receive the required approvals for any proposed future transfer. Such approvals, if granted, may be subject to the following additional restrictions:

- a requirement to pay the OCS a portion of the consideration we receive upon any sale of such technology to an entity that is not Israeli. The scope of the support received, the royalties that were paid by us, the amount of time that elapsed between the date on which the know-how was transferred and the date on which the grants were received, as well as the sale price, will be taken into account in order to calculate the amount of the payment; and

- the transfer of manufacturing rights could be conditioned upon an increase in the royalty rate and payment of increased aggregate royalties (up to 300% of the amount of the grant plus interest, depending on the percentage of the manufacturing that is foreign).

These restrictions may impair our ability to sell certain of our older technology assets outside of Israel. The restrictions will continue to apply even after we repay the full amount of royalties payable for the grants.

You may have difficulties enforcing a U.S. judgment against us and our executive officers and directors or asserting U.S. securities laws claims in Israel.

We are organized under the laws of Israel, and we maintain significant operations in Israel. In addition, the majority of our directors and executive officers are not residents of the United States and most of their assets and our assets are located outside the United States. Service of process upon our non-U.S. resident directors or executive officers and enforcement of judgments obtained in the United States against us and our directors and executive officers may be difficult to obtain within the United States. It may be difficult to assert U.S. securities law claims in original actions instituted in Israel. Israeli courts may refuse to hear a claim based on a violation of U.S. securities laws because Israel is not the most appropriate forum in which to bring such a claim. In addition, even if an Israeli court agrees to hear a claim, it may determine that Israeli law and not U.S. law is applicable to the claim. If U.S. law is found to be applicable, the substance of the applicable U.S. law must be proved as a fact, which can be a time-consuming and costly process. Certain matters of procedure will also be governed by Israeli law. Furthermore, there is little binding case law in Israel addressing these matters.

Israeli courts might not enforce judgments rendered outside Israel which may make it difficult to collect on judgments rendered against us. Subject to certain time limitations, an Israeli court may declare a foreign civil judgment enforceable only if it finds that (a) the judgment was rendered by a court which was, according to the laws of the state of the court, competent to render the judgment; (b) the judgment may no longer be appealed; (c) the obligation imposed by the judgment is enforceable according to the rules relating to the enforceability of judgments in Israel and the substance of the judgment is not contrary to public policy; and (d) the judgment is executory in the state in which it was given.

Even if these conditions are satisfied, an Israeli court will not enforce a foreign judgment if it was given in a state whose laws do not provide for the enforcement of judgments of Israeli courts (subject to exceptional cases) or if its enforcement is likely to prejudice the sovereignty or security of the State of Israel. An Israeli court also will not declare a foreign judgment enforceable if (i) the judgment was obtained by fraud; (ii) there is a finding of lack of due process; (iii) the judgment was rendered by a court not competent to render it according to the laws of private international law in Israel; (iv) the judgment is at variance with another judgment that was given in the same matter between the same parties and that is still valid; or (v) at the time the action was brought in the foreign court, a suit in the same matter and between the same parties was pending before a court or tribunal in Israel.

Provisions of Israeli law may delay, prevent or make difficult an acquisition of Commtouch, which could prevent a change of control and therefore depress the price of our shares.

Israeli corporate law regulates mergers and acquisitions of shares through tender offers, requires special approvals for transactions involving significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax law treats stock-for-stock acquisitions between an Israeli company and a foreign company less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his Ordinary Shares for shares in a foreign corporation to immediate taxation or to taxation before his investment in the foreign corporation becomes liquid. These provisions may adversely affect the price of our shares.



As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.

As a foreign private issuer whose shares are listed on the NASDAQ Capital Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Listing Rules.

Among other things, we may follow home country practice with regard to composition of the board of directors and quorum at shareholders' meetings. In addition, we may follow our home country law, instead of the NASDAQ Listing Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the Company, certain transactions other than a public offering involving issuances of a 20% or more interest in the Company and certain acquisitions of the stock or assets of another company.

A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements, must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

#### Item 4. Information on the Company.

##### Overview

The legal name of the Company is Commtouch Software Ltd., and its principal executive offices are located at 4A Hazoran Street, Poleg Industrial Park, P.O.Box 8511, Netanya 42504, Israel, where our telephone number is 011-972-9-863-6888. The Company was incorporated under the laws of the State of Israel on February 5, 1991 and its legal form is a company limited by shares. Its Articles of Association are on file in Israel with the office of the Israeli Registrar of Companies and available for public inspection at that office. The Company's wholly owned subsidiary, Commtouch Inc., is located at 292 Gibraltar Drive, Suite 107, Sunnyvale, California 94089, where our telephone number is (650) 864-2000.

We are a provider of messaging and Web security solutions to a wide array of customers and OEM distribution partners, including real-time anti-spam, Zero-Hour virus outbreak protection and Global View Mail Reputation services, as well as a GlobalView URL Filtering solution. The Company offers its solutions to network and security vendors offering content security gateways, unified threat management solutions, network routers and appliances, anti-virus solutions and to service providers such as Software-as-a-Service vendors, Web hosting providers and Internet Service Providers. At the core of Commtouch's messaging security offerings is Commtouch's proprietary Recurrent Pattern Detection (RPD)<sup>™</sup> technology which, in general terms, analyzes messages associated with mass email outbreaks and directs the blocking of such emails, without the need to analyze individual messages. At the core of Commtouch's URL filtering solutions is its "in the cloud" infrastructure, which analyzes various feeds from worldwide sources pertaining to URLs, and provides a ranking of the URLs tailored to the needs of each customer.

##### Additional Detail on Commtouch Offerings

We offer a Software Development Kit or SDK comprised of multiple components, which is built on our proprietary Recurrent Pattern Detection<sup>™</sup> technology; each different component enables third-party vendors to integrate a Company offering. Two components, known as ctasd and ctengine, represent alternative methods of enabling third-party vendors to integrate the Commtouch anti-spam solution into their existing offerings. Both ctengine and ctasd provide

these manufacturers or service providers with full spam identification and spam classification services from the Commtouch Detection Centers (described below). The SDK communicates fully with a remote Detection Center, receiving results to queries about suspicious messages and acting according to set policies on the customer side. These same two components also enable integration of the Company's Zero-Hour™ virus outbreak protection. This solution provides customers with the ability to block malevolent software (or as known in the industry "malware"), including email borne viruses, in real time, at the moment the initial attack occurs. During the initial attack phase, traditional anti-virus vendors are typically analyzing messages to determine whether they are indeed infected with a virus. It is this critical lag in response time by traditional anti-virus vendors that the Zero-Hour solution has been developed to remedy.



A third component of the SDK, known as ctigd, enables integration of the Company's GlobalView Mail Reputation Service. This service is typically integrated into a device that sits at the perimeter of the organization, deciding which email traffic to allow to enter the organization, and which to block. It accomplishes this by receiving classification data from a Commtouch Detection Center about the sender of each email message.

Products that may benefit from integration of the SDK solution include:

- Anti-virus applications;
- Content filtering solutions;
- Firewall systems;
- Security servers; and
- Other network appliances

In relation to the three components noted above, Commtouch has also developed plug-ins, filters and a connector to enable hosting and service providers to access these Commtouch services in connection with their existing messaging products. Commtouch's support of the hosting and service provider industry encompasses a wide range of third party technologies: integration with Parallels Plesk, H-Sphere and cPanel; plug-ins for common open source email filtering packages such as SpamAssassin; a connector for Microsoft Exchange; and a Filter for Sendmail and Postfix.

We also offer an enterprise anti-spam and Zero-Hour virus outbreak detection solution, consisting of both a software element, or the "Enterprise Gateway", and a service component, or a Commtouch "Detection Center", which is typically sold through reseller channels. At the Enterprise Gateway, messages are filtered at the customer organization's entry point, before being distributed to recipients, with added user-level controls and a top level of secure spam and virus detection services from the Detection Center, all allowing for real-time reaction to worldwide attacks. At the heart of the solution, however, is the Detection Center, which detects new spam and virus attacks as soon as they are launched and distributed over the Internet, and communicates the detection results to the Enterprise Gateways to enable real-time protection.

During late 2008, the Company released its Globalview URL filtering solution – a Web security solution representing the Company's first foray into a non-email centric market. The services associated with this solution analyze and categorize for customers of our OEM partners the website being accessed by such customers, mainly in order to prevent a) the possibility of malware attacks being propagated by malicious URLs, b) access to non-business related websites by employees and c) access by children to inappropriate websites.

#### Competitive Landscape

The markets in which Commtouch competes are intensely competitive and rapidly changing. However, we believe there is no single competitor that offers the complete package of anti-spam, anti-virus, IP reputation and Web defense protections that Commtouch provides.

The principal competitive factors in our industry include price, product functionality, product integration, platform coverage and ability to scale, worldwide sales infrastructure and global technical support. Some of our competitors have greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition and a larger installed customer base. Additionally, some of these competitors have research and development capabilities that may allow them to develop new or improved products that may compete with product lines we market and distribute, possibly at a lower cost. Our success will depend on our ability to adapt to these competing forces, to

develop more advanced products more rapidly and less expensively than our competitors, and to educate potential customers as to the benefits of using our products rather than developing their own products.

In the market for messaging security solutions, there are fewer providers offering somewhat ineffectual “content filtering” solutions (solutions focusing solely on the content of potential spam email) than in the past, and more sophisticated offerings that compete with our solutions. Email defense providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include Symantec (Brightmail), TrendMicro, McAfee (including products of the previously acquired Secure Computing) and Cisco (IronPort). Email defense providers offering solutions on an OEM basis similar to Commtouch’s business model, and which may be viewed as direct competitors, include Cloudmark, Mailshell and Mail-Filters.

Commtouch's GlobalView Mail Reputation Service competes in an evolving market. This market includes some established vendors, including TrendMicro, that are offering reputation-based solutions. In some cases, while the product positioning may be new, the underlying solutions may be mature – for example, Spamhaus repositioning its RBL, or “Real-time Block List”, service as a commercial reputation service. In addition, there are several startups competing in this space, such as Karmasphere.

The market for real-time virus protection products is also constantly evolving, as those promoting the proliferation of viruses continually seek new distribution techniques. Commtouch's offering differs from traditional anti-virus solutions in that we are offering an additional, complementary solution to signature and heuristic-based anti-virus engines. For this reason, our Zero-Hour virus outbreak protection engine has been employed by several anti-virus companies, including F-Secure and VirusBuster. If virus distribution methods continue to migrate from email to other formats, there may be less of a demand for our Zero-Hour solution and more of a demand for a Web security product, such as our GlobalView URL filtering solution.

In the market for Web security solutions, there are fewer providers offering somewhat ineffectual “content filtering” solutions (solutions focusing solely on “Black & White” lists) than in the past, and more advanced offerings that compete with our GlobalView URL filtering solution. Web security providers offering forms of software (gateway), multi-functional appliances and managed service solutions and which may be viewed as both competitors and potential customers to Commtouch include McAfee (Secure Computing), WebSense and IBM (ISS/Cobion). Web security providers offering solutions on an OEM basis similar to Commtouch's business model, and which may be viewed as direct competitors, include BrightCloud, RuleSpace and Puresight.

We expect that the markets for messaging and Web security solutions will continue to become more consolidated, with companies increasing their presence in this market or entering ancillary markets by acquiring or forming strategic alliances with our competitors or business partners. Some examples of this in the messaging security field are the acquisitions of IronPort by Cisco, CipherTrust by Secure Computing, Brightmail by Symantec Corp., Microsoft of both Frontbridge and Sybari Software and, more recently, Cloudmark of Bizanga. Some examples of this in the web defense field are the acquisitions of Fastdata by Cisco, SurfControl by WebSense and Secure Computing by McAfee.

See also disclosure under “Item 3. Key Information– RISK FACTORS—Business Risks—We have many established competitors who are offering a multitude of solutions to the problems of spam/virus distribution and Web-related security threats.”

#### Sales and Marketing

We utilize third party distribution channels to sell our products. Generally, our software is provided to OEM customers, who in turn integrate the software into their product or service offerings for sale of our services to their customers. We are paid service fees under a variety of fee structures, including fixed fee and fee sharing arrangements.

Our enterprise anti-spam and Zero-Hour anti-virus gateway product is sold through resellers, who pay us pre-negotiated fees from each sale closed with a reseller's customer.

All Company sales are managed by the Company's and its U.S. subsidiary's business development departments, each of which consists of a department head and a relatively small number of business development professionals. The Company's marketing efforts are aimed mainly at potential OEM customers. The marketing department is concentrated in the Company's Israel office, though our personnel travel internationally in furtherance of the Company's marketing goals.



## Intellectual Property

We regard our patented and patent pending anti-spam and anti-virus technology, copyrights, service marks, trademarks, trade secrets and similar intellectual property as critical to our success, and rely on patent, trademark and copyright law, trade secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights. During 2004, we purchased a United States patent, Patent No. 6,330,590, which we believe to be an integral part of our patent strategy aimed at protecting our proprietary anti-spam technology. During 2005, we filed in the United States an anti-spam related patent application, claiming priority for a prior period based on the filing of U.S. Provisional Patent Application. This application remains outstanding. During 2006, we filed in the United States a patent application relating to the prevention of spam in streaming systems or, in other words, unwanted conversational media sessions (i.e. voice and video related). This provisional application was converted to a formal patent application, which we continue to prosecute with the United States Patent and Trademark Office. During 2008, we filed a U.S. Provisional Patent Application for anti-malware data center aggregate, the subject of which remains unpublished and thus confidential. During 2009, it too converted into a formal patent application. We may seek to patent certain additional software or other technology in the future. We are only actively maintaining our registered trademark for "COMMTOUCH", which is registered in the U.S., Canada, Israel, European Union, China, Taiwan and South Korea. A previous registration of "PRONTO" in Canada is still in force, but we are not maintaining this registration and it will lapse. Since at least September 2003, we have claimed trademark rights in "RPD" and "Recurrent Pattern Detection", as applicable to our messaging security solutions. We have also been claiming trademark rights in Zero-Hour in relation to our virus outbreak detection product (and more recently one of our web security products) and GlobalView in relation to our IP reputation and Web security products.

It may be possible for unauthorized third parties to copy or reverse engineer certain portions of our products or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to the same extent as do the laws of the United States. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competing companies will not independently develop similar technology.

Other parties may assert infringement claims against us. We may also be subject to legal proceedings and claims from time to time in the ordinary course of our business, including claims of alleged infringement by us and/or our customers of the trademarks and other intellectual property rights of third parties. Our customer agreements typically include indemnity provisions, so we may be obligated to defend against third party intellectual property rights infringement claims on behalf of our customers. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

## Government Regulation

Laws aimed at curtailing the spread of spam have been adopted by the United States federal government, i.e. CAN-SPAM Act, and some individual U.S. states, with the CAN-SPAM Act superseding some state laws or certain elements thereof. See also disclosure under "Item 3. Key Information— RISK FACTORS—Business Risks— "Tighter governmental enforcement of regulations could decrease the distribution of unsolicited bulk (spam) email and malicious software and decrease demand for our solutions, or increase our cost of doing business." Despite this legislation, we have not seen abatement in the amount of spam traffic on the Internet; rather, a continuing increase in large numbers that is being distributed in more sophisticated ways. The continuing growth and development of the spam market may prompt calls for even more stringent Internet user protection laws that would limit the ability of companies and individuals promoting or delivering spam online, and thus potentially negatively affect our business.

The propagation of email viruses, whether through email or Web sites, which are aimed at destroying or stealing third party data, is illegal under standard state and federal law outlawing theft, misappropriation, conversion, etc., without the need for special legislation prohibiting such activities on the Internet. Despite the existence of these laws, sources

for Internet viruses continue to spread multi-variant viruses seemingly without much fear of recrimination. New laws providing for more stringent penalties could be adopted in various jurisdictions, but it is unclear what, if any, affect these would have on the anti-virus industry in general and our Zero-Hour Virus Outbreak Detection and GlobalView URL filtering solutions in particular.

Employees

As of December 31, 2009, 2008 and 2007, we had 72, 69 and 60 employees, respectively. None of our U.S. employees are covered by a collective bargaining agreement. As of December 31, 2009, our employees were categorized as follows:

| LOCATION              | General &<br>Administrative | Sales &<br>Marketing | Research &<br>Development | Hosting<br>(Operations) | TOTAL: |
|-----------------------|-----------------------------|----------------------|---------------------------|-------------------------|--------|
| I S R A E L<br>OFFICE | 7                           | 13                   | 37                        | -                       | 57     |
| U.S. OFFICE           | 4                           | 5                    | -                         | 6                       | 15     |

We believe that our relations with our employees are good.

Israeli law and certain provisions of the nationwide collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordinating Bureau of Economic Organizations (the Israeli federation of employers' organizations) apply to Commtouch's Israeli employees. These provisions principally concern the maximum length of the workday and workweek, minimum wages, contributions to a pension fund, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment. Furthermore, pursuant to such provisions, the wages of most of Commtouch's Israeli employees are subject to cost of living adjustments, based on changes in the Israeli Consumer Price Index. The amounts and frequency of such adjustments are modified from time to time. Also, all Israeli employees employed for at least a year commencing in 2009 are entitled to the funding of pension benefits by preset monthly contributions of the employee and the employer. Israeli law generally requires the payment of severance pay upon the retirement or death of an employee or upon termination of employment by the employer or, in certain circumstances, by the employee. We currently fund our ongoing severance obligations by making monthly payments for insurance policies and by an accrual. A general practice in Israel followed by Commtouch, although not legally required, is the contribution of funds on behalf of certain employees to an individual insurance policy known as "Managers' Insurance." This policy provides a combination of savings plan, insurance and severance pay benefits to the insured employee. It provides for payments to the employee upon retirement or death and secures a substantial portion of the severance pay, if any, to which the employee is legally entitled upon termination of employment. Each participating employee contributes an amount equal to 5% of such employee's base salary, and the employer contributes between 13.3% and 15.8% of the employee's base salary. Full-time employees who are not insured in this way are entitled to a savings account, to which each of the employee and the employer makes a monthly contribution of 5% of the employee's base salary. We also provide certain Israeli employees with an Education Fund, to which each participating employee contributes an amount equal to 2.5% of such employee's base salary, and the employer contributes an amount equal to 7.5% of the employee's base salary, up to a certain maximum base salary set by law.

#### Description of Property

All of our facilities are leased. Our headquarters, in Netanya, Israel, is approximately 1,057.4 square meters, and it houses senior management, research and development, sales, marketing and administrative personnel. Our subsidiary's Sunnyvale, California office, which is approximately 4, 527 square feet in size, houses administrative, sales and hosting (operations) personnel.

**Geographic Information**The Company conducts its business on the basis of one reportable segment (see also Note 1 of Notes to the Financial Statements for a brief description of the Company's business) in accordance with ASC 280, "Segment Reporting".

#### Revenues for Last Three Financial Years

See Item 5. Operating and Financial Review and Prospects - "Revenue Sources" and the financial statements included elsewhere in this annual report. Below is a breakdown of our revenues by location (in thousands):

|               | Year December 31, |          |          |
|---------------|-------------------|----------|----------|
|               | 2007              | 2008     | 2009     |
| Israel        | \$ 742            | \$ 1,080 | \$ 1,544 |
| North America | 6,424             | 8,018    | 8,032    |
| Europe        | 2,735             | 3,160    | 3,776    |
| Asia          | 1,038             | 1,497    | 1,508    |
| Other         | 311               | 337      | 329      |

|  |           |           |        |
|--|-----------|-----------|--------|
|  | \$ 11,250 | \$ 14,092 | 15,189 |
|--|-----------|-----------|--------|



We have had only negligible capital expenditures and divestitures in the last three financial years.

Item 4A. Unresolved Staff Comments.

Not applicable

Item 5. Operating and Financial Review and Prospects.

Overview

From 2003 through 2008, the sole focus of our business had been the development and selling, through reseller and OEM distribution channels, of anti-spam, Zero-Hour virus outbreak detection and IP reputation solutions to a wide array of customers. During late 2008, we expanded our focus by way of the release of our first URL filtering solutions for the web security market.

Critical Accounting Policies and Estimates

Operating and Financial Review and Prospects are based upon the Company's consolidated financial statements, which have been prepared in accordance with United States generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Management believes the critical accounting policies and areas that require the most significant judgments and estimates to be used in the preparation of the consolidated financial statements are accounting for stock-based compensation, revenue recognition, commitments and contingencies, valuation of investments and accounting for income taxes .

Accounting for Stock-Based Compensation:

ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statements.

The Company applies ASC 718, and ASC 505-50, "Equity Based Payments to Non-Employees" ("ASC 505-50"), with respect to options and warrants issued to non-employees. ASC 718 requires the use of an option valuation model to measure the fair value of the options and warrants at the measurement date as defined in ASC 505-50.

The Company recognizes compensation expense for the value of its awards on a straight line basis over the requisite service period of each of the awards, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company estimates the fair value of stock options granted using the Black-Scholes option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are the expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free interest rate is based on the yield from U.S. treasury bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

Revenue recognition

The Company derives revenues from Anti-Spam, Zero-Hour™ Virus Outbreak Protection, GlobalView Mail Reputation and GlobalView URL filtering Services. The service component of the Company's solutions is considered essential to the functionality of the software components. Furthermore, the software components cannot be effectively used on a standalone basis, or with a third party's service. The customer has no ability to effectively run the software or the Software Development Kit ("SDK") on its own hardware. As the software portion of the product cannot effectively stand on its own, the Company considers each sale as a service arrangement.

Therefore, revenues from such services are recognized over the service term, which generally includes a term period of one to three years.

Revenue is recognized in accordance with ASC 605, "Revenue Recognition", when the earnings process is complete, as evidenced by an agreement between the customer and the Company, when delivery has occurred or services have been rendered, when the fee is fixed or determinable and when collectability is probable.

We generally use customer purchase orders and contracts to determine the existence of an arrangement. We assess whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the price is subject to refund or adjustment. We assess collectability based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history.

Deferred revenues include unearned amounts received from customers, but not yet recognized as revenues.

#### Commitments and Contingencies

Commtouch periodically records the estimated impacts of various conditions, situations or circumstances involving uncertain outcomes. These events are called "contingencies", and Commtouch's accounting for such events is prescribed by ASC 450 "Contingencies" ("ASC 450 "). ASC 450 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."

ASC 450 does not permit the accrual of gain contingencies under any circumstances. For loss contingencies, the loss must be accrued if (1) information is available that indicates it is probable that the loss has been incurred, given the likelihood of the uncertain future events; and (2) that the amount of the loss can be reasonably estimated.

The accrual of a contingency involves considerable judgment on the part of management. Commtouch uses its internal expertise, and outside experts (such as lawyers, tax specialists and engineers), as necessary, to help estimate the probability that a loss has been incurred and the amount (or range) of the loss. The Company has recorded contingencies in situations where management determined it was probable a loss had been incurred and the amount could be reasonably estimated.

#### Valuation of investments

In 2008, the Company classified its marketable securities in accordance with ASC 320, "Investments-Debt and Equity Securities" ("ASC 320"), as available-for-sale. The marketable securities that were held for the short-term and available for immediate sale were stated at quoted market prices at balance sheet date. The Company's marketable securities consisted of highly-rated auction rate (AAA) securities ("ARS") which were federal backed student loan securities. Available-for-sale securities were carried at fair value, with the unrealized gains and losses, reported in "accumulated other comprehensive income (loss)" in shareholders' equity.

Commencing February 2008, all of the Company's ARSs (comprised of five securities) suffered from failed auctions. On January 5, 2009, all of the Company's marketable securities were purchased by the bank at full par value amounting to a total of \$2 million and by agreeing to the settlement with the bank, the Company essentially stated that it no longer had the intent of holding the ARSs until recovery, as it would recover any unrealized loss through the settlement offer and, accordingly, the ARSs were classified as trading securities as of December 31, 2008.

#### Accounting for income taxes

The Company accounts for income taxes in accordance with FASB ASC Topic 740, "Income Taxes" ("ASC 740"). ASC 740 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to amounts more likely than not to be realized.

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In 2009, a deferred tax asset in the amount of \$2.4 million in respect of loss carry forwards and other temporary differences was created in respect of forecasted taxable income that is more likely than not to be realized in the foreseeable future, based on our established pattern of profitability in the last few years.

Deferred tax assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences if not related to an asset or liability for financial reporting.

ASC 740 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. ASC 740 contains a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. No liability for unrecognized tax benefits was recorded as a result of the implementation of ASC 740.

Accounting for tax positions requires judgments, including estimating reserves for potential uncertainties. We also assess our ability to utilize tax attributes, including those in the form of carry forwards for which the benefits have already been reflected in the financial statements. We do not record valuation allowances for deferred tax assets that we believe are more likely than not to be realized in future periods. While we believe the resulting tax balances as of December 31, 2009 and 2008 are appropriately accounted for, the ultimate outcome of such matters could result in favorable or unfavorable adjustments to our consolidated financial statements.

#### Revenue Sources

We recognize revenues from anti-spam, Zero-Hour virus outbreak detection, GlobalView Reputation and URL filtering/Web security services. Revenues from these services are recognized when persuasive evidence of an arrangement exists, services are provided, the fee is fixed or determinable and collectability is probable. Revenues derived from these services are recognized ratably over the life of the service period.

#### Results of Operations

The following table sets forth financial data for the years ended December 31, 2007, 2008 and 2009 (in thousands):

|                                                 | 2007      | 2008      | 2009      |
|-------------------------------------------------|-----------|-----------|-----------|
| Revenues                                        | \$ 11,250 | \$ 14,092 | \$ 15,189 |
| Cost of revenues                                | 1,411     | 1,828     | 2,260     |
| Gross profit                                    | 9,839     | 12,264    | 12,929    |
| Operating expenses:                             |           |           |           |
| Research and development, net                   | 2,187     | 3,152     | 2,958     |
| Sales and marketing                             | 3,453     | 3,992     | 4,212     |
| General and administrative                      | 2,589     | 3,189     | 3,063     |
| Total operating expenses                        | 8,229     | 10,333    | 10,233    |
| Operating income                                | 1,610     | 1,931     | 2,696     |
| Financial income (expenses), net                | 527       | 346       | 60        |
| Net income before taxes on income (tax benefit) | 2,137     | 2,277     | 2,756     |
| Taxes on income (tax benefit)                   | 28        | 7         | (2,404)   |

|                                                                                 |    |       |    |       |    |       |
|---------------------------------------------------------------------------------|----|-------|----|-------|----|-------|
| Net income attributable to ordinary and equivalently participating shareholders | \$ | 2,109 | \$ | 2,270 | \$ | 5,160 |
|---------------------------------------------------------------------------------|----|-------|----|-------|----|-------|

Comparison of Years Ended December 31, 2009 and 2008

**Revenues.** Revenues increased by \$1.1 million from \$14.1 million in 2008 to \$15.2 million in 2009. The increase is mainly due to a growth in market share, especially in the international (non-U.S.) markets and due to sales derived from our Web security product launched in the fourth quarter of 2008. The number of parties we signed OEM agreements with increased by 29 in 2009 and amounted to 135 as of December 31, 2009, 18 of which are in respect of our Web security products.

**Cost of Revenues.** Cost of revenues increased by \$0.5 million from \$1.8 million in 2008 to \$2.3 million in 2009. The increase in 2009 is mainly due to higher facility costs and hosting expenses following the opening of a fifth data center in the U.S. aimed to serve the increasing number of customers. Cost of revenues increased in 2009 to a greater extent than the sales in 2009 due to economies of scale, i.e., most costs of revenues are fixed and are not affected by increases or decreases in revenues.

**Research and Development, net.** Research and development expenses decreased by 6% and amounted to \$3.0 million in 2009 compared to \$3.2 million in 2008. The decrease is mainly due to approval of a \$0.5 million OCS grant, which reduced our payroll cost in \$0.3 million during 2009; however, this decrease was offset by an increase due to recruitment of additional employees to support the company's efforts to develop new products. Research and development expenses include \$0.3 million of expenses in connection with ASC 718.

**Sales and Marketing.** Sales and marketing expenses increased by 6% and amounted to \$4.2 million compared to \$4.0 million in 2008. The increase is mainly due to recruitment of employees and increased selling and marketing activity. In 2009, sales and marketing expenses included \$0.3 million expenses in connection with ASC 718.

**General and Administrative.** General and administrative expenses decreased by 4% from \$3.2 million in 2008 to \$3.1 million in 2009. The decrease is mainly due to a decrease in expenses related to ASC 718. In 2009, general and administrative expenses included \$0.7 million expenses in connection with ASC 718.

**Financial Income (Expenses), Net.** Financial income (expenses), net, decreased by 83% from income of \$0.3 million in 2008 to income of \$60,000 in 2009. The decrease is primarily due to less interest income derived from declining interest rates throughout 2009 earned on the company's cash deposits.

**Taxes on income (tax benefit).** In 2009, a deferred tax asset in the amount of \$2.4 million in respect of loss carry forwards and other temporary differences was created in respect of forecasted taxable income that is more likely than not to be realized in the foreseeable future, based on our established pattern of profitability in the last few years.

Comparison of Years Ended December 31, 2008 and 2007

**Revenues.** Revenues increased by \$2.8 million from \$11.3 million in 2007 to \$14.1 million in 2008. The increase is mainly due to a growth in market share, especially in the international market. The number of OEMs increased by 32 in 2008 and amounted to 116 as of December 31, 2008.

**Cost of Revenues.** Cost of revenues increased by \$0.4 million from \$1.4 million in 2007 to \$1.8 million in 2008. The increase in 2008 is mainly due to higher facility costs and hosting expenses following the open of a fourth data center in Japan aiming to serve the increasing number of customers. Cost of revenues did not increase in the same proportion as sales in 2008 due to economies of scale. Most costs of revenues are fixed and are not affected by increases or decreases in revenues.

**Research and Development, net.** Research and development expenses increased by 44% and amounted to \$3.2 million in 2008 compared to \$2.2 million in 2007. The increase is due to recruitment of more employees as part of the

Company's decision to develop new products. Research and development expenses include \$319,000 of expenses in connection with ASC 718.

**Sales and Marketing.** Sales and marketing expenses increased by 16% and amounted to \$4.0 million compared to \$3.5 million in 2007. The increase is mainly due to recruitment of employees and increased selling and marketing activity. In 2008, sales and marketing expenses included \$298,000 expenses in connection with ASC 718.

**General and Administrative.** General and administrative expenses increased by 23% from \$2.6 million in 2007 to \$3.2 million in 2008. The increase is mainly due to the recruitment of two new employees. In 2008, general and administrative expenses included \$833,000 expenses in connection with ASC 718.



Financial Income (Expenses), Net. Financial income (expenses), net, decreased by 34% from income of \$527,000 in 2007 to income of \$346,000 in 2008. The decrease is primarily due to less interest income derived from declining interest rates throughout 2008, earned on the company's cash deposits.

#### Quarterly Results of Operations (Unaudited)

The following table sets forth certain unaudited quarterly statements of operations data for the eight quarters ended December 31, 2009. This information has been derived from the Company's consolidated unaudited financial statements, which, in management's opinion, have been prepared on the same basis as the audited consolidated financial statements, and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the quarters presented. This information should be read in conjunction with our audited consolidated financial statements and the notes thereto included elsewhere in this report. The operating results for any quarter are not necessarily indicative of the operating results for any future period.

|                                                                                 | Three Months Ended |                  |                   |                  |                  |                 |                   |                  |
|---------------------------------------------------------------------------------|--------------------|------------------|-------------------|------------------|------------------|-----------------|-------------------|------------------|
|                                                                                 | Mar. 31,<br>2008   | Jun. 30,<br>2008 | Sept. 30,<br>2008 | Dec. 31,<br>2008 | Mar. 31,<br>2009 | Jun 30,<br>2009 | Sept. 30,<br>2009 | Dec. 31,<br>2009 |
| (in thousands)<br>(unaudited)                                                   |                    |                  |                   |                  |                  |                 |                   |                  |
| Revenues                                                                        | \$ 3,401           | \$ 3,568         | \$ 3,622          | \$ 3,501         | \$ 3,543         | \$ 3,733        | \$ 3,899          | \$ 4,014         |
| Cost of revenues                                                                | 449                | 459              | 466               | 454              | 513              | 516             | 596               | 635              |
| Gross profit                                                                    | 2,952              | 3,109            | 3,156             | 3,047            | 3,030            | 3,217           | 3,303             | 3,379            |
| Operating expenses:                                                             |                    |                  |                   |                  |                  |                 |                   |                  |
| Research and development, net                                                   | 781                | 792              | 780               | 799              | 786              | 765             | 806               | 601              |
| Sales and marketing                                                             | 1,015              | 967              | 1,043             | 967              | 998              | 1,022           | 1,025             | 1,167            |
| General and administrative                                                      | 869                | 839              | 797               | 684              | 732              | 746             | 772               | 813              |
| Total operating expenses                                                        | 2,665              | 2,598            | 2,620             | 2,450            | 2,516            | 2,533           | 2,603             | 2,581            |
| Operating income                                                                | 287                | 511              | 536               | 597              | 514              | 684             | 700               | 798              |
| Financial income (expenses), net                                                | 120                | 71               | 108               | 47               | (78)             | 12              | 149               | (23)             |
| Net income                                                                      | 407                | 582              | 644               | 644              | 436              | 696             | 849               | 775              |
| Taxes on income (tax benefit)                                                   | 7                  | —                | —                 | —                | -                | -               | -                 | (2,404)          |
| Net income attributable to ordinary and equivalently participating shareholders | \$ 400             | \$ 582           | \$ 644            | \$ 644           | \$ 436           | \$ 696          | \$ 849            | \$ 3,179         |
| Basic                                                                           |                    |                  |                   |                  |                  |                 |                   |                  |
| Net income per share                                                            | \$ 0.02            | \$ 0.02          | \$ 0.02           | \$ 0.03          | \$ 0.02          | \$ 0.03         | \$ 0.03           | \$ 0.13          |
| Diluted net income per share                                                    | \$ 0.01            | \$ 0.02          | \$ 0.02           | \$ 0.02          | \$ 0.02          | \$ 0.03         | \$ 0.03           | \$ 0.13          |

#### New Accounting Pronouncements

In June 2009, the FASB issued ASC 105, "Generally Accepted Accounting Principles" ("ASC 105"). ASC 105 establishes the FASB Accounting Standards Codification, which will become the source of authoritative U.S. GAAP recognized by the FASB. Following this statement, the FASB will issue new standards in the form of Accounting Standards Updates ("ASUs"). ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of ASC 105 did not have any impact on the Company's financial statements, as it does not modify GAAP, except for the specific references to GAAP literature in the notes to the Company's consolidated financial statements.

In October 2009, the FASB issued an update to ASC 985-605, "Software-Revenue Recognition" (originally issued as EITF 09-3). In accordance with the update to the ASC, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the scope of the software revenue recognition guidance. In addition, hardware components of a tangible product containing software component are always excluded from the software revenue guidance. The mandatory adoption of this update is effective on January 1, 2011. The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. In such case the Company must also early adopt the amendment to ASC 605-25 with respect to multiple-elements arrangements. The Company does not expect the adoption of the update to have a material impact on its financial condition or results of operations.

In October 2009, the FASB issued an update to ASC 605-25, "Revenue recognition – Multiple-Element Arrangements", which amended the criteria for separating consideration in multiple-deliverable arrangements to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated and how the consideration should be allocated;
- Require an entity to allocate revenue in an arrangement using estimated selling prices ("ESP") of deliverables if a vendor does not have vendor-specific objective evidence of selling price ("VSOE") or third-party evidence of selling price ("TPE");
- Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and
- Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. The Company is currently evaluating the impact on its consolidated results of operations and financial condition.

#### Liquidity and Capital Resources

We have financed our operations from positive operating cash flows, the issuance of equity securities and, to a lesser extent, from private loans and research and development grants from the Israeli government.

As of December 31, 2008 and December 31, 2009, we had approximately \$16.4 million and \$17.3 million of cash and cash equivalents and marketable securities, respectively. The increase was mainly due to positive operating cash flow of \$5.1 million and receipt of proceeds from the exercise of warrants and options in the amount of \$0.2 million, less \$3.5 million expended in our Ordinary Share buyback plan (see discussion under Item 16E. "Purchases of Equity Securities by the Issuer and Affiliated Purchasers").

In 2009, net cash provided by operating activities was approximately \$5.1 million. The increase in operating cash flow was mainly due to our net income in 2009. Net cash used in financing activities in 2009 was approximately \$3.3 million, net of the share buyback activity. Net cash provided by investing activities in 2009 was \$1.9 million and consisted primarily of a sale of marketable securities of \$2.0 million, investment of \$0.5 million in Mirapoint Software, Inc. – one of our OEM customers, a decrease in short term cash deposits of \$0.7 million, and purchase of property and equipment in the amount of \$0.4 million. As of December 31, 2008 and December 31, 2009, we had working capital of \$14.8 million and \$16.9 million, respectively.

As of December 31, 2008, marketable securities of the Company represented short-term municipal ARS, which were purchased at par (100) and were valued at par (100). They were all invested in triple A rated securities. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Commencing February 2008, the ARS (comprised of five securities) suffered from failed auctions. On January 5, 2009, the Company's entire ARS portfolio was purchased by the issuing bank at full par value, amounting to a total of \$2 million. Therefore, there was no effect on the statement of operations in 2008 and 2009 from such securities.

Based on the cash balance at December 31, 2009, current projections of revenues and related expenses, the Company believes it has sufficient cash to continue operations at least through March 2011.

#### Contractual obligations

The following table summarizes our outstanding contractual obligations as of December 31, 2009 (in thousands):

| Contractual Obligation                                                                             | Payments due by period<br>(USD in thousands) |                     |           |           |                      |
|----------------------------------------------------------------------------------------------------|----------------------------------------------|---------------------|-----------|-----------|----------------------|
|                                                                                                    | Total                                        | Less than 1<br>year | 1-3 years | 3-5 years | More than 5<br>years |
| Operating lease obligation                                                                         | \$ 612                                       | \$ 478              | \$ 134    | \$ -      | \$ -                 |
| Other Long-term liabilities reflected on the<br>Company's Balance Sheet - Accrued<br>severance pay | 1,050                                        | -                   | -         | -         | 1,050                |
| Other Long-term asset reflected on the<br>Company's Balance Sheet - severance pay<br>fund          | (945))                                       | -                   | -         | -         | (945)                |
| Net - severance pay liability                                                                      | 105                                          | -                   | -         | -         | 105                  |
| Total                                                                                              | \$ 717                                       | \$ 478              | \$ 134    | \$ -      | \$ 105               |

#### Effective Corporate Tax Rates

The Company is subject to company tax on its taxable income. The applicable rate was 29% in 2007, 27% in 2008 and 26% in 2009, is 25% in 2010, and is scheduled to decline to 24% in 2011, 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter.

As of December 31, 2009, the Company's net operating loss carryforwards for tax purposes amounted to approximately \$ 76,000, which may be carried forward and offset against taxable income in the future, for an indefinite period.

As of December 31, 2009, for federal income tax purposes, the U.S. subsidiary had net operating loss carry-forwards of approximately \$ 92,000. These losses may offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2011 through 2025.

Utilization of U.S. net operating losses may be subject to substantial annual limitation due to a "change in ownership" under provisions of the Internal Revenue Code of 1986 and similar state provisions. Such limitation might result in the loss of some or all of our U.S. net operating losses.

## Impact of Inflation and Currency Fluctuations

Most of our sales are in U.S. dollars, and the rest are mainly in Euros. However, a portion of our costs relate to our operations in Israel. A substantial portion of our operating expenses in Israel, primarily our research and development expenses are denominated in NIS. Costs and revenues not denominated in U.S. dollars are re-measured to U.S. dollars, when recorded, at prevailing rates of exchange. This is done for the purposes of our financial statements and reporting. As a result, we are exposed to risk to the extent that the value of the U.S. dollar decreases against the NIS. In that event, the U.S. dollar cost of our operations will increase and our U.S. dollar-measured results of operations will be adversely affected, as occurred in the first half of 2008, when the NIS appreciated against the U.S. dollar, which resulted in a significant increase in the U.S. dollar cost of our operations. Also, in the event that the U.S. dollar appreciates against the Euro, our revenues will decrease. Consequently, we are and will be affected by changes in the prevailing NIS/U.S. dollar and Euro/ U.S. dollar exchange rates.

The annual rate of inflation in Israel was 3.9% in 2009, 3.8% in 2008 and 3.4% in 2007. The NIS appreciated against the U.S. dollar by approximately (0.7%) in 2009 and (1.1%) in 2008 and (8.9%) in 2007. The representative dollar exchange rate for converting the NIS to U.S. dollars, as reported by the Bank of Israel, was NIS 3.775 for one U.S. dollar on December 31, 2009. The representative dollar exchange rate was NIS 3.722 at March 16, 2010. Because exchange rates between the NIS and the dollar fluctuate continuously, exchange rate fluctuations and especially larger periodic devaluations will have an impact on our operating results and period-to-period comparisons of our results. The effects of foreign currency re-measurements are reported in the consolidated financial statements for relevant periods in the statement of operations.

## Item 6. Directors, Senior Management and Employees

The following table presents information with respect to our directors' beneficial ownership of our Ordinary Shares as of December 31, 2009. Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each director is based on 23,958,761 Ordinary Shares outstanding as of December 31, 2009. Ordinary Shares issuable upon exercise of options and other rights held and exercisable on or within sixty days of December 31, 2009 are deemed outstanding for the purpose of computing the percentage ownership of the director holding those options and other rights.

| Name and Position                     | Age | Ordinary Share Beneficial Ownership >1% | Number of Ordinary Shares Beneficially Owned | Number of Options and Warrants included in Beneficial Ownership                                                                                                                                                                 |
|---------------------------------------|-----|-----------------------------------------|----------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Amir Lev, Director, President and CTO | 49  | 3.3%                                    | 811,157                                      | 650,006 options, at exercise prices ranging from \$0.36 to \$6.60 per Ordinary Share. Expiration dates range from 12/30/11 to 8/4/15                                                                                            |
| Aviv Raiz, Director (1)(4)            | 51  | 22.8%                                   | 5,562,740                                    | 76,871 options, at exercise prices ranging from \$1.58 to \$6.60 per Ordinary Share. Expiration dates range from 12/30/11 to 10/26/15. Also, 333,333 warrants, with an exercise price of \$1.95, expiring in early October 2010 |

|                                                                       |    |      |           |                                                                                                                          |
|-----------------------------------------------------------------------|----|------|-----------|--------------------------------------------------------------------------------------------------------------------------|
| Gideon Mantel,<br>Director,<br>Chairman of the<br>Board and<br>CEO(4) | 50 | 5.5% | 1,365,643 | 962,617 options, at exercise prices ranging<br>from \$0.0375 to \$6.60. Expiration dates range<br>from 8/15/11 to 8/4/15 |
|-----------------------------------------------------------------------|----|------|-----------|--------------------------------------------------------------------------------------------------------------------------|

|                                                                   |    |      |           |                                                                                                                     |
|-------------------------------------------------------------------|----|------|-----------|---------------------------------------------------------------------------------------------------------------------|
| Hila Karah,<br>Director(1)(3)                                     | 41 | <1%  | <1%       |                                                                                                                     |
| Lloyd E.<br>Shefsky,<br>Director(2)(3)(5)                         | 69 | 1.5% | 365,485   | 135,205 options, at exercise prices ranging from \$1.17 to \$6.60. Expiration dates range from 12/30/11 to 10/26/15 |
| Yair Shamir,<br>Director<br>(Outside<br>Director)<br>(2)(3)(4)(6) | 65 | 4.7% | 1,200,241 | 27,913 options, at exercise prices ranging from \$1.58 to \$4.10. Expiration dates range from 3/31/14 to 10/26/15   |
| Yair Bar-Touv,<br>Director<br>(Outside<br>Director) (1)(2)        | 49 | <1%  | <1%       |                                                                                                                     |

(1) Member of the Compensation Committee

(2) Member of the Audit Committee

(3) Member of the Nominating Committee

(4) Member of the Investment Committee

(5) Mr. Shefsky's ownership information includes his individual holdings and holdings of LENE L.P. (134,265 Ordinary Shares), in which Mr. Shefsky currently holds a relatively nominal, limited partnership interest.

(6) Mr. Shamir's ownership interest includes 1,089,783 Ordinary Shares purchased by Catalyst Private Equity Partners II, for which Mr. Shamir acts as Chairman and Managing Partner. Mr. Shamir's options, as noted in the table above, are also held on behalf of Catalyst.

#### Other Senior Management Employees:

The following table sets forth the names and positions of our senior management employees, with ownership data being as of December 31, 2009:

| Name              | Age | Ownership >1%   | Position                                                                |
|-------------------|-----|-----------------|-------------------------------------------------------------------------|
| Gideon Mantel     | 50  | See table above | CEO and Chairman of the Board                                           |
| Amir Lev          | 49  | See table above | President and Chief Technical Officer                                   |
| Ron Ela           | 39  | (1)             | Chief Financial Officer                                                 |
| Ido Hadari        | 36  | (1)             | Chief Operating Officer                                                 |
| Gary Davis        | 48  | (1)             | Vice President, General Counsel and Corporate Secretary                 |
| Ronen Rosenblatt  | 44  | (1)             | Vice President, Research and Development Commtouch Software Ltd.        |
| Francois Depayras | 37  | (1)             | Vice President, Americas Sales and Business Development, Commtouch Inc. |
| Ofer Tal          | 39  | (1)             |                                                                         |



|                 |    |     |                                                                                                                                                                 |
|-----------------|----|-----|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Yossi Maslaton  | 43 | (1) | Vice President, International Sales and Business Development, Commtouch Software Ltd.<br>Vice President, Network Operations & Customer Services, Commtouch Inc. |
| Asaf Greiner    | 36 | (1) | Vice President, Products, Commtouch Software Ltd.                                                                                                               |
| Rebecca Herson  | 40 | (1) | Vice President, Marketing, Commtouch Software Ltd.                                                                                                              |
| Gabriel Mizrahi | 36 | (1) | Vice President, Technologies, Commtouch Software Ltd.                                                                                                           |

(1) less than 1%

Amir Lev is a co-founder of Commtouch and has served as its Chief Technology Officer and as a Director since its inception in 1991. Mr. Lev was also the General Manager of Commtouch from January 1997 through April 2000, and in May 2000 became President. Mr. Lev received a B.A. in Computer Science and Economics from Hebrew University, Jerusalem.

Aviv Raiz has served as a Director since December 2005. He is the founder and President of Eurotrust Ltd. Mr. Raiz has been active in the foreign exchange markets for the past twenty years, and has been a private equity investor in several high-tech, bio-tech and Internet companies for the past ten years. He holds an M.B.A. from Tel Aviv University.

Gideon Mantel is a co-founder of Commtouch and served as its Chief Financial Officer from its inception in February 1991 until October 1995, when he became Commtouch's Chief Operating Officer. In November 1997, he became Commtouch's Chief Executive Officer, and in December 2006, he was confirmed as Chairman of the Board. He has also served as a Director of Commtouch since inception. Mr. Mantel received a B.A. in Political Science and an M.B.A. from Tel Aviv University.

Hila Karah joined the Board of Directors in March 2008. Ms. Karah has been the CIO of Eurotrust Ltd. since 2006, and has been a private and public equity investor in several high-tech, bio-tech and Internet companies since 2000. Prior to her joining Eurotrust, she served as a partner financial analyst at Perceptive Life Sciences Ltd., a New York-based hedge fund. Prior to her position at Perceptive, Ms. Karah was a research analyst at Oracle Partners Ltd., a health care-focused hedge fund based in Connecticut. Ms. Karah holds a BA in Molecular and Cell Biology from the University of California, Berkeley, and has studied at the UCB-UCSF JMP.

Lloyd E. Shefsky has served as a Director of Commtouch since October 2003. He is a Clinical Professor of Entrepreneurship and Co-Director of the Center for Family Enterprises at the Kellogg School of Management and has taught in several countries. In 1970, he founded the Chicago law firm, Shefsky & Froelich Ltd., where has been Of Counsel since 1996. Since 1981 he has represented the Government of Israel throughout the Midwestern U.S. For nearly forty years he has represented hundreds of entrepreneurs and their companies, and during the past twenty-five years, such representation has included numerous Israeli companies with U.S. operations. Mr. Shefsky authored *Entrepreneurs Are Made Not Born*, which was translated into five foreign languages. He received his J.D. from the University of Chicago Law School, a B.S.C. from De Paul University (accounting), is a member of the Illinois and Florida Bars, and has a CPA certificate in Illinois.

Yair Shamir joined the Board of Directors as an Outside Director under the Israel Companies Law in March 2008. Mr. Shamir is the Chairman and Managing Partner of Catalyst Investments and the Chairman of IAI, Israeli Aerospace Industries. From 2004 to 2005, Mr. Shamir was Chairman of El Al, Israeli Airlines and lead the privatization process of the firm. From 1997 to 2005, Mr. Shamir served as Chairman and CEO of VCON Telecommunications Ltd. From 1995 to 1997, Mr. Shamir served as executive vice president of the Challenge Fund-Etgar L.P. From 1994 to 1995, he served as Chief Executive Officer of Elite Food Industries, Ltd. From 1988 to 1993, Mr. Shamir served as Executive Vice President and General Manager of Scitex Corporation, Ltd. Mr. Shamir served in the Israeli Air Force as a pilot and commander from 1963 to 1988. During his term in the Air Force, Mr. Shamir attained the rank of colonel and served as head of the electronics department, the highest professional electronics position within the Air Force. He currently serves as a director of DSP Group Corporation and also serves as director of other private hi-tech companies. Mr. Shamir holds a B.Sc. Electronics Engineering from the Technion, Israel Institute of Technology.

Yair Bar-Touv joined the Board of Directors as an Outside Director under the Israel Companies Law in March 2008. Mr. Bar-Touv is formerly the CIO of a leading government enterprise specializing in analytic software solutions for knowledge discovery (text and data mining) of large volumes of data, with a focus on changing the ways enterprise organizations make decisions with regards to primary business processes. Mr. Bar-Touv is also the former CEO of Elron Telesoft and co-CEO of NCC, a leading Systems Integrator operating in Israel and the USA, which was acquired in 1997 by Elron Electronics. Mr. Bar-Touv holds an M.Sc in Computer Engineering from the Technion Institute of Technology (1987) and a B.Sc in Electronic Engineering from Ben-Gurion University (1981).

Ron Ela joined Commtouch in July 2006 as its Chief Financial Officer. A Certified Public Accountant, Mr. Ela formerly held management positions at two Israeli-based NASDAQ listed companies, and most recently held the role of Controller at Verint Systems Ltd., a wholly-owned subsidiary of Verint Systems Inc. During the five years prior to that time, Mr. Ela served as Deputy Controller and subsequently Controller for Partner Communication Ltd. Also, Mr. Ela spent 3 years in public accounting with Kesselman & Kesselman, a member of PricewaterhouseCoopers in Israel. Mr. Ela has a B.A. in business administration majoring in accounting from the College of Management Academic Studies.

Ido Hadari joined Commtouch in 2008, as Vice President, International Sales and Business Development and since November 2009 is serving as Chief Operating Officer. Mr. Hadari has over a decade of business management and sales experience, most recently at Interwise, an enterprise voice and web conferencing provider that was acquired by AT&T. At Interwise, where he worked for eight years, he held various senior business development and channel management positions with responsibilities for regional sales in Europe and Asia, and global strategic alliances. He holds a BA magna cum laude in Business Administration and Economics from Hebrew University, Jerusalem.

Gary Davis joined Commtouch in September 1999 and serves as Vice President, General Counsel and Corporate Secretary. Mr. Davis has over 20 years of legal experience in both private law firm and corporate practices. Mr. Davis is certified to practice law in both the State of Israel and California. Prior to September 1999, Mr. Davis was in-house counsel to Israel Military Industries and Elta Electronics Industries. He received a B.A. in Political Economy of Industrial Societies from U.C. Berkeley and a J.D. in law from Golden Gate University.

Ronen Rosenblatt rejoined Commtouch in January 2009 and serves as Vice President, Engineering. For the past 18 years, he has held executive positions in the Israeli hi-tech industry ranging from start-ups to publically traded companies. Mr. Rosenblatt served as VP of research and development at Commtouch in its early stages until 2000 and most recently, he served as Vice President of research and development at NiceVision, a division of Nice Systems. Previously, Mr. Rosenblatt served in technology and business executive roles in several startup companies, including Xacct, a provider of industry-leading mediation software for telecom service providers that was acquired by Amdocs, Savantis, and Gigaspaces. He earned a Bachelor of Science degree from Tel-Aviv University and an Executive MBA from the Recanati School of Business.

Francois Depayras re-joined Commtouch in 2010 as Vice President, Americas Sales and Business Development. Mr. Depayras has over a decade of experience in the messaging market, from leadership roles at Critical Path and Ensim as well as his prior affiliation with Commtouch. At Critical Path, Mr. Depayras served as Senior Product Manager, responsible for the development of a hosted email solution targeting large enterprises. He then served as Vice President of Sales and Alliances at Ensim, where he was responsible for managing worldwide sales of user provisioning software solutions targeting both service providers and enterprises, and managed relationships with strategic partners. Prior to these positions, Mr. Depayras worked at Commtouch for four years in a variety of roles, his last post being Director of Business Development. He holds an MBA from San Francisco State University.

Ofer Tal joined Commtouch in 2009 as Vice President, International Sales & Business Development. Mr. Tal is an experienced business development & sales executive with nearly a decade of global experience in technology solutions across EMEA. Most recently prior to Commtouch, he served as Senior Director of Channel Sales and then

Director of Sales, SEMEA at GigaSpaces Technologies. Prior to GigaSpaces, he held various senior business development and sales positions at Interwise, an enterprise voice and web conferencing provider that was acquired by AT&T. He holds an LL.B from the University of Tel Aviv School of Law.

Yossi Maslaton joined Commtouch in 1998 and has served as Vice President of Network Operations and Customer Services since early 2005. Before 2005 he was Director of Service Operations. With over 20 years of experience in the fields of Information Technology and Networking, Mr. Maslaton is responsible for the operations of Commtouch's data centers and customer services, servicing tens of millions of users daily with the highest standards of uptime. From 1991 to 1998 Mr. Maslaton was Manager of Information Systems and labs for RND Networks, a group of hi-tech startups in the network-routing field. Prior to that, Mr. Maslaton managed the technical field-operations of a large project for the Israel Defense Forces in the areas of distributed computing systems and radio communications.

Asaf Greiner joined Commtouch in 2008 and serves as Vice President, Products. Mr. Greiner has over a decade of experience in executive and entrepreneurial roles, previously serving as Director of Business Innovation at Aladdin Knowledge Systems, a company specializing in software and Internet security. Previously he co-founded and acted as general manager of beeFENCE, a network security company, and Aduva, a Linux lifecycle management company that was acquired by SUN Microsystems. He holds an MBA summa cum laude from The Interdisciplinary Center, Herzliya and a BA in Business and Economics from Hebrew University, Jerusalem.

Rebecca Steinberg Herson joined Commtouch in April 2006 as Director of Marketing. Currently, she serves as Vice President, Marketing, orchestrating the company's global marketing strategy and activities. Prior to joining Commtouch, Ms. Herson served as Vice President of Marketing at Redmatch, a software start-up. Previously, she led marketing initiatives at Whale Communications (acquired in 2006 by Microsoft), Orkit Communications (NASDAQ: ORCT) and at various not-for-profit organizations. As the head of marketing for six years at Whale, an Internet security company, she was responsible for launching numerous hardware/software products and held a key role in establishing the company as a market leader in the secure remote access field. Ms. Herson holds a BA magna cum laude from Yale University, and an MS in Management from Boston University.

Gabriel Mizrahi joined Commtouch in 2008 and serves as Vice President, Technologies. Prior to Commtouch, Mr. Mizrahi co-founded and served as CTO of PineApp, a global messaging and Web security company that utilizes Commtouch's technology. Prior to PineApp, Mr. Mizrahi was a Project Manager in a large integration company, where he led Unix and Linux projects in the field of Internet Security & Networking. He has extensive technical knowledge and experience in tailor-made solutions and complex technology integration, and received a prestigious award from the Chief of Electronics and Computers of the Israel Defense Force for designing, developing and implementing a logistics and technical management system. Mr. Mizrahi holds a technical degree in electronics from Ort College.

#### Election of Directors

Directors (other than outside directors, as explained below) are elected by shareholders at the annual general meeting of the shareholders and hold office until the next annual general meeting following the general meeting at which such director is elected and until a successor is elected, or until the director is removed. An annual general meeting must be held at least once in every calendar year, but not more than fifteen months after the preceding annual general meeting. Directors may be removed and other directors may be elected in their place or to fill vacancies in the Board of Directors at any time by the holders of a majority of the voting power at a general meeting of the shareholders. Until a vacancy is filled by the shareholders, the Board of Directors may appoint new directors temporarily to fill vacancies on the Board of Directors. The Amended and Restated Articles of Association of Commtouch authorize the shareholders to determine, from time to time, the number of directors. The maximum number of directors is currently fixed at ten directors, though only seven directors are currently serving on the Board of Directors. There are no family relationships among any of the directors, officers or key employees of Commtouch.

#### Alternate Directors

The Amended and Restated Articles of Association of Commtouch provide that any director may appoint another person to serve as an alternate director and may remove such alternate. Any alternate director possesses all the rights and obligations of the director who appointed him, except that the alternate has no standing at any meeting while the appointing director is present, the alternate may not in turn appoint an alternate for himself (unless the instrument appointing him otherwise expressly provides) and the alternate is not entitled to remuneration. A person who is not qualified to be appointed as a director may not be appointed as an alternate director. Unless the appointing director limits the time or scope of the appointment, the appointment is effective for all purposes until the appointing director ceases to be a director or terminates the appointment. The appointment of an alternate director does not in itself diminish the responsibility of the appointing director as a director.



## Independent and Outside Directors

The Israel Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint at least two outside directors. No person may be appointed as an outside director if the person or the person's relative, partner, employer or any entity under the person's control has or had, on or within the two years preceding the date of the person's appointment to serve as outside director, any affiliation with the company or any entity controlling, controlled by or under common control with the company. The term affiliation includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder.

No person may serve as an outside director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an outside director or may otherwise interfere with the person's ability to serve as an outside director. If, at the time outside directors are to be appointed, all current members of the Board of Directors are of the same gender, then at least one outside director must be of the other gender. At least one of the outside directors is required to have "financial and accounting expertise," unless another member of the audit committee, who is an independent director under the NASDAQ Listing Rules, has "financial and accounting expertise," and the other outside director or directors are required to have "professional expertise," all as defined under the Israel Companies Law.

Outside directors are to be elected by a majority vote at a shareholders' meeting, provided that either:

• such majority includes at least one-third of the shares held by non-controlling shareholders who are present and voting at the meeting; or

• the total number of shares held by non-controlling shareholders voting against the election of the director at the meeting does not exceed one percent of the aggregate voting rights in the company.

The initial term of an outside director is three years and may be extended for an additional period of three years. Outside directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the outside director ceases to meet the statutory qualifications for their appointment or if they violate their fiduciary duty to the company. Each committee of a company's Board of Directors must include at least one outside director and the audit committee (the existence of which is required under the Israel Companies Law) must include all outside directors. An outside director is entitled to compensation as provided in the regulations adopted under the Israel Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an outside director.

Mr. Shamir and Mr. Bar-Touv currently serve as the Company's outside directors.

In addition, the NASDAQ Listing Rules currently require Commtouch to have at least a majority of independent directors, as defined under Listing Rule 5605(a)(2), on the Board of Directors and to maintain an audit committee of at least three members, each of whom must:

- (i) be independent as defined under Listing Rule 5605(a)(2);

- (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Securities Exchange Act of 1934, as amended, or “Exchange Act”, as set forth below (subject to the exemptions provided in Exchange Act Rule 10A-3(c));
- (iii) not have participated in the preparation of the financial statements of the Company or any current subsidiary of the Company at any time during the past three years; and
- (iv) be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement and cash flow statement.

Under limited circumstances, the Company may have one audit committee member not independent in accordance with the above, but such a member would only be able to serve for a maximum of two years.



Exchange Act Rule 10A-3(b)(1) requires that members of the audit committee meet that rule's definition of independence, which requires that an audit committee member may not, except in his or her capacity as a director or committee member, (i) accept directly or indirectly any consulting, advisory, or other compensatory fee from the Company or any of its subsidiaries (except for fixed amounts of compensation under a retirement plan for prior service with the Company, provided that such compensation is not contingent in any way on continued service), and (ii) be an "affiliated person" of the Company or any of its subsidiaries.

NASDAQ rules also require that the Company certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. Also, the Company is required to disclose whether or not it has an "audit committee financial expert" on its audit committee, as defined under Item 16A to Form 20-F.

The three directors who serve on our audit committee, Mr. Shamir, Mr. Bar-Touv and Mr. Shefsky, qualify as independent directors under NASDAQ Listing Rules (including Exchange Act Rule 10A-3). Furthermore, Mr. Shamir and Mr. Bar-Touv meet the qualification requirements for outside directors, as required under the Israel Companies Law.

The Company has identified the following Board members as "Independent directors" pursuant to NASDAQ Listing Rule 5605(a)(2):

- |    |               |
|----|---------------|
| a. | Yair Bar-Touv |
| b. | Yair Shamir   |
| c. | Aviv Raiz     |
| d. | Hila Karah    |
| e. | Lloyd Shefsky |

Pursuant to the Israeli Companies Law, an Israeli company, whose shares are publicly traded, may elect to adopt a provision in its articles of association pursuant to which a majority of its board of directors will constitute individuals complying with certain independence criteria prescribed by the Israel Companies Law. We have not included such a provision in our articles of association since our board of directors complies with the independence requirements of the NASDAQ and Securities and Exchange Commission regulations described above.

#### Audit Committee

As noted above in the discussion under "Independent and Outside Directors", the Israel Companies Law requires public companies to appoint an audit committee. The responsibilities of the audit committee include identifying irregularities in the management of the Company's business, approving management compensation and approving related party transactions as required by law. An audit committee must consist of at least three directors meeting the independence standards under the NASDAQ Listing Rules and must include all outside directors under the Israel Companies Law, all as described above. Furthermore, the Israel Companies Law specifically prohibits the chairman of the Board of Directors, any director employed by or otherwise providing services to a company and a controlling shareholder or any relative of a controlling shareholder from being a member of the audit committee. Our Audit Committee is in compliance with the noted requirements.

#### Compensation Committee

The Compensation Committee is responsible for determining salaries, incentives and other forms of compensation for Commtouch's directors and its executive officers. The Compensation Committee is also responsible for administering

the various stock option plans, including the issuance of grants of options to employees of the Company and its subsidiary.

#### Nominating Committee

The committee's responsibilities include identifying individuals qualified to become board members and recommending director nominees to the board.

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#### Investment Committee

The committee's responsibilities include identifying appropriate investment vehicles for the cash reserves of the Company and recommending to the board appropriate investment policy from time to time.

#### Internal Auditor

Under the Israel Companies Law, the Board of Directors must appoint an internal auditor, nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether a company's actions comply with relevant law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an interested party or office holder, or a relative of an interested party or office holder, and he or she may not be the company's independent accountant or its representative.

#### Approval of Certain Transactions; Obligations of Directors, Officers and Shareholders

The Israel Companies Law codifies the fiduciary duties that office holders, including directors and executive officers, owe to a company. An office holder's fiduciary duties consist of a duty of care and a duty of loyalty. Each person listed in the first table that appears above at the beginning of this Item 6 is an office holder.

The duty of loyalty requires an office holder to act in good faith and for the benefit of the company, including to avoid any conflict of interest between the office holder's position in the company and such person's personal affairs, avoiding any competition with the company, avoiding exploiting any corporate opportunity of the company in order to receive personal advantage for such person or others, and revealing to the company any information or documents relating to the company's affairs which the office holder has received due to his or her position as an office holder. A company may approve any of the acts mentioned above provided that all the following conditions apply: the office holder acted in good faith and neither the act nor the approval of the act prejudices the good of the company, and the office holder disclosed the essence of his personal interest in the act, including any substantial fact or document, a reasonable time before the date for discussion of the approval.

The duty of care requires an office holder to act with a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to use reasonable means to obtain information regarding the advisability of a given action submitted for his or her approval or performed by virtue of his or her position and all other relevant information material to these actions.

Under the Israel Companies Law, all arrangements as to compensation of office holders who are not directors require approval of the Board of Directors unless the Articles of Association provide otherwise. Arrangements regarding the compensation of directors also require audit committee and shareholder approval.

The Israel Companies Law requires that an office holder promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. "Personal interest," as defined by the Companies Law, includes a personal interest of any person in an act or transaction of the company, including a personal interest of his relative or of a corporation in which that person or a relative of that person is a 5% or greater shareholder, a holder of 5% or more of the voting rights, a director or general manager, or in which he or she has the right to appoint at least one director or the general manager. "Personal interest" does not apply to a personal interest stemming merely from holding shares in the company.

The office holder must make the disclosure of his personal interest no later than the first meeting of the company's board of directors that discusses the particular transaction. This duty does not apply to the personal interest of a relative of the office holder in a transaction unless it is an "extraordinary transaction." An "extraordinary transaction" is

defined as a transaction not in the ordinary course of business, a transaction that is not on market terms, or a transaction that is likely to have a material impact on the company's profitability, assets or liabilities, and a "relative" as a spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouses of any of the foregoing.

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In the case of a transaction that is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, only Board approval is required unless the Articles of Association of the company provide otherwise. Our Amended and Restated Articles of Association do not provide otherwise. Such approval must determine that the transaction is not adverse to the company's interest. If the transaction is an extraordinary transaction, then in addition to any approval required by the Articles of Association, it also must be approved by the audit committee and by the Board and, under specified circumstances, by a meeting of the shareholders. An Israeli company whose shares are publicly traded shall not be entitled to approve such a transaction unless, at the time the approval was granted, two members of the audit committee were outside directors and at least one of them was present at the meeting at which the audit committee decided to grant the approval. An office holder who has a personal interest in a matter that is considered at a meeting of the Board of Directors or the audit committee generally may not be present at this meeting or vote on this matter unless a majority of the board of directors or the audit committee has a personal interest in the matter. If a majority of the board of directors or the audit committee has a personal interest in the transaction, shareholder approval also would be required.

The Israel Companies Law applies the same disclosure requirements to a controlling shareholder of a public company, which includes a shareholder that holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions, including a private placement, with a controlling shareholder or in which a controlling shareholder has a personal interest, and the terms of compensation of a controlling shareholder who is an office holder, require the approval of the audit committee, the Board of Directors and the shareholders of the company. The shareholder approval must either include at least one-third of the disinterested shareholders who are present, in person or by proxy, at the meeting or, alternatively, the total shareholdings of the disinterested shareholders who vote against the transaction must not represent more than one percent of the voting rights in the company.

Under the Israel Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders and refrain from abusing his or her power in the company, including, among other things, in respect to his or her voting at the general meeting of shareholders on the following matters:

- any amendment to the Articles of Association;
- an increase of the company's authorized share capital;
- a merger; or
- approval of interested party transactions that require shareholder approval.

In addition, any controlling shareholder, any shareholder who can determine the outcome of a shareholder vote and any shareholder who, under the company's Articles of Association, can appoint or prevent the appointment of an office holder, is under a duty to act with fairness towards the company. The Israel Companies Law provides that a breach of the duty of fairness will be governed by the laws governing breach of contract. The Israel Companies Law does not describe the substance of this duty.

#### Insurance, Indemnification and Exculpation of Directors and Officers; Limitations on Liability

The Israel Companies Law permits a company to insure an office holder in respect of liabilities incurred by him or her as a result of the breach of his or her duty of care to the company or to another person, or as a result of the breach of his or her duty of loyalty to the company, to the extent that he or she acted in good faith and had reasonable cause to believe that the act would not prejudice the company. A company can also insure an office holder for monetary liabilities as a result of an act or omission that he or she committed in connection with his or her serving as an office holder. Moreover, a company can indemnify an office holder for (a) any monetary liability imposed upon such a office

holder for the benefit of a third party pursuant to a court judgment, including a settlement or an arbitrator's decision, confirmed by a court, (b) reasonable legal costs, including attorney's fees, expended by a office holder as a result of an investigation or proceeding instituted against the office holder by a competent authority, provided that such investigation or proceeding concludes without the filing of an indictment against the office holder and either i) no financial liability was imposed on the office holder in lieu of criminal proceedings or ii) financial liability was imposed on the office holder in lieu of criminal proceedings but the alleged criminal offense does not require proof of criminal intent, and (c) reasonable litigation expenses, including legal fees, actually incurred by such a office holder or imposed upon the office holder by a court order, in a proceeding brought against the office holder by or on behalf of the company or by others, or in a criminal action in which he was acquitted, or in a criminal action which does not require proof of criminal intent in which he was convicted. The Companies Law further provides that the indemnification provision in a company's articles of association (i) may be an obligation to indemnify in advance, provided that, other than litigation expenses, it is limited to events the board of directors can foresee in light of the company's actual activities when providing the obligation and that it is limited to a sum or standards the board of directors determines is reasonable in the circumstances, and (ii) may permit the company to indemnify an officer or a director after the fact.

Furthermore, a company can, with one limited exception, exculpate an office holder in advance, in whole or in part, from liability for damages sustained by a breach of duty of care to the company.

All of these provisions are specifically limited in their scope by the Companies Law, which provides that a company may not indemnify or exculpate an officer or director nor enter into an insurance contract that would provide coverage for any monetary liability incurred as a result of (i) a breach by the officer or director of the duty of loyalty, unless the officer or director acted in good faith and had a reasonable basis to believe that the act would not prejudice the company, in which case the company is permitted to indemnify and provide insurance to but not to exculpate; (ii) an intentional or reckless breach by the officer or director of the duty of care, other than if solely done in negligence; (iii) any act or omission done with the intent to derive an illegal personal benefit; or (iv) any fine levied or forfeit against the director or officer.

Our Amended and Restated Articles of Association allow us to insure, exculpate and indemnify office holders to the fullest extent permitted by law provided such insurance, exculpation or indemnification is approved in accordance with the Israel Companies Law. We have acquired directors' and officers' liability insurance covering the officers and directors of Commtouch and its subsidiary for certain claims. At the annual meeting of shareholders held on November 18, 2002, the shareholders approved a form of indemnification, exculpation and insurance agreement that is applicable to all our directors. The form of this agreement, as well as related provisions in our Amended and Restated Articles of Association, were amended at the annual meeting of shareholders held on December 30, 2005.

#### Compensation of Directors and Executive Officers

The directors of Commtouch can be remunerated by Commtouch for their services as directors to the extent such remuneration is approved by Commtouch's audit committee, Board of Directors and shareholders. Through 2008, directors did not receive cash compensation for their services. However, at the annual meeting in December 2008, shareholders approved the payment of cash compensation, in addition to equity compensation (options), according to the following:

- a. NIS 31,700 base annually per director, as linked to the applicable Israeli consumer price index, payable in four equal installments at the beginning of each calendar quarter; and
- b. NIS 1,590 per director per face to face Board or committee meeting or NIS954 (60% of NIS 1590) in case of telephonic participation at such meeting, payable at the beginning of each calendar quarter following the quarter during which a Board member participated in a meeting. No separate per meeting compensation will be paid for committee meetings that are held on the same day immediately prior or subsequent to a Board meeting. In that event, a Board and committee meeting will be considered one meeting.
- c. For non-Israeli based directors, the amounts set forth will be paid in United States dollars, according to the representative rate of exchange published by the Bank of Israel on the date of payment.

Directors also are reimbursed for their expenses for each Board of Directors meeting attended. See in this item 6., "Amended and Restated 1999 Non-employee Directors Stock Option Plan" for a discussion of director compensation in the form of option grants. During 2009, options to purchase 427,000 Ordinary Shares were granted to directors and executive officers under the Company's stock option plans at a weighted average exercise price of \$ 3.19 per share. The aggregate direct remuneration paid by Commtouch to all directors and executive officers (9 persons) in 2009 was approximately \$850 thousand. During the same period Commtouch accrued or set aside approximately \$90 thousand for the same group to provide pension, retirement or similar benefits. As of December 31, 2009, directors and executive officers of Commtouch (9 persons) held an aggregate of 3,024,033 stock options to purchase a like number of Ordinary Shares, with 2,025,286 of those options being vested and exercisable within sixty days of said date.

#### Options to Purchase Securities from Registrant or Subsidiaries

As of December 31, 2009, options to purchase 4,428,365 Ordinary Shares were outstanding and held by 45 persons made up of then existing employees, consultants, executive officers and non–employee directors under the Company’s stock option plans, and there were 845,200 shares available for grant under all plans. Of the number of options outstanding, 2,757,251 were vested and exercisable. Additionally, these outstanding options had exercise prices ranging from \$0.0375 to \$6.60 per share, a weighted average per share exercise price of approximately \$2.46 and termination dates ranging from February 2011 to December 2015.



## Employee Stock Option Plans

Employees, including executive officers and other management employees, participate in the Company's employee option plans. The Commtouch Software Ltd. 2006 U.S. Stock Option Plan, primarily covering the granting of options to employees and consultants based in the United States, was adopted on December 15, 2006 and has a term of ten years. The Commtouch Software Ltd. Amended and Restated Israeli Share Options Plan, primarily covering the granting of options to employees, consultants and directors based in Israel, was adopted on June 22, 2003 and has a term of ten years. While Israeli based directors receive their grants under the Israeli plan, the principal terms of their grants are identical to those of non-Israeli based directors receiving their grants under the non-employee director plan (discussed below).

Some previous employee option plans have either terminated or were amended and restated, though options remain outstanding and exercisable under those plans. Such plans include the Amended and Restated 1996 CSI Stock Option Plan which expired on January 1, 2006 and the Amended and Restated 1999 3(i) Share Option Plan, which was replaced by the above described Israeli Share Option Plan.

All employee stock option plans are administered by the Compensation Committee. Subject to the provisions of the employee stock plans and applicable law, the Compensation Committee has the authority to determine, among other things, to whom options may be granted; the number of Ordinary Shares to which an option may relate; the exercise price for each share; the vesting period of the option and the terms, conditions and restrictions thereof, including accelerated vesting on change of control provisions; to amend provisions relating to such plans; and to make all other determinations deemed necessary or advisable for the administration of such plans.

### Amended and Restated 1999 Non-Employee Directors Stock Option Plan

New non-employee directors are currently entitled to an initial grant of 50,000 options. Non-employee directors who are re-elected at the annual meeting of shareholders are entitled to additional grants of 16,667 options, though at the annual meeting held October 26, 2009 shareholders approved a one-time increase in the grants to re-elected directors to 30,000 options.

The Company's Non-Employee Directors Plan was extended by an additional ten years at the annual meeting of shareholders held on December 15, 2008. Under this plan, each option becomes exercisable at a rate of 1/16th of the option shares every three months, and has an exercise price equal to the fair market value of the Ordinary Shares on the grant date of such option. Up through 2004, each option granted had a maximum term of ten years, but would terminate earlier if the optionee ceased to be a member of the Board of Directors. Options granted to directors during 2005 - 2009 have a maximum term of six years. At the annual meeting of shareholders of December 30, 2005, shareholders approved an amendment to the Non-Employee Directors Plan to allow for the acceleration of unvested options for any director who has served the Company for at least three years, unless the director resigned voluntarily or was removed from the Board of Directors due to a failure to perform any of his/her duties to the Company.

## Employees

See Item 4: Employees

## Item 7. Major Shareholders and Related Party Transactions.

The following table presents information with respect to beneficial ownership of our Ordinary Shares as of December 31, 2009, including:

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each person or entity known to Commtouch to own beneficially more than five percent of Commtouch's Ordinary Shares, and

- all executive officers and directors as a group.

Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power, with respect to shares. To our knowledge, except under applicable community property laws or as otherwise indicated, the persons named in the table have sole voting and sole investment control and rights to receive economic benefits with respect to all shares beneficially owned. The applicable percentage of ownership for each shareholder is based on 23,958,761 Ordinary Shares outstanding as of December 31, 2009. Ordinary Shares issuable upon exercise of options and other rights held and exercisable on or within sixty days of December 31, 2009 are deemed outstanding for the purpose of computing the percentage ownership of the person holding those options and other rights and for all directors and officers as a group, but are not deemed outstanding for computing the percentage ownership of any other person. Major shareholders in the Company have the same voting rights as all other shareholders.

| MAJOR SHAREHOLDERS OF ORDINARY SHARES                                   | Amount Owned   | Percent of Class |
|-------------------------------------------------------------------------|----------------|------------------|
| Aviv Raiz*                                                              | 5,562,740**    | 22.8%            |
| Gideon Mantel*                                                          | 1,365,643***   | 5.5%             |
| Catalyst Private Equity Partners II LP                                  | 1,200,241****  | 5%               |
| All directors and executive officers as a group at 12/31/09 (9 persons) | 9,564,605***** | 36.3%            |

\*These shareholders of record reside in Israel. With respect to Catalyst Private Equity Partners II LP, the Chairman and Managing Partner of this limited partnership, Mr. Yair Shamir – a director in the Company - resides in Israel.

\*\*Includes 76,871 options and 333,333 warrants, exercisable into a like number of Ordinary Shares.

\*\*\*Includes 962,617 options exercisable into a like number of Ordinary Shares.

\*\*\*\*Includes 27,913 options exercisable into a like number of Ordinary Shares.

\*\*\*\*\*Includes 2,025,286 options exercisable into a like number of Ordinary Shares. Also, this number includes 134,265 shares held by LENE L.P., in which Mr. Lloyd Shefsky holds a relatively small limited partner interest, without any control over partnership management.

Based on a review of the information provided to us by our transfer agent, as of December 31, 2009, there were 79 holders of record of our Ordinary Shares, including 52 holders of record residing in the United States holding 22,493,527 Ordinary Shares, or approximately 94% of the aggregate 23,958,761 Ordinary Shares outstanding as of such date. These numbers are not representative of the number of beneficial holders of our shares nor is it representative of where such beneficial holders reside since many of these ordinary shares were held of record by brokers or other nominees (including one U.S. nominee company, CEDE & Co., which held approximately 87% of our outstanding Ordinary Shares as of such date on behalf of approximately 91 brokers and banks).

#### Significant Changes in Percentage Ownership During the Past Three Years

Since December 2006, Catalyst Private Equity Partners II LP has acquired through purchases on the open market a total of 1,172,328 Ordinary Shares, which as of the filing of this annual report represents slightly less than 5% ownership in the Company.

#### Interest of Management and their Family Members in Certain Transactions

There were no related party transactions during 2009 or through the date of filing of this Form 20-F.

#### Item 8. Financial Information.

See Item 18: Financial Statements. If the Company decides to distribute a cash dividend out of income that has been tax exempt due to an “approved enterprise” status under the Law for the Encouragement of Capital Investments, 5719-1959, the amount of cash dividend will be subject to corporate tax at the rate then in effect under Israeli law. The Company has never declared or paid cash dividends on its Ordinary Shares. However, the Company has not adopted a policy not to pay cash dividends and therefore may declare a dividend in the future. The Company’s current plans are to retain future earnings primarily to finance the development of its business and for other corporate purposes.

We are not a party to any litigation, and we are not aware of any threatened litigation which, in the aggregate, would be material to the business of the Company.



Except as otherwise disclosed in this Annual Report, there has been no material change in our financial position since December 31, 2009.

#### Item 9. The Offer and Listing.

The Company's Ordinary Shares have been traded publicly on NASDAQ as follows:

- a. From July 13, 1999 through June 29, 2004, under the symbol "CTCH" (up to June 7, 2002 on the National Market, and subsequently on the Small Cap Market, which during 2005 was renamed the "Capital Market");
- b. From June 30, 2004 through June 26, 2005, under the symbol "CTCHC";
- c. From June 27, 2005 through January 1, 2008, under the symbol "CTCH";
- d. From January 2, 2008 through January 29, 2008, under the symbol "CTCHD"; and
- e. From January 30, 2008, under the symbol CTCH.

Since December 16, 2009, the Company's Ordinary Shares have also been traded on the Tel Aviv Stock Exchange, or "TASE", under the symbol CTCH.

The following table lists the high and low closing sales prices for the Company's Ordinary Shares on the NASDAQ Capital Market, for the periods indicated:

|                         | High    | Low     |
|-------------------------|---------|---------|
| 2005:                   | \$ 3.90 | \$ 1.35 |
| 2006:                   | \$ 4.08 | \$ 2.10 |
| 2007:                   | \$ 7.44 | \$ 3.69 |
| 2008:                   | \$ 6.22 | \$ 1.50 |
| 2009:                   | \$ 4.30 | \$ 1.57 |
| 2008:                   |         |         |
| First Quarter           | \$ 6.22 | \$ 3.68 |
| Second Quarter          | \$ 4.40 | \$ 2.77 |
| Third Quarter           | \$ 3.45 | \$ 2.15 |
| Fourth Quarter          | \$ 2.50 | \$ 1.50 |
| 2009:                   |         |         |
| First Quarter           | \$ 2.12 | \$ 1.57 |
| Second Quarter          | \$ 2.04 | \$ 1.71 |
| Third Quarter           | \$ 3.73 | \$ 2.63 |
| Fourth Quarter          | \$ 4.30 | \$ 3.39 |
| Most Recent Six Months: |         |         |

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|                |    |      |    |      |
|----------------|----|------|----|------|
| September 2009 | \$ | 3.21 | \$ | 2.63 |
| October 2009   | \$ | 3.73 | \$ | 3.11 |
| November 2009  | \$ | 3.42 | \$ | 3.03 |
| December 2009  | \$ | 3.88 | \$ | 3.39 |
| January 2010   | \$ | 4.30 | \$ | 3.84 |
| February 2010  | \$ | 4.00 | \$ | 3.82 |

Given the limited trading history on the TASE, the Company is providing the high and low prices only for the period December 16, 2009 through February 28, 2010. Share prices on the TASE are quoted in New Israeli Shekels (NIS):

|                                        | High     | Low     |
|----------------------------------------|----------|---------|
| December 2009(since December 16, 2009) | NIS 15.1 | NIS14.6 |
| January 2010                           | NIS 16.6 | NIS15.9 |
| February 2010                          | NIS 15.7 | NIS15.2 |

#### Item 10. Additional Information.

We are registered under the Israel Companies Law as a public company with registration number 52-004418-1. The objective stated in our memorandum of association is to engage in any lawful activity.

#### DESCRIPTION OF SHARES

Set forth below is a summary of the material provisions governing our share capital. This summary is not complete and should be read together with our Memorandum of Association and Amended and Restated Articles of Association, copies of which are filed with this report or have been filed as exhibits to certain of our prior filings with the SEC.

As of December 31, 2009, our authorized share capital consisted of 55,353,340 Ordinary Shares, NIS 0.15 par value. As of December 31, 2009, there were 23,958,761 Ordinary Shares issued and outstanding.

#### DESCRIPTION OF ORDINARY SHARES

All issued and outstanding Ordinary Shares of Commtouch are duly authorized and validly issued, fully paid and nonassessable.

The Ordinary Shares do not have preemptive rights. Our Memorandum of Association, Amended and Restated Articles of Association and the laws of the State of Israel do not restrict in any way the ownership or voting of Ordinary Shares by non-residents of Israel, except with respect to subjects of countries which are in a state of war with Israel.

#### DIVIDEND AND LIQUIDATION RIGHTS

The Ordinary Shares are entitled to their full proportion of any cash or share dividend declared.

Subject to the rights of the holders of shares with preferential or other special rights that may be authorized, the holders of Ordinary Shares are entitled to receive dividends in proportion to the sums paid up or credited as paid up on account of the nominal value of their respective holdings of the shares in respect of which the dividend is being paid (without taking into account the premium paid up on the shares) out of assets legally available therefor and, in the event of our winding up, to share ratably in all assets remaining after payment of liabilities in proportion to the nominal value of their respective holdings of the shares in respect of which such distribution is being made, subject to applicable law. Declaration of a dividend requires Board of Directors approval.

Under current Israeli regulations, any dividends or other distributions paid in respect of Ordinary Shares purchased by non-residents of Israel with certain non-Israeli currencies (including U.S. dollars) will be freely repatriable in such non-Israeli currencies at the rate of exchange prevailing at the time of conversion, provided that Israeli income tax has been paid on, or withheld from, such payments.





## MODIFICATION OF CLASS RIGHTS

If at any time the share capital is divided into different classes of shares, then, unless the conditions of allotment of such class provide otherwise, the rights, additional rights, advantages, restrictions and conditions attached or not attached to any class, at any given time, may be modified, enhanced, added or abrogated by resolution at a meeting of the holders of the shares of such class.

Pursuant to Israel's securities laws, a company registering its shares for trade on the Tel Aviv Stock Exchange may not have more than one class of shares for a period of one year following registration, after which it is permitted to issue preferred shares, if the preference of those shares is limited to a preference in the distribution of dividends and these preferred shares have no voting rights.

## SPECIAL PROVISIONS IN AMENDED AND RESTATED ARTICLES OF ASSOCIATION RELATING TO DIRECTORS

The discussion regarding approval of director compensation and transactions with the Company under "Item 6. Directors, Senior Management and Employees - Approval of Certain Transactions; Obligations of Directors, Officers and Shareholders" is incorporated herein by reference.

## VOTING, SHAREHOLDER MEETINGS AND RESOLUTIONS

Holders of Ordinary Shares have one vote for each share held on all matters submitted to a vote of shareholders.

An annual general meeting must be held once every calendar year at such time (not more than 15 months after the last preceding annual general meeting) and at such place, either within or outside the State of Israel, as may be determined by the Board of Directors. The quorum required for a general meeting of shareholders consists of at least two shareholders present in person or by proxy and holding at least one-third of the voting rights of the issued share capital. A meeting adjourned for lack of a quorum may be adjourned to the same day in the next week at the same time and place, or to such time and place as the Board of Directors may determine in a notice to shareholders. At such reconvened meeting any two shareholders entitled to vote and present in person or by proxy will constitute a quorum. Rule 5620(c) to Nasdaq Listing Rules requires that an issuer listed on Nasdaq should have a quorum requirement that in no case be less than 33 1/3% of the outstanding shares of the company's common voting stock. However, as mentioned above, our articles of association, consistent with the Companies Law, provides for a lower quorum requirement at an adjourned meeting.

Generally, shareholder resolutions will be deemed adopted if approved by the holders of a majority of the voting power represented at the meeting, in person or by proxy, and voting thereon. For certain matters as described under the Israel Companies law, there is a requirement that the majority include the affirmative vote of at least one-third of the votes cast by shareholders who are not controlling shareholders of the Company or interested parties in the matter to be voted upon (or their representatives) or, alternatively, the total shareholdings of the votes cast against the proposal (other than by the Company's controlling shareholders or interested parties in the matter to be voted upon) must not represent more than one percent of the voting rights in the Company.

## ANTI-TAKEOVER PROVISIONS UNDER ISRAELI LAW

Under the Companies Law, a merger is generally required to be approved by the shareholders and board of directors of each of the merging companies. If the share capital of the company that will not be the surviving company is divided into different classes of shares, the approval of each class is also required. In addition, a merger can be completed only after 30 days have passed from the shareholders' approval of each of the merging companies, all approvals have been submitted to the Israeli Registrar of Companies and at least fifty days have passed from the time

that a proposal for approval of the merger was filed with the Registrar.

The Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would hold 25% or more of the voting rights in the company, unless there is already another 25% shareholder of the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of tender offer if as a result of the acquisition the purchaser would hold more than 45% of the voting rights in the company, unless someone else already holds 45% of the voting power of the company.

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Finally, Israeli tax law treats specified acquisitions, including a stock-for-stock swap between an Israeli company and a foreign company, less favorably than does U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his Ordinary Shares for shares in a foreign corporation to taxation before it would become taxable in the United States, even though the investment has not become liquid, although in the case of shares of a foreign corporation that are traded on a stock exchange, the tax may be postponed subject to certain conditions.

#### TRANSFER OF SHARES AND NOTICES

Fully paid Ordinary Shares that are issued and not subject to any legal restrictions on transference may be transferred freely. Each shareholder of record is entitled to receive at least twenty-one days' prior notice (and for certain matters, thirty-five days' prior notice) before the date of a shareholder meeting and at least five days notice before the record date for the meeting. For purposes of determining the shareholders entitled to notice and to vote at such meeting, the Board of Directors may fix a record date not exceeding 40 days prior to the date of any shareholder meeting.

#### CHANGES IN OUR CAPITAL

Changes in our capital are subject to the approval of the shareholders by a majority of the votes of shareholders present by person or by proxy and voting at the shareholders meeting.

#### ACCESS TO INFORMATION

We file reports with the Israeli Registrar of Companies regarding our registered address, our registered capital, our shareholders of record and the number of shares held by each, the identity of the directors and details regarding security interests on our assets. In addition, Commtouch must file with the Israeli Registrar of Companies its Amended and Restated Articles of Association and any further amendments thereto. The information filed with the Registrar of Companies is available to the public. In addition to the information available to the public, our shareholders are entitled, upon request, to review and receive copies of all minutes of meetings of our shareholders.

We are subject to certain of the information reporting requirements of the Exchange Act. As a "foreign private issuer," we are exempt from the rules and regulations under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and "short-swing" profit recovery provisions contained in Section 16 of the Exchange Act, with respect to their purchase and sale of the ordinary shares. In addition, we are not required to file reports and financial statements with the SEC as frequently or as promptly as U.S. companies whose securities are registered under the Exchange Act. However, we file with the SEC an Annual Report on Form 20-F containing financial statements audited by an independent registered public accounting firm. We also furnish quarterly reports on Form 6-K containing unaudited financial information after the end of each quarter and other reports on Form 6-K from time to time. We post our Annual Report on Form 20-F on our Website ([www.commtouch.com](http://www.commtouch.com)) promptly following the filing of our Annual Report with the Securities and Exchange Commission. The information on our website is not incorporated by reference into this Annual Report.

This report and other information filed or to be filed by us can be inspected and copied at the public reference facilities maintained by the SEC at:

100 F Street, NE  
Public Reference Room  
Washington, D.C. 20549

The SEC maintains a Web site at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system.



In addition, since we are also listed on the Tel Aviv Stock Exchange we submit copies of all our filings with the Securities and Exchange Commission to the Israeli Securities Authority and the Tel Aviv Stock Exchange. Such copies can be retrieved electronically through the Tel Aviv Stock Exchange's internet messaging system ([www.maya.tase.co.il](http://www.maya.tase.co.il)) and through the MAGNA distribution site of the Israeli Securities Authority ([www.magna.isa.gov.il](http://www.magna.isa.gov.il)).

## MATERIAL CONTRACTS DURING PAST TWO YEARS

Equity Investments. Commtouch made a \$750,000 investment in Mirapoint Software, Inc., a secure messaging vendor and an OEM licensee, as part of Mirapoint's larger financing round in the fourth quarter of 2007. In connection therewith, Commtouch received a minority ownership interest in Mirapoint of approximately 8%. During early 2009, Commtouch made an additional investment in Mirapoint, as part of a larger financing round, in the amount of \$477,000. In total, Commtouch investments in Mirapoint as of December 31, 2009 amounted to \$1,227,000.

### Amended and Restated Articles of Association

See the discussion under Item 4 "Information on the Company- Overview" for instructions on how to locate the Company's Amended and Restated Articles of Association. In addition, the Articles are incorporated by reference to this Form 20-F under Exhibit 1.2 below.

## EXCHANGE CONTROLS

Non-residents of Israel who own our ordinary shares may freely convert all amounts received in Israeli currency in respect of such ordinary shares, whether as a dividend, liquidation distribution or as proceeds from the sale of the ordinary shares, into freely-repatriable non-Israeli currencies at the rate of exchange prevailing at the time of conversion (provided in each case that the applicable Israeli income tax, if any, is paid or withheld).

Until May 1998, Israel imposed extensive restrictions on transactions in foreign currency. These restrictions were largely lifted in May 1998. Since January 1, 2003, all exchange control restrictions have been eliminated although there are still reporting requirements for foreign currency transactions. Legislation remains in effect, however, pursuant to which currency controls can be imposed by administrative action at any time.

The State of Israel does not restrict in any way the ownership or voting of our ordinary shares by non-residents of Israel, except with respect to subjects of countries that are in a state of war with Israel.

## ISRAELI TAXATION

The following is a summary of the principal tax laws applicable to companies in Israel, including special reference to their effect on us, and Israeli government programs benefiting us. This section also contains a discussion of the material Israeli tax consequences to you if you acquire Ordinary Shares of our company. This summary does not discuss all the acts of Israeli tax law that may be relevant to you in light of your personal investment circumstances or if you are subject to special treatment under Israeli law. To the extent that the discussion is based on new tax legislation which has not been subject to judicial or administrative interpretation, we cannot assure you that the views expressed in this discussion will be accepted by the tax authorities. The discussion should not be understood as legal or professional tax advice and is not exhaustive of all possible tax considerations.

### General Corporate Tax Structure

Generally, Israeli companies are subject to "Corporate Tax" on their taxable income. The applicable rate was 29% in 2007, 27% in 2008, 26% in 2009, is 25% in 2010 and is scheduled to decline to 24% in 2011, 23% in 2012, 22% in

2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter.

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#### Tax Benefits under the Law for the Encouragement of Industry (Taxes), 1969

The Law for the Encouragement of Industry (Taxes), 1969, generally referred to as the Industry Encouragement Law, provides several tax benefits for industrial companies. An industrial company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year exclusive of income from specified government loans, capital gains, interest and dividends, is derived from an industrial enterprise owned by it. An industrial enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Under the Industry Encouragement Law, industrial companies are entitled to a number of corporate tax benefits, including:

- deduction of purchase of know-how and patents and/or right to use a patent over an eight-year period ;
- the right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company;
  - accelerated depreciation rates on equipment and buildings.
- Expenses related to a public offering on TA stock exchange and as of 1.1.2003 on recognized stock markets outside of Israel, are deductible in equal amounts over three years.

Under some tax laws and regulations, an industrial enterprise may be eligible for special depreciation rates for machinery, equipment and buildings. These rates differ based on various factors, including the date the operations begin and the number of work shifts. An industrial company owning an approved enterprise may choose between these special depreciation rates and the depreciation rates available to the approved enterprise.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority.

We believe that we currently qualify as an industrial company within the definition of the Industry Encouragement Law. We cannot assure you that the Israeli tax authorities will agree that we qualify, or, if we qualify, that we will continue to qualify as an industrial company or that the benefits described above will be available to us in the future.

#### Special Provisions Relating to Measurement of Taxable Income

Our company is taxed until tax year 2007 (including) under the Income Tax Law (Inflationary Adjustments), 1985, generally referred to as the Inflationary Adjustments Law. The Inflationary Adjustments Law is highly complex and represents an attempt to overcome the problems presented to a traditional tax system by an economy undergoing rapid inflation. Its features, which are material to us, are summarized as follows:

- Where a company's equity, as calculated under the Inflationary Adjustments Law, exceeds the depreciated cost of its fixed assets (as defined in the Inflationary Adjustments Law), a deduction from taxable income is permitted equal to the excess multiplied by the applicable annual rate of inflation. The maximum deduction permitted in any single tax year is 70% of taxable income, with the unused portion permitted to be carried forward, linked to the Israeli consumer price index. The unused portion that was carried forward may be deductible in full in the following year.
- Where a company's depreciated cost of fixed assets exceeds its equity, then the excess multiplied by the applicable annual rate of inflation is added to taxable income. (hereinafter: "inflation supplement"). Note, the inflation supplement will only be added to the corporate income but not to other incomes such as capital gains.

- Subject to specified limitations, depreciation deductions on fixed assets and losses carried forward are adjusted for inflation based on the change in the consumer price index.

In February 2008, the Inflationary Adjustments Law was repealed.

#### Capital Gains Tax on Sales of Our Ordinary Shares

Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares in Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder's country of residence provides otherwise. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli consumer price index or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

As of January 1, 2006, the tax rate applicable to capital gains derived from the sale of shares, whether listed on a stock market or not, is 20% for Israeli individuals, unless such shareholder claims a deduction for financing expenses in connection with such shares, in which case the gain will generally be taxed at a rate of 25%. Additionally, if such shareholder is considered a "material shareholder" at any time during the 12-month period preceding such sale, i.e., such shareholder holds directly or indirectly, including with others, at least 10% of any means of control in the company, the tax rate shall be 25%. Israeli companies are subject to the Corporate Tax rate on capital gains derived from the sale of shares, unless such companies were not subject to the Adjustments Law (or certain regulations) at the time of publication of the aforementioned amendment to the Tax Ordinance that came into effect on January 1, 2006, in which case the applicable tax rate is 25%. However, the foregoing tax rates do not apply to: (i) dealers in securities; and (ii) shareholders who acquired their shares prior to an initial public offering (that may be subject to a different tax arrangement).

Non-Israeli residents are exempt from Israeli capital gains tax on any gains derived from the sale of shares of Israeli companies publicly traded on a recognized stock exchange or regulated market outside of Israel, provided however that such capital gains are not derived from a permanent establishment in Israel, such shareholders are not subject to the Adjustments Law, and such shareholders did not acquire their shares prior to an initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In some instances where our shareholders may be liable to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

Pursuant to the Convention Between the government of the United States of America and the government of Israel with Respect to Taxes on Income, as amended (the "U.S.-Israel Tax Treaty"), the sale, exchange or disposition of ordinary shares by a person who (i) holds the ordinary shares as a capital asset, (ii) qualifies as a resident of the United States within the meaning of the U.S.-Israel Tax Treaty and (iii) is entitled to claim the benefits afforded to such person by the U.S.-Israel Tax Treaty, generally, will not be subject to the Israeli capital gains tax. Such exemption will not apply if (i) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding such sale, exchange or disposition, subject to certain conditions, or (ii) the capital gains from such sale, exchange or disposition can be allocated to a permanent establishment in Israel. In such case, the sale, exchange or disposition of ordinary shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, such Treaty U.S. Resident would be permitted to claim a credit for such taxes against the U.S. federal income tax imposed with respect to such sale, exchange or



disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

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## Taxation of Non-Resident Holders of Shares

Non-residents of Israel are subject to income tax on income accrued or derived from sources in Israel. Such sources of income include passive income such as dividends, royalties and interest, as well as non-passive income from services rendered in Israel. On distributions of dividends other than bonus shares, or stock dividends, income tax is withheld at the source at the following rates: for dividends distributed on or after January 1, 2006 - 20%, or 25% for a shareholder that is considered a “material shareholder” at any time during the 12-month period preceding such distribution, unless a different rate is provided in a treaty between Israel and the shareholder’s country of residence. Under the U.S.-Israel Tax Treaty, the maximum tax on dividends paid to a holder of ordinary shares who is a Treaty U.S. Resident is 25%. Furthermore, dividends not generated by an Approved Enterprise (or Benefited Enterprise) paid to a U.S. corporation holding at least 10% of our issued voting power during the part of the tax year which precedes the date of payment of the dividend and during the whole of its prior tax year, are generally taxed at a rate of 12.5%.

For information with respect to the applicability of Israeli capital gains taxes on the sale of ordinary shares by United States residents, see above “— Capital Gains Tax on Sales of Our Ordinary Shares.”

## UNITED STATES FEDERAL INCOME TAX CONSEQUENCES

THE FOLLOWING SUMMARY IS INCLUDED HEREIN FOR GENERAL INFORMATION AND IS NOT INTENDED TO BE, AND SHOULD NOT BE CONSIDERED TO BE, LEGAL OR TAX ADVICE. EACH U.S. HOLDER SHOULD CONSULT WITH HIS OR HER OWN TAX ADVISOR AS TO THE PARTICULAR U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PURCHASE, OWNERSHIP AND SALE OF ORDINARY SHARES, INCLUDING THE EFFECTS OF APPLICABLE STATE, LOCAL, FOREIGN OR OTHER TAX LAWS AND POSSIBLE CHANGES IN THE TAX LAWS.

### U.S. Federal Income Taxation

Subject to the limitations described in the next paragraph, the following discussion summarizes the material U.S. federal income tax consequences to a “U.S. Holder” arising from the purchase, ownership and sale of the Ordinary Shares. For this purpose, a “U.S. Holder” is a holder of Ordinary Shares that is: (1) an individual citizen or resident of the United States, including an alien individual who is a lawful permanent resident of the United States or meets the substantial presence residency test under U.S. federal income tax laws; (2) a corporation (or entity treated as a corporation for U.S. federal tax purposes) or a partnership (other than a partnership that is not treated as a U.S. person under any applicable U.S. Treasury Regulations) created or organized under the laws of the United States or the District of Columbia or any political subdivision thereof; (3) an estate, the income of which is includable in gross income for U.S. federal income tax purposes regardless of source; (4) a trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have authority to control all substantial decisions of the trust; (5) a trust that has a valid election in effect to be treated as a U.S. person to the extent provided in U.S. Treasury regulations, or (6) any person otherwise subject to U.S. federal income tax on a net income basis in respect of the Ordinary Shares, if such status as a U.S. Holder is not overridden pursuant to the provisions of an applicable tax treaty.

This summary is for general information purposes only and does not purport to be a comprehensive description of all of the U.S. federal income tax considerations that may be relevant to a decision to purchase our Ordinary Shares. This summary generally considers only U.S. Holders that will own our Ordinary Shares as capital assets. Except to the limited extent discussed below, this summary does not consider the U.S. federal tax consequences to a person that is not a U.S. Holder, nor does it describe the rules applicable to determine a taxpayer’s status as a U.S. Holder. This summary is based on the provisions of the Internal Revenue Code of 1986, as amended, or the Code, final, temporary and proposed U.S. Treasury Regulations promulgated thereunder, administrative and judicial interpretations thereof, and the U.S./Israel Income Tax Treaty, all as in effect as of the date hereof and all of which are subject to change,

possibly on a retroactive basis, and all of which are open to differing interpretations. Commtouch will not seek a ruling from the U.S. Internal Revenue Service, or the IRS, with regard to the U.S. federal income tax treatment of an investment in our Ordinary Shares by U.S. Holders and, therefore, can provide no assurances that the IRS will agree with the conclusions set forth below.

This discussion does not address all of the aspects of U.S. federal income taxation that may be relevant to a particular shareholder based on such shareholder's particular circumstances and in particular does not discuss any estate, gift, generation-skipping, transfer, state, local or foreign tax considerations. In addition, this discussion does not address the U.S. federal income tax treatment of a U.S. Holder who is: (1) a bank, life insurance company, regulated investment company, or other financial institution or "financial services entity"; (2) a broker or dealer in securities or foreign currency; (3) a person who acquired our Ordinary Shares in connection with employment or other performance of services; (4) a U.S. Holder that is subject to the U.S. alternative minimum tax; (5) a U.S. Holder that holds our Ordinary Shares as a hedge or as part of a hedging, straddle, conversion or constructive sale transaction or other risk-reduction transaction for U.S. federal income tax purposes; (6) a tax-exempt entity; (7) real estate investment trusts; (8) a U.S. Holder that expatriates out of the United States or a former long-term resident of the United States; or (9) a person having a functional currency other than the U.S. dollar. This discussion does not address the U.S. federal income tax treatment of a U.S. Holder that owns, directly or constructively, at any time, Ordinary Shares representing 10% or more of our voting power. Additionally, the U.S. federal income tax treatment of persons who hold Ordinary Shares through a partnership or other pass-through entity are not considered.

Each prospective investor is advised to consult such person's own tax advisor with respect to the specific U.S. federal and state income tax consequences to such person of purchasing, holding or disposing of the Ordinary Shares, including the effects of applicable state, local, foreign or other tax laws and possible changes in the tax laws.

#### Distributions on Ordinary Shares

Subject to the discussion under the heading "Passive Foreign Investment Companies" below, a U.S. Holder will be required to include in gross income as ordinary income the amount of any distribution paid on Ordinary Shares (including the amount of any Israeli tax withheld on the date of the distribution), to the extent that such distribution does not exceed our current and accumulated earnings and profits, as determined for U.S. federal income tax purposes. The amount of a distribution which exceeds our earnings and profits will be treated first as a non-taxable return of capital, reducing the U.S. Holder's tax basis for the Ordinary Shares to the extent thereof, and then capital gain. Corporate holders generally will not be allowed a deduction for dividends received. In general, preferential tax rates not exceeding 15% for "qualified dividend income" and long-term capital gains are applicable for U.S. Holders that are individuals, estates or trusts (these preferential rates are scheduled to expire for taxable years beginning after December 31, 2010, after which time dividends are scheduled to be taxed at ordinary income rates and long-term capital gains are scheduled to be taxed at rates not exceeding 20%). For this purpose, "qualified dividend income" means, inter alia, dividends received from a "qualified foreign corporation." A "qualified foreign corporation" is a corporation that is entitled to the benefits of a comprehensive tax treaty with the United States which includes an exchange of information program. The IRS has stated that the Israel/U.S. Tax Treaty satisfies this requirement and we believe we are eligible for the benefits of that treaty.

In addition, our dividends will be qualified dividend income if our Ordinary Shares are readily tradable on NASDAQ or another established securities market in the United States. Dividends will not qualify for the preferential rate if we are treated, in the year the dividend is paid or in the prior year, as a passive foreign investment company, or PFIC. A U.S. Holder will not be entitled to the preferential rate: (i) if the U.S. Holder has not held our Ordinary Shares or ADRs for at least 61 days of the 121 day period beginning on the date which is 60 days before the ex-dividend date, or (ii) to the extent the U.S. Holder is under an obligation to make related payments on substantially similar property. Any days during which the U.S. Holder has diminished its risk of loss on our Ordinary Shares are not counted towards meeting the 61-day holding period. Finally, U.S. Holders who elect to treat the dividend income as "investment income" pursuant to Code section 163(d)(4) will not be eligible for the preferential rate of taxation.

The amount of a distribution with respect to our Ordinary Shares will be measured by the amount of the fair market value of any property distributed, and for U.S. federal income tax purposes, the amount of any Israeli taxes withheld therefrom. (See discussion above under “Taxation of Non-Resident Holders of Shares.”) Cash distributions paid by us in NIS will be included in the income of U.S. Holders at a U.S. dollar amount based upon the spot rate of exchange in effect on the date the dividend is includible in the income of the U.S. Holder, and U.S. Holders will have a tax basis in such NIS for U.S. federal income tax purposes equal to such U.S. dollar value. If the U.S. Holder subsequently converts the NIS, any subsequent gain or loss in respect of such NIS arising from exchange rate fluctuations will be U.S. source ordinary exchange gain or loss.

Distributions paid by us will generally be foreign source income for U.S. foreign tax credit purposes. Subject to the limitations set forth in the Code, U.S. Holders may elect to claim a foreign tax credit against their U.S. income tax liability for Israeli income tax withheld from distributions received in respect of the Ordinary Shares. In general, these rules limit the amount allowable as a foreign tax credit in any year to the amount of regular U.S. tax for the year attributable to foreign source taxable income. This limitation on the use of foreign tax credits generally will not apply to an electing individual U.S. Holder whose creditable foreign taxes during the year do not exceed \$300, or \$600 for joint filers, if such individual’s gross income for the taxable year from non-U.S. sources consists solely of certain passive income. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received with respect to the Ordinary Shares if such U.S. Holder has not held the Ordinary Shares for at least 16 days out of the 31-day period beginning on the date that is 15 days before the ex-dividend date or to the extent that such U.S. Holder is under an obligation to make certain related payments with respect to substantially similar or related property. Any day during which a U.S. Holder has substantially diminished his or her risk of loss with respect to the Ordinary Shares will not count toward meeting the 16-day holding period. A U.S. Holder will also be denied a foreign tax credit if the U.S. Holder holds the Ordinary Shares in an arrangement in which the U.S. Holder’s reasonably expected economic profit is insubstantial compared to the foreign taxes expected to be paid or accrued. The rules relating to the determination of the U.S. foreign tax credit are complex, and U.S. Holders should consult with their own tax advisors to determine whether, and to what extent, they are entitled to such credit. U.S. Holders that do not elect to claim a foreign tax credit may instead claim a deduction for Israeli income taxes withheld, provided such U.S. Holders itemize their deductions.

#### Disposition of Shares

Except as provided under the PFIC rules described below, upon the sale, exchange or other disposition of our Ordinary Shares, a U.S. Holder will recognize capital gain or loss in an amount equal to the difference between such U.S. Holder’s tax basis for the Ordinary Shares and the amount realized on the disposition (or its U.S. dollar equivalent determined by reference to the spot rate of exchange on the date of disposition, if the amount realized is denominated in a foreign currency). The gain or loss realized on the sale or exchange or other disposition of Ordinary Shares will be long-term capital gain or loss if the U.S. Holder has a holding period of more than one year at the time of the disposition.

In general, gain realized by a U.S. Holder on a sale, exchange or other disposition of Ordinary Shares will generally be treated as U.S. source income for U.S. foreign tax credit purposes. A loss realized by a U.S. Holder on the sale, exchange or other disposition of Ordinary Shares is generally allocated to U.S. source income. However, U.S. Treasury Regulations require such loss to be allocated to foreign source income to the extent certain dividends were received by the taxpayer within the 24-month period preceding the date on which the taxpayer recognized the loss. The deductibility of a loss realized on the sale, exchange or other disposition of Ordinary Shares is subject to limitations.

#### Passive Foreign Investment Companies

Special U.S. federal income tax laws apply to a U.S. Holder who owns shares of a corporation that was (at any time during the U.S. Holder's holding period) PFIC. We would be treated as a PFIC for U.S. federal income tax purposes for any tax year if, in such tax year, either:

75% or more of our gross income (including our pro rata share of gross income for any company, U.S. or foreign, in which we are considered to own 25% or more of the shares by value), in a taxable year is passive (the "Income Test");  
or

At least 50% of our assets, averaged over the year and generally determined based upon value (including our pro rata share of the assets of any company in which we are considered to own 25% or more of the shares by value), in a taxable year are held for the production of, or produce, passive income (the "Asset Test").

For this purpose, passive income generally consists of dividends, interest, rents, royalties, annuities and income from certain commodities transactions and from notional principal contracts. Cash is treated as generating passive income.

If we are or become a PFIC, each U.S. Holder who has not elected to treat us as a qualified electing fund by making a "QEF election", or who has not elected to mark the shares to market (as discussed below), would, upon receipt of certain distributions by us and upon disposition of our Ordinary Shares at a gain, be liable to pay U.S. federal income tax at the then prevailing highest tax rates on ordinary income plus interest on such tax, as if the distribution or gain had been recognized ratably over the taxpayer's holding period for the Ordinary Shares. In addition, when shares of a PFIC are acquired by reason of death from a decedent that was a U.S. Holder, the tax basis of such shares would not receive a step-up to fair market value as of the date of the decedent's death, but instead would be equal to the decedent's basis if lower, unless all gain were recognized by the decedent. Indirect investments in a PFIC may also be subject to special U.S. federal income tax rules.

The PFIC rules would not apply to a U.S. Holder who makes a QEF election for all taxable years that such U.S. Holder has held the Ordinary Shares while we are a PFIC, provided that we comply with certain reporting requirements. Instead, each U.S. Holder who has made such a QEF election is required for each taxable year that we are a PFIC to include in income such U.S. Holder's pro rata share of our ordinary earnings as ordinary income and such U.S. Holder's pro rata share of our net capital gains as long-term capital gain, regardless of whether we make any distributions of such earnings or gain. In general, a QEF election is effective only if we make available certain required information. The QEF election is made on a shareholder-by-shareholder basis and generally may be revoked only with the consent of the IRS. Although we have no obligation to do so, we intend to comply with the applicable information reporting requirements for U.S. Holders to make a QEF election.

A U.S. Holder of PFIC shares which are traded on certain public markets, including the NASDAQ, can elect to mark the shares to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the PFIC shares and the U.S. Holder's adjusted tax basis in the PFIC shares. Losses are allowed only to the extent of net mark-to-market gain previously included income by the U.S. Holder under the election for prior taxable years.



In light of the complexity of PFIC rules, we cannot assure you that we have not been or are not a PFIC or will avoid becoming a PFIC in the future. U.S. Holders who hold Ordinary Shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to certain exceptions for U.S. Holders who made a QEF or mark-to-market election. U.S. Holders are strongly urged to consult their tax advisors about the PFIC rules, including the eligibility, manner, and consequences to them of making a QEF or mark-to-market election with respect to our Ordinary Shares in the event we that qualify as a PFIC. For those U.S. Holders who determine that we were a PFIC in any of our taxable years and notify us in writing of their request for the information required in order to effectuate the QEF election described above, we will promptly make such information available to them.

#### Information Reporting and Withholding

A U.S. Holder may be subject to backup withholding (currently at a rate of 28%, but scheduled to increase to 31% for taxable years beginning after December 31, 2010) with respect to cash dividends and proceed from a disposition of Ordinary Shares. In general, back-up withholding will apply only if a U.S. Holder fails to comply with certain identification procedures. Backup withholding will not apply with respect to payments made to certain exempt recipients, such as corporations and tax-exempt organizations. Backup withholding is not an additional tax and may be claimed as a credit against the U.S. federal income tax liability of a U.S. Holder, provided that the required information is timely furnished to the IRS.

#### Non-U.S. Holders of Ordinary Shares

Except as provided below, an individual, corporation, estate or trust that is not a U.S. Holder generally will not be subject to U.S. federal income or withholding tax on the payment of dividends on, and the proceeds from the disposition of, our Ordinary Shares.

A non-U.S. Holder may be subject to U.S. federal income or withholding tax on a dividend paid on our Ordinary Shares or the proceeds from the disposition of our Ordinary Shares if: (i) such item is effectively connected with the conduct by the non-U.S. Holder of a trade or business in the United States or, in the case of a non-U.S. Holder that is a resident of a country which has an income tax treaty with the United States, such item is attributable to a permanent establishment or, in the case of gain realized by an individual non-U.S. Holder, a fixed place of business in the U.S.; (ii) in the case of a disposition of our Ordinary Shares, the individual non-U.S. Holder is present in the U.S. for 183 days or more in the taxable year of the sale and certain other conditions are met; (iii) the non-U.S. Holder is subject to U.S. federal income tax pursuant to the provisions of the U.S. tax law applicable to U.S. expatriates.

In general, non-U.S. Holders will not be subject to backup withholding with respect to the payment of dividends on our Ordinary Shares if payment is made through a paying agent, or office of a foreign broker outside the United States. However, if payment is made in the United States or by a U.S. related person, non-U.S. Holders may be subject to backup withholding, unless the non-U.S. Holder provides on an applicable Form W-8 (or a substantially similar form) a taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption. A U.S. related person for these purposes is a person with one or more current relationships with the United States.

The amount of any backup withholding from a payment to a non-U.S. Holder will be allowed as a credit against such holder's U.S. federal income tax liability and may entitle such holder to a refund, provided that the required information is timely furnished to the IRS.



Item 11. Qualitative and Quantitative Disclosure about Market Risk.

We develop our technology in Israel and seek to provide our services worldwide. As a result, our foreign currency exposures give rise to market risk associated with exchange rate movements of the U.S. dollar, our functional and reporting currency, against the NIS and Euro. We are exposed to the risk of fluctuation in the U.S. dollar/NIS and the U.S. dollar/Euro exchange rate. Our shekel-denominated expenses consist principally of salaries and related personnel expenses, as well as vehicle lease payments. Although the majority of our revenues are in US dollars, a substantial portion of our sales are derived from the Euro currency. Neither a ten percent increase nor decrease in current exchange rates would have a material effect on our consolidated financial statements in the next six months.

Due to the fact that we do not have any material debt, we have concluded that there is currently no material interest market risk exposure.

Therefore, no quantitative tabular disclosures are provided.

Item 12. Description of Securities Other than Equity Securities.

The Company does not have any outstanding American Depositary Shares or American Depositary Receipts.

PART II

Item 13. Defaults, Dividend Arrearages and Delinquencies.

None.

Item 14. Material Modifications to the Rights of Security Holders and Use of Proceeds.

None.

Item 15T. Controls and Procedures.

(a) As of December 31, 2009, we performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act). Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and our management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of December 31, 2009, to provide reasonable assurance that the information required to be disclosed in filings and submissions under the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified by the SEC's rules and forms, and that such information related to us and our consolidated subsidiary is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions about required disclosure.

(b) and (c) Our management is responsible for establishing and maintaining adequate internal control over our financial reporting, as such term is defined in Rule 13a-15(f) under the Security Exchange Act. Our internal control over financial reporting system was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective can only provide reasonable assurance with respect to financial statements. Also projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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Our management assessed our internal control over financial reporting as of December 31, 2009. Our management based its assessment on criteria established in Internal Control- Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this assessment, our management has concluded that, as of December 31, 2009, our internal control over financial reporting is effective.

(d) Our independent registered public accounting firm, Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, independently assessed the effectiveness of the Company's internal control over financial reporting. Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, has issued an attestation report in respect of our internal control over financial reporting as of December 31, 2009, which is included under Item 18 on page F-3 of this annual report. We note that this report is provided voluntarily for 2009, as non-accelerated filers are not required to include it in their Form 20-F filing.

(e) During the period covered by this annual report on Form 20-F, there were no changes to our internal control over financial reporting that occurred during the year ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 16A. Audit Committee Financial Expert.

The Board of Directors of the Company has determined that Mr. Yair Shamir, a member of the Audit Committee, is an audit committee financial expert as that term is defined in Item 16A of Form 20-F and is independent as that term is defined in NASDAQ Listing Rule 5605(a)(2).

Item 16B. Code of Ethics.

The Company, by way of Board of Directors resolution, has adopted a Code of Ethics applicable to its senior financial officers, including its principal executive, financial and accounting officers. The Code of Ethics is posted on the Company's website at [www.commtouch.com](http://www.commtouch.com), under the link to "investor relations".

Item 16C. Principal Accountant Fees and Services.

Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, has served as our Independent Registered Public Accounting Firm for each of the fiscal years in the three-year period ended December 31, 2009, for which audited financial statements appear in this annual report on Form 20-F. The following table presents the aggregate fees for professional and other services rendered by Kost, Forer, Gabbay & Kasierer for 2009 and 2008:

|                | Year ended December 31, |            |
|----------------|-------------------------|------------|
|                | 2009                    | 2008       |
|                | Fees                    | Fees       |
| Audit fees (1) | \$ 133,000              | \$ 125,000 |
| Tax Fees (2)   | \$ 18,000               | \$ 21,000  |
| Total          | \$ 151,000              | \$ 146,000 |

(1) Audit fees consist of fees billed for the annual audit services engagement and other audit services, which are those services that only the Independent Registered Public Accounting Firm can reasonably provide, and include the group audit including statutory audits; consents; attest services; and assistance in connection with documents filed with the SEC. These fees also include the attestation of our internal control over financial reporting.

(2) Tax fees include fees billed for tax compliance services, including the preparation of original and amended tax returns and claims for refund; tax consultations, such as assistance and representation in connection with tax audits

and appeals, transfer pricing, and requests for rulings or technical advice from taxing authority; and tax planning services.

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## Audit Committee Pre-approval Policies and Procedures

Below is a summary of our current Policies and Procedures:

The main role of the Company's audit committee is to assist the Board of Directors in fulfilling its responsibility for oversight of the quality and integrity of the accounting, auditing and reporting practices of the Company. The Audit Committee oversees the appointment, compensation, and oversight of the Company's independent registered public accounting firm engaged to prepare or issue an audit report on the financial statements of the Company. The audit committee's specific responsibilities in carrying out its oversight role include the approval of all audit and non-audit services to be provided by the external auditor and the quarterly review of the firm's non-audit services and related fees. These services may include audit services, audit-related services, tax services and other services, as described above. It is the policy of the audit committee to approve in advance the particular services or categories of services to be provided to the Company periodically. Additional services may be pre-approved by the audit committee on an individual basis during the year. The audit committee did not avail itself of section (c)(7)(i)(C) of Rule 2-01 of Regulation S-X during 2007, which allows for an exemption from the pre-approval process under certain limited circumstances.

Item 16D. Exemptions from the Listing Standards for Audit Committees.

Not applicable.

Item 16E. Purchases of Equity Securities by the Issuer and Affiliated Purchasers.

In July 2008, the Company announced the commencement of an Ordinary Share buyback plan, under which the Company purchased almost \$5 million worth of its Ordinary Shares through the end of 2009. The Company completed its buyback plan in December 2009 and, in total, it expended \$4,872,000 to repurchase 2,163,826 Ordinary Shares at an average price of \$2.25 per share. Repurchases during 2009 are summarized in the following table:

## ISSUER PURCHASES OF SECURITIES

| Period                     | Total Number<br>Of Shares<br>Purchased | Average Price<br>Paid Per Share<br>(\$) | Total Number<br>Of Shares<br>Purchased As<br>Part of Publicly<br>Announced<br>Plan | Maximum U.S.<br>Dollar Value That<br>May Yet Be<br>Purchased Under<br>The Plan |
|----------------------------|----------------------------------------|-----------------------------------------|------------------------------------------------------------------------------------|--------------------------------------------------------------------------------|
| January 1-<br>January 31   | 118,500                                | 2.02                                    | 118,500                                                                            | 3,427,369                                                                      |
| February 1-<br>February 28 | 79,700                                 | 1.96                                    | 79,700                                                                             | 3,270,927                                                                      |
| March 1-<br>March 31       | 132,772                                | 1.84                                    | 132,772                                                                            | 3,027,229                                                                      |
| April 1 –<br>April 30      | 155,949                                | 1.85                                    | 155,949                                                                            | 2,739,110                                                                      |
| May 1 –<br>May 31          | 101,165                                | 1.93                                    | 101,165                                                                            | 2,544,065                                                                      |

|                               |           |      |           |           |
|-------------------------------|-----------|------|-----------|-----------|
| June 1-<br>June 30            | 169,000   | 1.96 | 169,000   | 2,212,520 |
| July 1 –<br>July 31           | 98,243    | 2.35 | 98,243    | 1,981,397 |
| August 1-<br>August 31        | 124,530   | 2.68 | 124,530   | 1,647,721 |
| September 1 –<br>September 30 | 124,978   | 2.76 | 124,978   | 1,302,754 |
| October 1 –<br>October 31     | 119,472   | 3.35 | 119,472   | 902,878   |
| November 1 –<br>November 30   | 155,290   | 3.23 | 155,290   | 401,085   |
| December 1 –<br>December 31   | 78,149    | 3.47 | 78,149    | 127,573   |
| Total                         | 1,457,748 | 2.43 | 1,457,748 | N/A       |

#### Subsequent Event

On March 15, 2010, the Company announced that its board of directors had authorized an additional plan for the repurchase of the Company's Ordinary Shares in the open market or through privately negotiated transactions, in an amount in cash of up to \$5 million. The Company has begun implementing the plan.

#### Item 16F. Change in Registrant's Certifying Accountant.

Not applicable.

#### Item 16G. Corporate Governance.

Under NASDAQ Listing Rule 5615(a)(3), foreign private issuers, such as our Company, are permitted to follow certain home country corporate governance practices instead of certain provisions of certain NASDAQ Listing Rules. We do not comply with the following requirements of the NASDAQ Listing Rules, and instead follow Israeli law and practice with respect to such corporate governance practices:

NASDAQ Listing Rule 5250(d) requires that an annual report be delivered to shareholders in accordance with three alternative delivery methods set forth in the rule. One of those delivery methods allows for the posting of the annual report on the Company's website. However, that method also requires that i) a prominent undertaking be posted on the website indicating that, upon request, shareholders may receive a hard copy of the annual report free of charge, and ii) simultaneous with this posting, the Company issue a press release stating that its annual report has been filed with the SEC (or other appropriate regulatory authority). This press release must also state that the annual report is available on the Company's website and include the website address and that shareholders may receive a hard copy free of charge upon request.

While the Company's most current annual report on Form 20-F, inclusive of consolidated financial statements, is available on its website at [www.commtouch.com](http://www.commtouch.com), and the Company has indicated publicly that it will provide copies of that report free of charge, upon shareholder request, nevertheless the Company is not in strict compliance with the NASDAQ rule. The Company does not include a statement on its website in the form noted above and does not issue a press release upon the posting of the annual report to its website; rather, the Company is following its home country practice (in Israel, which, in addition to the Company's activities noted above, also enables shareholders to inspect the Company's annual consolidated financial statements in person at its principal offices).

Rule 5620(c) to Nasdaq Listing Rules requires that an issuer listed on Nasdaq should have a quorum requirement that in no case be less than 33 1/3% of the outstanding shares of a company's common voting stock. However, the Company's articles of association, consistent with the Companies Law, provides for a lower quorum in the event of a meeting adjourned for lack of a quorum, in which case any two shareholders entitled to vote and present in person or by proxy at such adjourned meeting shall constitute a quorum. Our quorum requirements for an adjourned meeting do not comply with the NASDAQ requirements and we instead follow our home country practice.

As a foreign private issuer listed on the NASDAQ Capital Market, we may also follow home country practice with regard to, among other things, composition of the board of directors, director nomination process and regularly scheduled meetings at which only independent directors are present. In addition, we may follow our home country practice, instead of the NASDAQ Listing Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company. A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements, must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission or on its website each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

### PART III

Item 17. Financial Statements.

The Company has responded to Item 18

Item 18. Financial Statements.

See pages F-1 to F-26.



COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2009

U.S. DOLLARS IN THOUSANDS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

COMMTOUCH SOFTWARE LTD.

We have audited the accompanying consolidated balance sheets of Commtouch Software Ltd. ("the Company") and its subsidiary as of December 31, 2008 and 2009, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiary as of December 31, 2008 and 2009, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 26, 2010 expressed an unqualified opinion thereon.

Tel-Aviv, Israel  
March 26, 2010

/s/ Kost, Forer, Gabbay & Kasierer  
KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

COMMTOUCH SOFTWARE LTD.

We have audited Commtouch Software Ltd.'s ("Commtouch" or the "Company") internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). Commtouch's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Commtouch maintained in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Commtouch and its subsidiary as of December 31, 2009 and 2008, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2009 and our report dated March 26, 2010 expressed an unqualified opinion thereon.

Tel-Aviv, Israel

/s/ Kost, Forer, Gabbay & Kasierer  
KOST FORER GABBAY & KASIERER

March 26, 2010

A Member of Ernst & Young Global

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## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

|                               | December 31      |                  |
|-------------------------------|------------------|------------------|
|                               | 2008             | 2009             |
| <b>ASSETS</b>                 |                  |                  |
| <b>CURRENT ASSETS:</b>        |                  |                  |
| Cash and cash equivalents     | \$ 13,661        | \$ 17,275        |
| Short-term cash deposit       | 740              | -                |
| Marketable securities         | 2,000            | -                |
| Trade receivables             | 1,614            | 1,932            |
| Deferred income taxes         | -                | 1,417            |
| Prepaid expenses              | 270              | 233              |
| Other accounts receivable     | 119              | 410              |
| <b>Total current assets</b>   | <b>18,404</b>    | <b>21,267</b>    |
| <b>LONG-TERM ASSETS:</b>      |                  |                  |
| Long-term lease deposits      | 64               | 63               |
| Investment in affiliate       | 750              | 1,227            |
| Severance pay fund            | 720              | 945              |
| Deferred income taxes         | -                | 987              |
| Property and equipment, net   | 771              | 701              |
| <b>Total long-term assets</b> | <b>2,305</b>     | <b>3,923</b>     |
| <b>Total assets</b>           | <b>\$ 20,709</b> | <b>\$ 25,190</b> |

The accompanying notes are an integral part of the consolidated financial statements.

## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands, except share and per share data

|                                                                                                     | December 31      |                  |
|-----------------------------------------------------------------------------------------------------|------------------|------------------|
|                                                                                                     | 2008             | 2009             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                         |                  |                  |
| <b>CURRENT LIABILITIES:</b>                                                                         |                  |                  |
| Accounts payable                                                                                    | \$ 253           | \$ 357           |
| Employees and payroll accruals                                                                      | 726              | 996              |
| Accrued expenses and other liabilities                                                              | 187              | 210              |
| Government authorities                                                                              | 50               | 18               |
| Deferred revenues                                                                                   | 2,341            | 2,834            |
| <b>Total current liabilities</b>                                                                    | <b>3,557</b>     | <b>4,415</b>     |
| <b>LONG-TERM LIABILITIES:</b>                                                                       |                  |                  |
| Long-term deferred revenues                                                                         | 635              | 848              |
| Accrued severance pay                                                                               | 857              | 1,050            |
| <b>Total long-term liabilities</b>                                                                  | <b>1,492</b>     | <b>1,898</b>     |
| <b>COMMITMENTS AND CONTINGENCIES</b>                                                                |                  |                  |
| <b>SHAREHOLDERS' EQUITY:</b>                                                                        |                  |                  |
| Ordinary shares nominal value NIS 0.15 par value-                                                   |                  |                  |
| Authorized: 55,353,340 shares as of December 31, 2008 and 2009; Issued: 25,912,737                  |                  |                  |
| and 26,122,587 shares as of December 31, 2008 and 2009, respectively;                               |                  |                  |
| Outstanding: 25,206,659 and 23,958,761 shares as of December 31, 2008 and 2009,                     |                  |                  |
| respectively                                                                                        | 890              | 842              |
| Additional paid-in capital                                                                          | 182,144          | 183,731          |
| Treasury shares (706,078 and 2,163,826 Ordinary shares at December 31, 2008 and 2009, respectively) | (1,306)          | (4,788)          |
| Accumulated other comprehensive income                                                              | 23               | 23               |
| Accumulated deficit                                                                                 | (166,091)        | (160,931)        |
| <b>Total shareholders' equity</b>                                                                   | <b>15,660</b>    | <b>18,877</b>    |
| <b>Total liabilities and shareholders' equity</b>                                                   | <b>\$ 20,709</b> | <b>\$ 25,190</b> |

The accompanying notes are an integral part of the consolidated financial statements.

## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands, except share and per share data

|                                                                                     | Year ended December 31, |            |            |
|-------------------------------------------------------------------------------------|-------------------------|------------|------------|
|                                                                                     | 2007                    | 2008       | 2009       |
| Revenues                                                                            | \$ 11,250               | \$ 14,092  | \$ 15,189  |
| Cost of revenues                                                                    | 1,411                   | 1,828      | 2,260      |
| Gross profit                                                                        | 9,839                   | 12,264     | 12,929     |
| Operating expenses:                                                                 |                         |            |            |
| Research and development, net                                                       | 2,187                   | 3,152      | 2,958      |
| Sales and marketing                                                                 | 3,453                   | 3,992      | 4,212      |
| General and administrative                                                          | 2,589                   | 3,189      | 3,063      |
| Total operating expenses                                                            | 8,229                   | 10,333     | 10,233     |
| Operating income                                                                    | 1,610                   | 1,931      | 2,696      |
| Financial income, net                                                               | 527                     | 346        | 60         |
| Income before taxes on income (tax benefit)                                         | 2,137                   | 2,277      | 2,756      |
| Taxes on income (tax benefit)                                                       | 28                      | 7          | (2,404)    |
| Net income                                                                          | \$ 2,109                | \$ 2,270   | \$ 5,160   |
| Basic net earnings per share                                                        | \$ 0.08                 | \$ 0.09    | \$ 0.21    |
| Diluted net earnings per share                                                      | \$ 0.08                 | \$ 0.08    | \$ 0.20    |
| Weighted average number of shares used in computing basic net earnings per share    | 24,846,690              | 25,618,933 | 24,531,810 |
| Weighted average numbers of shares used in computing diluted net earnings per share | 27,591,498              | 26,929,407 | 25,291,517 |

The accompanying notes are an integral part of these consolidated financial statements.

## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars in thousands, except share data

|                                                                                  | Ordinary<br>shares | Ordinary<br>shares<br>amount | Additional<br>paid-in<br>capital | Treasury<br>stock | Accumulated<br>other<br>comprehensive<br>income *) | Accumulated<br>deficit | Total<br>comprehensive<br>income | Total    |
|----------------------------------------------------------------------------------|--------------------|------------------------------|----------------------------------|-------------------|----------------------------------------------------|------------------------|----------------------------------|----------|
| Balance as of<br>January 1, 2007                                                 | 24,011,155         | \$ 845                       | \$ 177,095                       | \$ -              | \$ 23                                              | \$ (170,470)           |                                  | \$ 7,493 |
| Issuance of shares<br>upon exercise of<br>options and<br>warrants                | 1,334,887          | 48                           | 1,615                            | -                 | -                                                  | -                      |                                  | 1,663    |
| Stock-based<br>compensation<br>related to<br>employees                           | -                  | -                            | 1,015                            | -                 | -                                                  | -                      |                                  | 1,015    |
| Stock-based<br>compensation<br>related to options<br>granted to<br>non-employees | -                  | -                            | 68                               | -                 | -                                                  | -                      |                                  | 68       |
| Net income                                                                       | -                  | -                            | -                                | -                 | -                                                  | 2,109                  | \$ 2,109                         | 2,109    |
| Total<br>comprehensive<br>income                                                 |                    |                              |                                  |                   |                                                    |                        | \$ 2,109                         |          |
| Balance as of<br>December 31, 2007                                               | 25,346,042         | 893                          | 179,793                          | -                 | 23                                                 | (168,361)              |                                  | 12,348   |
| Purchase of<br>treasury shares                                                   | (706,078)          | (28)                         | -                                | (1,306)           | -                                                  | -                      |                                  | (1,334)  |
| Issuance of shares<br>upon exercise of<br>options and<br>warrants                | 566,695            | 25                           | 819                              | -                 | -                                                  | -                      |                                  | 844      |
| Stock-based<br>compensation<br>related to<br>employees                           | -                  | -                            | 1,495                            | -                 | -                                                  | -                      |                                  | 1,495    |
| Stock-based<br>compensation<br>related to options<br>granted to<br>non-employees | -                  | -                            | 37                               | -                 | -                                                  | -                      |                                  | 37       |



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|                                                                      |             |        |            |            |       |              |    |       |           |
|----------------------------------------------------------------------|-------------|--------|------------|------------|-------|--------------|----|-------|-----------|
| Net income                                                           | -           | -      | -          | -          | -     | 2,270        | \$ | 2,270 | 2,270     |
| Total comprehensive income                                           |             |        |            |            |       |              | \$ | 2,270 |           |
| Balance as of December 31, 2008                                      | 25,206,659  | 890    | 182,144    | (1,306)    | 23    | (166,091)    |    |       | 15,660    |
| Purchase of treasury shares                                          | (1,457,748) | (56)   | -          | (3,482)    | -     | -            |    |       | (3,538)   |
| Issuance of shares upon exercise of options                          | 209,850     | 8      | 210        | -          | -     | -            |    |       | 218       |
| Stock-based compensation related to employees                        | -           | -      | 1,345      | -          | -     | -            |    |       | 1,345     |
| Stock-based compensation related to options granted to non-employees | -           | -      | 32         | -          | -     | -            |    |       | 32        |
| Net income                                                           | -           | -      | -          | -          | -     | 5,160        | \$ | 5,160 | 5,160     |
| Total comprehensive income                                           |             |        |            |            |       |              | \$ | 5,160 |           |
| Balance as of December 31, 2009                                      | 23,958,761  | \$ 842 | \$ 183,731 | \$ (4,788) | \$ 23 | \$ (160,931) |    |       | \$ 18,877 |

\*) Relates to foreign currency translation adjustments

The accompanying notes are an integral part of the consolidated financial statements.

## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

|                                                                                                                          | Year ended December 31, |                  |                  |
|--------------------------------------------------------------------------------------------------------------------------|-------------------------|------------------|------------------|
|                                                                                                                          | 2007                    | 2008             | 2009             |
| <b>Cash flows from operating activities:</b>                                                                             |                         |                  |                  |
| Net income                                                                                                               | \$ 2,109                | \$ 2,270         | \$ 5,160         |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b>                                 |                         |                  |                  |
| Depreciation                                                                                                             | 397                     | 466              | 491              |
| Compensation related to options granted to employees and non-employees                                                   | 1,083                   | 1,532            | 1,377            |
| Increase in deferred income taxes                                                                                        | -                       | -                | (2,404)          |
| <b>Changes in assets and liabilities:</b>                                                                                |                         |                  |                  |
| Increase in trade receivables                                                                                            | (540)                   | (504)            | (318)            |
| Increase in prepaid expenses and other accounts receivable                                                               | (107)                   | (46)             | (271)            |
| Increase (decrease) in accounts payable                                                                                  | 24                      | (69)             | 112              |
| Increase (decrease) in employees and payroll accruals, accrued expenses and other liabilities and government authorities | 279                     | (198)            | 261              |
| Increase (decrease) in deferred revenues                                                                                 | 861                     | (459)            | 706              |
| Increase (decrease) in accrued severance pay, net                                                                        | 11                      | 27               | (32)             |
| Other                                                                                                                    | (2)                     | -                | -                |
| <b>Net cash provided by operating activities</b>                                                                         | <b>4,115</b>            | <b>3,019</b>     | <b>5,082</b>     |
| <b>Cash flows from investing activities:</b>                                                                             |                         |                  |                  |
| Change in short-term cash deposit                                                                                        | (1,600)                 | 860              | 740              |
| Decrease (increase) in long-term lease deposits                                                                          | (20)                    | (31)             | 1                |
| Sale of marketable securities                                                                                            | -                       | -                | 2,000            |
| Investment in affiliate                                                                                                  | (750)                   | -                | (477)            |
| Purchase of property and equipment                                                                                       | (605)                   | (504)            | (412)            |
| <b>Net cash provided by (used in) investing activities</b>                                                               | <b>(2,975)</b>          | <b>325</b>       | <b>1,852</b>     |
| <b>Cash flows from financing activities:</b>                                                                             |                         |                  |                  |
| Purchase of treasury shares at cost                                                                                      | -                       | (1,334)          | (3,538)          |
| Proceeds from options and warrants exercised                                                                             | 1,663                   | 844              | 218              |
| <b>Net cash provided by (used in) financing activities</b>                                                               | <b>1,663</b>            | <b>(490)</b>     | <b>(3,320)</b>   |
| Increase in cash and cash equivalents                                                                                    | 2,803                   | 2,854            | 3,614            |
| Cash and cash equivalents at the beginning of the year                                                                   | 8,004                   | 10,807           | 13,661           |
| <b>Cash and cash equivalents at the end of the year</b>                                                                  | <b>\$ 10,807</b>        | <b>\$ 13,661</b> | <b>\$ 17,275</b> |

The accompanying notes are an integral part of the consolidated financial statements.

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## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

|                                                     | Year ended December 31, |         |        |
|-----------------------------------------------------|-------------------------|---------|--------|
|                                                     | 2007                    | 2008    | 2009   |
| (a) Non-cash transactions:                          |                         |         |        |
| Purchase of property and equipment - trade payables | \$ (33)                 | \$ (13) | \$ (9) |
| Supplemental cash flow activities:                  |                         |         |        |
| Cash paid during the year for:                      |                         |         |        |
| Income taxes                                        | \$ 20                   | \$ -    | \$ -   |

The accompanying notes are an integral part of the consolidated financial statements.

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands, except share and per share data

NOTE 1: GENERAL

a. Commtouch Software Ltd. ("Commtouch" or the Company") was incorporated under the laws of Israel in 1991. The Company and its subsidiary (Commtouch Inc.) develop and provide messaging and Web security solutions to OEM partners and enterprises. The Company's business is to develop and sell, through a variety of third party distribution channels, these solutions to various customers. The Company's messaging solutions are comprised of anti-spam, Zero-Hour anti-virus and GlobalView Mail Reputation solutions, and its Web security solution is known as GlobalView URL filtering.

b. The Company expects that it will continue to be dependent upon third-party distribution channels for a significant portion of its revenues, which are expected to be derived from sales of the Company's anti-spam, anti-virus, IP reputation and URL filtering solutions.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP").

a. Use of estimates:

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U. S. dollars:

A majority of the revenues of the Company and its subsidiary is generated in United States dollars ("dollars"). In addition, a substantial portion of their costs is incurred or denominated in dollars. The Company's management believes that the dollar is the currency of the primary economic environment in which the Company and its subsidiary operate. Thus, the dollar is their functional and reporting currency. Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars, in accordance with ASC Topic 830, "Foreign Currency Matters". All transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statements of operations as financial income or expenses, as appropriate.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All inter-company balances and transactions have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents are short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less when purchased.

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Short-term bank deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term bank deposits. Such short-term bank deposits are stated at cost.

f. Marketable securities:

In 2008, the Company classified its marketable securities in accordance with ASC 320, "Investments-Debt and Equity Securities" ("ASC 320"), as available-for-sale. The marketable securities that are held for the short-term and available for immediate sale were stated at quoted market prices at balance sheet date. The Company's marketable securities consisted of highly-rated auction rate (AAA) securities ("ARS") which were federal backed student loan securities. Available-for-sale securities were carried at fair value, with the unrealized gains and losses, reported in "accumulated other comprehensive income (loss)" in shareholders' equity.

Commencing February 2008, all of the Company's ARSs (comprised of five securities) suffered from failed auctions. On January 5, 2009, all of the Company's marketable securities were purchased by the bank at full par value amounting to a total of \$ 2,000 and by agreeing to the settlement with the bank, the Company essentially stated that it no longer had the intent of holding the ARSs until recovery, as it would recover any unrealized loss through the settlement offer and, accordingly, the ARSs were classified as trading securities as of December 31, 2008.

g. Investment in affiliate:

For the purposes of these financial statements, an affiliated company is a company held to the extent of 20% or more, or a company less than 20% held, in which the Company can exercise significant influence over operating and financial policy of the affiliate. For the year ended December 31, 2007, the investment in an affiliated company (Imatrix) is accounted for under the equity method in accordance with ASC 323 "Investments—Equity Method". Profits on inter-company sales not realized outside the group were eliminated.

As of December 31, 2007, the Company lacks the ability to exercise significant influence over operating and financial policies of Imatrix and, accordingly, the investment is accounted for on a cost basis.

In November 2007 and April 2009, the Company made a \$ 750 and \$ 477, respectively, cash investment in Mirapoint Inc. ("Mirapoint"), a secure messaging vendor and an OEM licensee. The investment in an affiliated company is accounted for under the cost method since the Company cannot exercise significant influence over the operating and financial policies of Mirapoint.

The Company's investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an investment may not be recoverable. As of December 31, 2009, no impairment losses have been identified.





## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

## h. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated using the straight line method over the estimated useful lives of the assets at the following annual rates:

|                                    | %                                                                   |
|------------------------------------|---------------------------------------------------------------------|
| Computers and peripheral equipment | 33.33                                                               |
| Office furniture and equipment     | 7 – 20                                                              |
| Motor vehicles                     | 15                                                                  |
| Leasehold improvements             | Over the shorter of the term of the lease or the life of the assets |

## i. Impairment of long-lived assets:

The Company and its subsidiary's long-lived assets are reviewed for impairment in accordance with ASC 360 "Property, Plant and Equipment", whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. No impairment losses were recorded in 2007 through 2009.

## j. Fair value measurements

Concurrently with the adoption of ASC 820, the Company adopted ASC Topic 825, "Financial Instruments," ("ASC 825") which permits entities to elect, at specified election dates, to measure eligible financial instruments at fair value. As of December 31, 2009, the Company did not elect the fair value option under ASC 825 for any financial assets and liabilities that were not previously measured at fair value.

The carrying amounts of cash and cash equivalents, marketable securities, trade receivables, prepaid expenses, other accounts receivable and accounts payable, approximate their fair values due to the short-term maturities of financial instruments.

## k. Revenue recognition:

The Company derives revenues from Anti-Spam, Zero-Hour™ Virus Outbreak Protection, GlobalView Mail Reputation and GlobalView URL filtering Services. The service component of the Company's solutions is considered essential to the functionality of the software components. Furthermore, the software components can not be effectively used on a standalone basis, or with a third party's service. The customer has no ability to effectively run the software or the Software Development Kit ("SDK") on its own hardware. As the software portion of the product cannot effectively

stand on its own, the Company considers each sale as a service arrangement.

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COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Therefore, revenues from such services are recognized over the service term, which generally includes a term period of one to three years.

Revenue is recognized in accordance with ASC 605, "Revenue Recognition", when the earnings process is complete, as evidenced by an agreement between the customer and the Company, when delivery has occurred or services have been rendered, when the fee is fixed or determinable and when collectability is probable.

Deferred revenues include unearned amounts received from customers, but not yet recognized as revenues.

l. Research and development costs:

ASC 985-20, "Costs of Software to be Sold, Leased or Marketed", requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working models and the point at which the products are ready for general release, have been insignificant. Therefore, all research and development costs have been expensed.

m. Government grants:

Royalty-bearing grants from the Government of Israel for funding certain approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred and recorded as a deduction of research and development costs. Research and development grants from the Government of Israel amounted to \$ 263, \$0 and \$0 in 2009, 2008 and 2007, respectively

n. Concentrations of credit risk:

The Company and its subsidiary have no significant off-balance-sheet concentration of credit risk.

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of trade receivables and cash and cash equivalents. The majority of the Company's short-term deposits and cash and cash equivalents are invested in dollars and dollar linked investments and are deposited in major banks in the United States and Israel. Such investments in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are institutions with high credit standing, and accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are derived from transactions with companies located primarily in North America, Europe, Israel and Asia. An allowance for doubtful accounts is determined with respect to those amounts that the Company and its subsidiary have determined to be doubtful of collection. The allowance for doubtful accounts was \$ 0 at December 31, 2008 and 2009. Bad debt expense for each of the years ended December 31, 2007,

2008 and 2009 was \$ 0.

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## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

## o. Accounting for stock-based compensation:

ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated income statements.

The Company applies ASC 718, and ASC 505-50, "Equity Based Payments to Non-Employees" ("ASC 505-50"), with respect to options and warrants issued to non-employees. ASC 718 requires the use of an option valuation model to measure the fair value of the options and warrants at the measurement date as defined in ASC 505-50.

The Company recognizes compensation expense for the value of its awards on a straight line basis over the requisite service period of each of the awards, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company estimates the fair value of stock options granted using the Black-Scholes option-pricing model. The option-pricing model requires a number of assumptions, of which the most significant are the expected stock price volatility and the expected option term. Expected volatility was calculated based upon actual historical stock price movements. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free interest rate is based on the yield from U.S. treasury bonds with an equivalent term. The Company has historically not paid dividends and has no foreseeable plans to pay dividends.

The fair value for options granted in 2007, 2008 and 2009 is estimated at the date of grant using a Black-Scholes options pricing model with the following weighted average assumptions:

| Employee stock options  | Year ended December 31, |             |             |
|-------------------------|-------------------------|-------------|-------------|
|                         | 2007                    | 2008        | 2009        |
| Volatility              | 70%                     | 80%         | 82%         |
| Risk-free interest rate | 3.76%-4.94%             | 1.79%-2.79% | 1.34%-1.61% |
| Dividend yield          | 0%                      | 0%          | 0%          |
| Expected life (years)   | 4.08                    | 3.03        | 3.35        |

## p. Basic and diluted net earnings per share:

Basic and diluted net earnings per share are presented in accordance with ASC Topic 260, "Earnings per Share", for all periods presented.



COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands, except share and per share data

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Basic net earnings per share have been computed using the weighted-average number of Ordinary shares outstanding during the year. Diluted net earnings per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus the weighted average number of dilutive potential Ordinary shares considered outstanding during the year.

In 2007, 2008 and 2009, the difference between the denominator of basic and diluted net earnings per share is due to the effect of dilutive securities for stock options and warrants. In 2007, 2008 and 2009 363,133 ,1,563,038 and 2,584,732, respectively, weighted average number of shares related to options and warrants outstanding were excluded from calculation of the diluted earnings per share since they would have an anti-dilutive effect.

q. Severance pay:

The Company's liability for severance pay in Israel is calculated pursuant to Israel's Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's obligation for all of its Israeli employees is fully provided by monthly deposits with severance pay funds and insurance policies, and by an accrual. The value of those funds and policies is recorded as an asset in the Company's balance sheet.

The deposited funds include profits and losses accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies.

Severance (income) expense for the years ended December 31, 2007, 2008 and 2009 was approximately \$ 11, \$ 26 and \$ (31), respectively.

r. Treasury shares:

The Company repurchases its Ordinary shares from time to time on the open market and holds such shares as Treasury shares. The Company presents the cost to repurchase Treasury shares as a reduction in shareholders' equity.

s. Income taxes:

The Company accounts for income taxes in accordance with ASC Topic 740, "Income Taxes" ("ASC 740"). ASC 740 prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to amounts more likely than not to be realized.

Deferred tax assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences if not related

to an asset or liability for financial reporting.

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## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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U.S. dollars in thousands, except share and per share data

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

ASC 740 contains a two-step approach to recognizing and measuring a liability for uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. No liability for unrecognized tax benefits was recorded as a result of the implementation of ASC 740.

## t. Recently issued accounting pronouncements:

In June 2009, the FASB issued ASC 105, "Generally Accepted Accounting Principles" ("ASC 105"). ASC 105 establishes the FASB Accounting Standards Codification, which will become the source of authoritative U.S. GAAP recognized by the FASB. Following this statement, the FASB will issue new standards in the form of Accounting Standards Updates ("ASUs"). ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of ASC 105 did not have any impact on the Company's financial statements, as it does not modify GAAP, except for the specific references to GAAP literature in the notes to the Company's consolidated financial statements.

In October 2009, the FASB issued an update to ASC 985-605, "Software-Revenue Recognition" (originally issued as EITF 09-3). In accordance with the update to the ASC, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the scope of the software revenue recognition guidance. In addition, hardware components of a tangible product containing software component are always excluded from the software revenue guidance. The mandatory adoption is on January 1, 2011. The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. In such case the Company must also early adopt the amendment to ASC 605-25 with respect to multiple-elements arrangements. The Company does not expect the adoption of the update to have a material impact on its consolidated financial condition or results of operations.

In October 2009, the FASB issued an update to ASC 605-25, "Revenue recognition - Multiple-Element Arrangements", that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements to:

- Provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- Require an entity to allocate revenue in an arrangement using estimated selling prices ("ESP") of deliverables if a vendor does not have vendor-specific objective evidence of selling price ("VSOE") or third-party evidence of selling price ("TPE"); and



## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

-Eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

-Require expanded disclosures of qualitative and quantitative information regarding application of the multiple-deliverable revenue arrangement guidance.

The Company may elect to adopt the update prospectively, to new or materially modified arrangements beginning on the adoption date, or retrospectively, for all periods presented. The Company is currently evaluating the impact on its consolidated results of operations and financial condition.

## NOTE 3: PROPERTY AND EQUIPMENT

|                                    | December 31 |          |
|------------------------------------|-------------|----------|
|                                    | 2008        | 2009     |
| <b>Cost:</b>                       |             |          |
| Computers and peripheral equipment | \$ 2,846    | \$ 3,224 |
| Office furniture and equipment     | 605         | 614      |
| Motor vehicles                     | 88          | 88       |
| Leasehold improvements             | 1,157       | 1,191    |
|                                    | 4,696       | 5,117    |
| Less accumulated depreciation      | (3,925)     | (4,416)  |
| Property and Equipment, net        | \$ 771      | \$ 701   |

Depreciation expense amounted to approximately \$ 397, \$ 466 and \$ 491 in 2007, 2008 and 2009, respectively.

## NOTE 4: COMMITMENTS AND CONTINGENCIES

a. Commtouch Software Ltd. which is incorporated in Israel, partially financed its research and development expenditures under programs sponsored by the Office of Chief Scientist ("OCS") for the support of certain research and development activities conducted in Israel.

In connection with its research and development, the Company received and accrued participation payments from the OCS in the aggregate amount of \$ 263. In return for the OCS's participation, the Company is committed to pay royalties at a rate of 3% of sales of the developed product, up to 100% of the amount of grants received (100% plus interest at LIBOR). The Company's total commitment for royalties payable with respect to future sales, based on OCS participations received or accrued, net of royalties paid or accrued, totaled approximately \$ 255 as of December 31, 2009. For the years ended December 31, 2009 and 2008, the amounts of \$ 8 and \$ 0, respectively, were recorded as cost of revenues with respect to royalties due to the OCS.

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## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 4: COMMITMENTS AND CONTINGENCIES (Cont.)

## b. Operating leases:

The Company leases its facility in Israel under an operating lease agreement expiring on December 31, 2010. The subsidiary leases its facility in the U.S. under an operating lease agreement expiring on February 28, 2011.

Facilities rent expense for 2007, 2008 and 2009 was approximately \$ 164, \$ 202 and \$ 259, respectively.

Annual minimum future lease payments due under the above agreements (and motor vehicle leases, which expire in 2012), at the exchange rate in effect on December 31, 2009, are approximately as follows:

|      |    |     |
|------|----|-----|
| 2010 | \$ | 478 |
| 2011 |    | 116 |
| 2012 |    | 18  |
|      | \$ | 612 |

## NOTE 6: SHAREHOLDERS' EQUITY

## a. General:

The Ordinary shares of the Company have been traded on the Nasdaq National Market (now known as the Nasdaq Global Market) and Nasdaq Capital Market (formerly The NASDAQ SmallCap Market), since July 1999 and 2002, respectively.

On December 16, 2009, the Company's Ordinary shares became listed for trading publicly on the Tel Aviv Stock Exchange, or "TASE", thus becoming a "dual listed" company.

The Ordinary shares confer upon their holders the right to receive notice to participate and vote in general shareholder meetings of the Company and to receive dividends, if declared. In January 2008, the Board of Directors and shareholders approved a 3:1 reverse stock split of the Company's share capital. As a result of this action, every three shares (including all authorized, issued and outstanding shares and all outstanding warrants and options to purchase shares) were combined into one share of the same respective class of shares bearing a par value of NIS 0.15 each.

## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 6: SHAREHOLDERS' EQUITY (Cont.)

## b. Warrants to investors:

As of December 31, 2009, the Company's outstanding warrants issued to various parties were as follows:

| Issuance date | Warrants granted for Ordinary shares | Exercise price per share | Remaining warrants exercisable | Exercisable through |
|---------------|--------------------------------------|--------------------------|--------------------------------|---------------------|
| October 2005  | 500,000                              | \$ 1.95                  | 458,333                        | October 2010        |
| May 2006      | 23,364                               | \$ 3.21                  | 23,364                         | May 2011            |
| Total         | 523,364                              |                          | 481,697                        |                     |

## c. Employee stock options:

In 1996, the Company adopted the 1996 CSI Stock Option Plan for granting options to its U.S. employees and consultants to purchase Ordinary shares of the Company, which was replaced in 2006 by the 2006 U.S. Stock Option Plan. Until 1999, the Company issued options to purchase Ordinary shares to its Israeli employees pursuant to individual agreements. In 1999, the Company approved the 1999 Section 3(i) share option plan for its Israeli employees and consultants, (which was amended in 2003 and renamed the "Amended and Restated Israeli Share Option Plan"). As of December 31, 2009, an aggregate of 845,200 Ordinary shares of the Company are still available for future grant to employees and directors.

Options granted under such plans and agreements up to September 2005, expire generally after ten years from the date of grant, with grants from September 2005 having six-year terms from the date of grant. Options cease vesting upon termination of the optionee's employment or other relationship with the Company. The options generally vest over a period of four years. The exercise price of the options granted under the individual agreements may not be less than the nominal value of the shares into which such options are exercisable. Any options that are canceled or not exercised within the option term become available for future grant.

## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 6: SHAREHOLDERS' EQUITY (Cont.)

A summary of the Company's employees share option activity under the plans is as follows:

|                                                                | Number of<br>shares<br>2009 | Weighted<br>average<br>exercise<br>price<br>2009 | Aggregate<br>intrinsic<br>value<br>2009 |
|----------------------------------------------------------------|-----------------------------|--------------------------------------------------|-----------------------------------------|
| Outstanding at the beginning of the year                       | 3,512,557                   | \$ 2.69                                          | \$ 1,009                                |
| Granted                                                        | 682,167                     | \$ 2.57                                          |                                         |
| Exercised                                                      | (209,850)                   | \$ 1.04                                          |                                         |
| Expired and Forfeited                                          | (245,006)                   | \$ 3.96                                          |                                         |
|                                                                |                             |                                                  | *)                                      |
| Outstanding at the end of the year                             | 3,739,868                   | \$ 2.67                                          | \$ 4,966                                |
| Options vested and expected to vest at the end of the year     | 3,601,244                   | \$ 2.65                                          | \$ 4,852                                |
| Exercisable options at the end of the year                     | 2,413,521                   | \$ 2.35                                          | \$ 3,771                                |
| Weighted average fair value of options granted during the year |                             | \$ 1.54                                          |                                         |

\*) 885,822 options were out of the money as of December 31, 2009, and their intrinsic value was \$0.

The aggregate intrinsic value of the Company's options is the difference between the Company's closing share price on the last trading day of the fiscal year 2009 and the exercise price, times the number of options.

The options outstanding as of December 31, 2009, have been separated into ranges of exercise prices, as follows:

| Exercise price per share | Options outstanding | Weighted average remaining contractual life in years | Weighted average exercise price per share | Options exercisable | Weighted average exercise price per share of exercisable options |
|--------------------------|---------------------|------------------------------------------------------|-------------------------------------------|---------------------|------------------------------------------------------------------|
| \$ 0.03-\$0.27           | 111,606             | 1.62                                                 | \$ 0.04                                   | 111,606             | \$ 0.04                                                          |
| \$ 0.33-\$0.60           | 500,000             | 2.77                                                 | \$ 0.35                                   | 500,000             | \$ 0.35                                                          |

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|                |           |      |         |           |         |
|----------------|-----------|------|---------|-----------|---------|
| \$ 0.81-\$0.84 | 38,667    | 1.84 | \$ 0.82 | 38,667    | \$ 0.82 |
| \$ 0.93-\$1.89 | 624,549   | 4.59 | \$ 1.39 | 430,561   | \$ 1.31 |
| \$ 1.93-\$2.91 | 712,488   | 4.32 | \$ 2.21 | 257,139   | \$ 2.56 |
| \$ 3.12-\$4.35 | 1,262,279 | 2.78 | \$ 3.39 | 822,930   | \$ 3.24 |
| \$ 4.69-\$6.60 | 490,279   | 3.65 | \$ 6.23 | 252,618   | \$ 6.21 |
|                | 3,739,868 | 3.44 | 2.67    | 2,413,521 | \$ 2.35 |

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## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 6: SHAREHOLDERS' EQUITY (Cont.)

## d. Non-employee directors stock option plan:

In 1999, the Company adopted the 1999 Non-Employee Directors Stock Option Plan, and in 2008 shareholders approved an extension of the term of this plan through July 13, 2019. The original allotment of shares to this plan was 1,263,333. On December 15, 2006, the Company combined the remaining pool of options in the employee stock option plans reserve with the amount of options remaining in the Non-Employee Directors Stock Option Plan reserve.

Since the annual meeting of shareholders in 2003 and up until December 31, 2008, new directors joining the Board are entitled to an option grant of 50,000 Ordinary shares. Directors who are re-elected at the annual meeting of shareholders are entitled to additional grants of 16,667 options, though at the annual meeting held October 26, 2009 shareholders approved a one-time increase in the grants to re-elected directors to 30,000 options.

Each option granted under the Non-Employee Directors Stock Option Plan becomes exercisable at a rate of 1/16th of the shares every three months. Each option has an exercise price equal to the fair market value of the Ordinary shares on the grant date of such option. Until September 2005, each option granted had a maximum term of ten years, but since September 2005, the term of granted options is six years. Options will terminate earlier if the optionee ceases to be a member of the Board of Directors.

During 2009, the Company granted 150,000 options to non-employee directors at a weighted average exercise price of \$ 3.29 per share. Weighted average fair value of options granted during the year is \$1.84. As of December 31, 2009, 286,440 options were vested and unexercised and 608,337 were outstanding under the Non-Employee Directors Stock Option Plan.

## e. Options to non-employees:

| Issuance date     | Options granted<br>for Ordinary<br>Shares | Exercise price<br>per share | Options<br>exercisable | Exercisable<br>through |
|-------------------|-------------------------------------------|-----------------------------|------------------------|------------------------|
| May 2006-2008 (i) | 83,334                                    | \$3.21-\$5.73               | 60,414                 | May 2013               |
| Total             | 83,334                                    |                             | 60,414                 |                        |

(i) As a consideration for consulting services, on May 7, 2006 the Company issued 50,000 options to a service provider to purchase the Company's Ordinary shares at a price of \$ 3.21 per option. On May 5, 2007, the Company issued an additional 16,667 options to the service provider to purchase the Company's Ordinary shares at a price of \$ 5.73 per option. On May 6, 2008, the Company issued an additional 16,667 options to purchase Ordinary shares to the service provider at a price of \$ 3.85 per option. The options shall vest and become exercisable at a rate of 1/16 of the options every three months. The Company has accounted for this grant under the fair value method of ASC 505-50. The fair value for these options was estimated using a Black-Scholes option-pricing model. Compensation expense for 2007, 2008 and 2009 amounted to \$ 70, \$ 37 and \$ 32, respectively.

f. The total unrecognized estimated compensation cost related to non-vested stock options granted until December 31, 2009 was \$ 2,797 which is expected to be recognized over a period of up to four years.

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## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 6: SHAREHOLDERS' EQUITY (Cont.)

- g. Total stock-based compensation expenses recognized in 2007, 2008 and 2009:

The total stock-based compensation expense related to all of the Company's equity-based awards, recognized for the year ended December 31, 2007, 2008 and 2009, was comprised as follows:

|                            | Year ended December 31, |          |          |
|----------------------------|-------------------------|----------|----------|
|                            | 2007                    | 2008     | 2009     |
| Cost of revenues           | \$ 31                   | \$ 45    | \$ 40    |
| Research and development   | 246                     | 319      | 302      |
| Selling and marketing      | 194                     | 298      | 300      |
| General and administrative | 612                     | 870      | 735      |
|                            | \$ 1,083                | \$ 1,532 | \$ 1,377 |

## NOTE 7: INCOME TAXES

- a. Corporate tax structure:

Israeli companies are generally subject to company tax on their taxable income. The applicable rate is 29% in 2007, 27% in 2008, 26% in 2009, 25% in 2010, and scheduled to decline to 24% in 2011, 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter.

- b. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985:

Results for tax purposes are measured in terms of earnings in NIS after certain adjustments for increases in the Israeli Consumer Price Index ("CPI"). As explained in Note 2b, the financial statements are measured in U.S. dollars. The difference between the annual change in the Israeli CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of ASC 740, the Company has not provided deferred income taxes on the difference between the functional currency and the tax bases of assets and liabilities. In February 2008, the inflationary adjustment law was cancelled.

- c. Tax benefits under Israel's Law for the Encouragement of Industry (Taxation), 1969:

The Company may currently qualify as an "industrial company" within the definition of the Law for the Encouragement of Industry (Taxation), as such, it may be eligible for certain tax benefits, including, inter alia, special depreciation rates for machinery, equipment and buildings, amortization of patents, certain other intangible property rights and deduction of share issuance expenses.



## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 7: INCOME TAXES (Cont.)

## d. Net operating loss carryforwards:

As of December 31, 2009, the Company's net operating loss carryforwards for tax purposes amounted to approximately \$ 76,000 which may be carried forward and offset against taxable income in the future, for an indefinite period.

As of December 31, 2009, for federal income tax purposes, the U.S. subsidiary had net operating loss carry-forwards of approximately \$ 92,000. These losses may offset any future U.S. taxable income of the U.S. subsidiary and will expire in the years 2011 through 2025.

Utilization of U.S. net operating losses may be subject to substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitations may result in the expiration of net operating losses before utilization.

Management currently believes that since the Company has history of losses it is more likely than not that some of the deferred tax assets regarding the loss carry forwards will not be utilized in the foreseeable future. Thus, a valuation allowance was provided to reduce deferred tax assets to their realizable value.

## e. Deferred income taxes:

Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. As of December 31, 2008 and 2009, the Company's deferred taxes were in respect of the following:

|                                                | December 31, |           |
|------------------------------------------------|--------------|-----------|
|                                                | 2008         | 2009      |
| Net operating loss carry-forwards              | \$ 54,522    | \$ 53,213 |
| Reserves and allowances                        | 226          | 274       |
| Property and Equipment                         | 50           | 52        |
| Research and development costs                 | 471          | 642       |
| Deferred tax assets before valuation allowance | 55,269       | 54,181    |
| Valuation allowance                            | (55,269)     | (51,777)  |
| Deferred tax asset                             | \$ -         | \$ 2,404  |
| Domestic:                                      |              |           |
| Current deferred tax asset, net                | \$ -         | \$ 1,283  |
| Non-current deferred tax asset, net            | -            | 986       |
|                                                | -            | 2,269     |

Foreign:

|                                     |      |          |
|-------------------------------------|------|----------|
| Current deferred tax asset, net     |      | 134      |
| Non-current deferred tax asset, net | -    | 1        |
|                                     |      | 135      |
|                                     | \$ - | \$ 2,404 |

Current deferred tax asset, net, is included within other current assets in the balance sheets.

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## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 7: INCOME TAXES (Cont.)

f. For the years ended December 31, 2007 and 2008, the main reconciling items between the statutory tax rate of the Company and the effective tax rate are the non-recognition of the benefits from accumulated net operating loss carry forward due to the uncertainty of the realization of such tax benefits. For the year ended December 31, 2009, the main reconciling items between the statutory tax rate of the Company and the effective tax rate are the non-recognition of the benefits from accumulated net operating loss carry forward due to the uncertainty of the realization of such tax benefits, as well as recognition of a deferred tax asset of \$2,404 in respect of net operating loss carry forwards and temporary differences that are more likely than not to be realized in the foreseeable future.

g. Income before taxes on income (tax benefit) consists of the following:

|        | Year ended December 31, |          |          |
|--------|-------------------------|----------|----------|
|        | 2007                    | 2008     | 2009     |
| Israel | \$ 1,947                | \$ 2,011 | \$ 2,573 |
| U.S.   | 190                     | 266      | 183      |
|        | \$ 2,137                | \$ 2,277 | \$ 2,756 |

The Company is required to calculate and account for income taxes in each jurisdiction in which the Company or its subsidiary operate. Significant judgment is required in determining its worldwide provision for income taxes and recording the related assets and liabilities.

h. Taxes on income (tax benefit) are comprised of the following:

|                 | Year ended December 31, |      |            |
|-----------------|-------------------------|------|------------|
|                 | 2007                    | 2008 | 2009       |
| Current taxes:  |                         |      |            |
| Foreign         | \$ 28                   | \$ 7 | \$ -       |
|                 | \$ 28                   | \$ 7 | \$ -       |
| Deferred taxes: |                         |      |            |
| Foreign         | \$ -                    | \$ - | \$ (135)   |
| Domestic        | -                       | -    | (2,269)    |
|                 | \$ -                    | \$ - | \$ (2,404) |





## COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

## NOTE 7: INCOME TAXES (Cont.)

## i. Tax assessments:

The Company has final tax assessments in Israel through 2003.

## NOTE 8: GEOGRAPHIC INFORMATION

The Company conducts its business on the basis of one reportable segment. The Company has adopted ASC 280, "Segment Reporting".

## a. Revenues from external customers:

|               | Year ended December 31, |           |           |
|---------------|-------------------------|-----------|-----------|
|               | 2007                    | 2008      | 2009      |
| Israel        | \$ 742                  | \$ 1,080  | \$ 1,544  |
| North America | 6,424                   | 8,018     | 8,032     |
| Europe        | 2,735                   | 3,160     | 3,776     |
| Asia          | 1,038                   | 1,497     | 1,508     |
| Other         | 311                     | 337       | 329       |
|               | \$ 11,250               | \$ 14,092 | \$ 15,189 |

For the years ended December 31, 2007, 2008 and 2009, there are no major customers.

## b. The Company's net amount of long-lived assets is as follows:

|        | December 31 |        |
|--------|-------------|--------|
|        | 2008        | 2009   |
| Israel | \$ 175      | \$ 198 |
| U.S.A. | 596         | 503    |
|        | \$ 771      | \$ 701 |

## COMMTouch SOFTWARE LTD. AND ITS SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands, except share and per share data

NOTE 9:-

## FINANCIAL INCOME, NET

|                                                              | Year ended December 31, |        |        |
|--------------------------------------------------------------|-------------------------|--------|--------|
|                                                              | 2007                    | 2008   | 2009   |
| <b>Income:</b>                                               |                         |        |        |
| Interest on cash and cash equivalents and short term deposit | \$ 575                  | \$ 434 | \$ 108 |
| Capital gain on sale of marketable securities                | -                       | -      | 38     |
| <b>Expenses:</b>                                             |                         |        |        |
| Foreign currency exchange differences                        | (46)                    | (81)   | (74)   |
| Other                                                        | (2)                     | (7)    | (12)   |
|                                                              | \$ 527                  | \$ 346 | \$ 60  |

NOTE 10:

## SUBSEQUENT EVENTS

On March 15, 2010, the Company announced that its board of directors authorized an additional plan for the repurchase of the Company's ordinary shares in the open market or through privately negotiated transactions, in an amount in cash of up to \$5,000. The plan will commence immediately, and the term of the plan will be reviewed on a quarterly basis by the board of directors. Under the repurchase program, share purchases may be made from time to time depending on market conditions, share price, trading volume and other factors.

The repurchase program does not require the Company to acquire a specific number of shares and may be suspended from time to time or discontinued.

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Item 19. Exhibits.

The list of exhibits required by this Item is incorporated by reference to the Exhibit Index which precedes the exhibits to this report.

SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

COMMTOUCH SOFTWARE LTD.

By: /s/ Ron Ela  
Ron Ela  
Chief Financial Officer  
March 26, 2010

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Item 19. Exhibits

| Exhibit Number | Description of Document                                                                                                            |
|----------------|------------------------------------------------------------------------------------------------------------------------------------|
| 1.1            | Memorandum of Association of the Company.(1)                                                                                       |
| 1.2            | Amended and Restated Articles of Association of the Company, as amended on December 14, 2007.(2)                                   |
| 4.1            | Commtouch Software Ltd. 2006 U.S. Stock Option Plan.(3)                                                                            |
| 4.2            | Amended and Restated Commtouch Software Ltd. 1999 Non–Employee Directors Stock Option Plan.(4)                                     |
| 4.3            | Extension of Amended and Restated Commtouch Software Ltd. 1999 Non-Employee Directors Stock Option Plan.(5)                        |
| 4.4            | Commtouch Software Ltd. Amended and Restated Israeli Share Option Plan [successor plan to 1999 Section 3(i) Share Option Plan].(6) |
| 4.5            | Commtouch Software Ltd. Amended and Restated 1996 CSI Stock Option Plan.(7)                                                        |
| 4.6            | Amended and Restated 1999 Section 3(i) Share Option Plan.(8)                                                                       |
| 4.7            | Summary of Director Compensation.                                                                                                  |
| 8              | List of Subsidiaries of the Company.                                                                                               |
| 12.1           | Certification of Company’s Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a).                       |
| 12.2           | Certification of Company’s Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a).                       |
| 13             | Certification of Company’s Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. 1350.                 |
| 15             | Consent of Kost, Forer, Gabbay & Kasierer, independent auditors.                                                                   |

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(1)Incorporated by reference to exhibits in Amendment No. 1 to Registration Statement on Form F–1 of Commtouch Software Ltd., File No. 333–78531.

(2)Incorporated by reference to Exhibit 1.2 to Annual Report on Form 20–F for the year ended December 31, 2007.

(3)Incorporated by reference to Exhibit 99.4 to Registration Statement on Form S–8 No. 333–141177. [filed March 9, 2007]

(4)

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Incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 No. 333-141177. [filed March 9, 2007]

(5) Incorporated by reference to Exhibit 4.6 to Annual Report on form 20-F for the year ended December 31, 2008.

(6) Incorporated by reference to Exhibit 99.3 to Registration Statement on Form S-8 No. 333-141177. [filed March 9, 2007]

(7) Incorporated by reference to Exhibit 99.2 to Registration Statement on Form S-8 No. 333-141177. [filed March 9, 2007]

(8) Incorporated by reference to Exhibit 5 to Schedule TO, filed July 20, 2001.

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