

PIMCO Income Strategy Fund II
Form 497
September 10, 2018
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September 7, 2018

PROSPECTUS SUPPLEMENT

(To Prospectus dated September 7, 2018)

**PIMCO Income Strategy Fund II
Up to 11,500,000 Common Shares**

PIMCO Income Strategy Fund II (the "Fund") has entered into a sales agreement (the "Sales Agreement") with JonesTrading Institutional Services LLC ("JonesTrading") relating to its common shares of beneficial interest ("Common Shares") offered by this Prospectus Supplement and the accompanying Prospectus. In accordance with the terms of the Sales Agreement, the Fund may offer and sell up to 11,500,000 of its Common Shares, par value \$0.00001 per share, from time to time through JonesTrading as its agent for the offer and sales of the Common Shares. Under the Investment Company Act of 1940, as amended (the "1940 Act"), the Fund may not sell any Common Shares at a price below the current net asset value of such common shares, exclusive of any distributing commission or discount. The Fund's investment objective is to seek high current income, consistent with the preservation of capital.

The Fund's outstanding Common Shares are listed on the New York Stock Exchange ("NYSE") under the symbol "PFN," as will be the Common Shares offered in this Prospectus Supplement and the accompanying Prospectus, subject to notice of issuance. The last reported sale price for the Common Shares on July 31, 2018 was \$10.70 per share. The net asset value of the Common Shares at the close of business on July 31, 2018 was \$10.04 per share.

Sales of the Common Shares, if any, under this Prospectus Supplement and the accompanying Prospectus may be made in negotiated transactions or transactions that are deemed to be "at the market" as defined in Rule 415 under the Securities Act of 1933, as amended (the "1933 Act"), including sales made directly on the NYSE or sales made to or through a market maker other than on an exchange.

JonesTrading will be entitled to compensation of up to 1.00% of the gross proceeds with respect to sales of the Common Shares actually effected by JonesTrading under the Sales Agreement. In connection with the sale of the Common Shares on our behalf, JonesTrading may be deemed to be an "underwriter" within the meaning of the 1933 Act and the compensation of JonesTrading may be deemed to be underwriting commissions or discounts.

JonesTrading is not required to sell any specific number or dollar amount of Common Shares, but will use its commercially reasonable efforts to sell the Common Shares offered by this Prospectus Supplement and the accompanying Prospectus. There is no arrangement for Common Shares to be received in an escrow, trust or similar arrangement.

You should review the information set forth under "Prospectus Supplement Summary - Risks" on page S-4 of this Prospectus Supplement and "Principal Risks of the Fund" on page 53 of the accompanying Prospectus before investing in the Common Shares.

Neither the U.S. Securities and Exchange Commission ("SEC") nor the U.S. Commodity Futures Trading Commission ("CFTC") have approved or disapproved of these securities or determined that this Prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Prospectus Supplement dated September 7, 2018

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You should read this Prospectus Supplement and the accompanying Prospectus before deciding whether to invest in the Common Shares and retain them for future reference. The Prospectus Supplement and the accompanying Prospectus contain important information about the Fund. Material that has been incorporated by reference and other information about us can be obtained from us by calling toll free (844) 33-PIMCO (844-337-4626) or by writing to the Fund at c/o Pacific Investment Management Company LLC, 1633 Broadway, New York, New York 10019. You may also obtain a copy of the Statement of Additional Information (and other information regarding the Fund) from the Securities and Exchange Commission's (the "SEC") Public Reference Room in Washington, D.C. by calling (202) 551-8090. The SEC charges a fee for copies. The Fund's Statement of Additional Information and most recent annual and semiannual reports are available, free of charge, on the Fund's website (<http://www.pimco.com>). You can obtain the same information, free of charge, from the SEC's website (<http://www.sec.gov>).

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About this Prospectus Supplement

You should rely only on the information contained or incorporated by reference in this Prospectus Supplement and the accompanying Prospectus. The Fund has not, and JonesTrading has not, authorized anyone to provide you with inconsistent information. If anyone provides you with inconsistent information, you should not assume that the Fund or JonesTrading has authorized or verified it. The Fund is not, and JonesTrading is not, making an offer of these securities in any state where the offer is not permitted. You should not assume that the information contained in this Prospectus Supplement and the accompanying Prospectus is accurate as of any date other than the date on the front hereof or thereof. The Fund's business, financial condition, results of operations and prospects may have changed since that date.

This document has two parts. The first part is this Prospectus Supplement, which describes the terms of this offering of Common Shares and also adds to and updates information contained in the accompanying Prospectus. The second part is the accompanying Prospectus, which gives more general information and disclosure. To the extent the information contained in this Prospectus Supplement differs from or is additional to the information contained in the accompanying Prospectus, you should rely only on the information contained in this Prospectus Supplement. You should read this Prospectus Supplement and the accompanying Prospectus before investing in the Common Shares.

Cautionary Notice Regarding Forward-Looking Statements

This Prospectus Supplement, the accompanying Prospectus and the Fund's Statement of Additional Information, including documents incorporated by reference, contain "forward-looking statements." Forward-looking statements can be identified by the words "may," "will," "intend," "expect," "estimate," "continue," "plan," "anticipate," and similar terms and the negative of such terms. By their nature, all forward-looking statements involve risks and uncertainties, and actual results could differ materially from those contemplated by the forward-looking statements. Several factors that could materially affect the Fund's actual results are the performance of the portfolio of securities held by the Fund, the conditions in the U.S. and international financial and other markets, the price at which the Fund's Common Shares will trade in the public markets and other factors discussed in the Fund's periodic filings with the SEC.

Although the Fund believes that the expectations expressed in our forward-looking statements are reasonable, actual results could differ materially from those expressed or implied in our forward-looking statements. The Fund's future financial condition and results of operations, as well as any forward-looking statements, are subject to change and are subject to inherent risks and uncertainties, such as those disclosed in the "Principal Risks of the Fund" section of the accompanying Prospectus. You are cautioned not to place undue reliance on these forward-looking statements. All forward-looking statements contained or incorporated by reference in this Prospectus Supplement or the accompanying Prospectus are made as of the date of this Prospectus Supplement or the accompanying Prospectus, as the case may be. Except for the Fund's ongoing obligations under the federal securities laws, the Fund does not intend, and the Fund undertakes no obligation, to update any forward-looking statement. The forward-looking statements contained in this Prospectus Supplement, the accompanying Prospectus and the Fund's Statement of Additional Information are excluded from the safe harbor protection provided by section 27A of the 1933 Act.

Currently known risk factors that could cause actual results to differ materially from the Fund's expectations include, but are not limited to, the factors described in the "Principal Risks of the Fund" section of the accompanying Prospectus. The Fund urges you to review carefully those sections for a more detailed discussion of the risks of an investment in our securities.

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Prospectus Supplement Summary

This is only a summary. This summary may not contain all of the information that you should consider before investing in the Fund's common shares of beneficial interest (the "Common Shares"). You should review the more detailed information contained in this Prospectus Supplement and in the accompanying Prospectus and in the Statement of Additional Information, especially the information set forth under the heading "Principal Risks of the Fund" beginning on page 53 of the accompanying Prospectus.

The Fund

PIMCO Income Strategy Fund II (the "Fund") is a diversified, closed-end management investment company that commenced operations on October 29, 2004, following the initial public offering of its Common Shares. Effective March 1, 2010, the Fund changed its name from PIMCO Floating Rate Strategy Fund to its current name, PIMCO Income Strategy Fund II.

The Common Shares are listed on the New York Stock Exchange ("NYSE") under the symbol "PFN." As of July 31, 2018, the net assets of the Fund attributable to Common Shares were \$599,263,606 and the Fund had outstanding 59,684,499 Common Shares and 3,698 auction rate preferred shares of beneficial interest ("ARPS" and, together with any other preferred shares issued by the Fund, "Preferred Shares"). The last reported sale price of the Common Shares, as reported by the NYSE on July 31, 2018, was \$10.70 per Common Share. The net asset value of the Common Shares at the close of business on July 31, 2018, was \$10.04 per Common Share. See "Description of Capital Structure" in the accompanying Prospectus.

Investment Objective

The Fund's investment objective is to seek high current income, consistent with the preservation of capital.

Investment Strategy

The Fund seeks to achieve its investment objective by utilizing a dynamic asset allocation strategy that focuses on duration management, credit quality analysis, risk management techniques and broad diversification among issuers, industries and sectors. The Fund normally invests in a diversified portfolio of floating and/or fixed rate debt instruments. On behalf of the Fund, Pacific Investment Management Company LLC, the Fund's investment manager ("PIMCO" or the "Investment Manager") employs an active approach to allocation among multiple fixed-income sectors based on, among other things, market conditions, valuation assessments and economic outlook, credit market trends and other economic factors. The types of securities and instruments in which the Fund may invest are summarized under "Portfolio Contents" in the accompanying Prospectus.

Risks

Investment in the Fund's Common Shares involves substantial risks arising from, among other strategies, the Fund's ability to invest in debt instruments that are, at the time of purchase, rated below investment grade (below Baa3 by Moody's Investors Service, Inc. ("Moody's")) or below BBB- by either S&P Global Ratings, a division of The McGraw-Hill Company, Inc. ("S&P") or Fitch, Inc. ("Fitch")) or unrated but determined by PIMCO to be of comparable quality, the Fund's exposure to foreign and emerging markets securities and currencies and to mortgage-related and other asset-backed securities, and the Fund's use of leverage. Debt securities of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and to repay principal, and are commonly referred to as "high yield" securities or "junk bonds." The Fund's exposure to foreign securities and currencies, and particularly to emerging markets securities and currencies, involves special risks, including foreign currency risk and the risk that the securities may decline in response to unfavorable political and legal developments, unreliable or untimely information or economic and financial instability. Mortgage-related and other asset-backed securities are subject to extension and prepayment risk and often have complicated structures that make them difficult to value. Because of the risks associated with investing in high yield securities, foreign and emerging market securities (and related exposure to foreign currencies) and mortgage-related and other asset-backed securities, and using leverage, an investment in the Fund should be considered speculative. Before investing in the Common Shares, you should read the discussion of the principal risks of investing in the Fund in "Principal Risks of the Fund" in the accompanying Prospectus. Certain of these risks are summarized in "Prospectus Summary—Principal Risks of the Fund" in the accompanying Prospectus. The Fund cannot assure you that it will achieve its investment objective, and you could lose all of your investment in the Fund.

Investment Manager

Pacific Investment Management Company LLC ("PIMCO" or the "Investment Manager") serves as the investment manager of the Fund. Subject to the supervision of the Board of Trustees of the Fund (the "Board"), PIMCO is responsible for managing the investment activities of the Fund and the Fund's business affairs and other administrative matters. The Investment Manager receives an annual fee from the Fund, payable monthly, in an amount equal to 0.83% of the Fund's average weekly "total managed assets." "Total managed assets" includes the total assets of the Fund (including any assets attributable to any preferred shares or other forms of leverage that may be outstanding) minus accrued liabilities (other than liabilities representing leverage). PIMCO is located at 650 Newport Center Drive, Newport Beach, CA, 92660. Organized in 1971, PIMCO provides investment management and advisory services to private accounts of institutional and individual clients and to registered investment companies. PIMCO is a majority-owned indirect

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subsidiary of Allianz SE, a publicly traded European insurance and financial services company. As of June 30, 2018, PIMCO had approximately \$1.71 trillion in assets under management.

The Offering

The Fund and the Investment Manager have entered into the Sales Agreement with JonesTrading relating to the Common Shares offered by this Prospectus Supplement and the accompanying Prospectus. In accordance with the terms of the Sales Agreement, the Fund may offer and sell up to 11,500,000 Common Shares, par value \$0.00001, through JonesTrading as its agent for the offer and sale of the Common Shares.

The Fund's outstanding Common Shares are listed on the NYSE under the symbol "PFN," as will be the Common Shares offered in this Prospectus Supplement and the accompanying Prospectus, subject to notice of issuance. The last reported sale price for the Common Shares on July 31, 2018 was \$10.70 per share.

Sales of the Common Shares, if any, under this Prospectus Supplement and the accompanying Prospectus may be made in negotiated transactions or transactions that are deemed to be "at the market" as defined in Rule 415 under the 1933 Act, including sales made directly on the NYSE or sales made to or through a market maker other than on an exchange. See "Plan of Distribution" in this Prospectus Supplement. The Common Shares may not be sold through agents, underwriters or dealers without delivery or deemed delivery of a prospectus and a prospectus supplement describing the method and terms of the offering of the Fund's securities. Under the 1940 Act, the Fund may not sell any Common Shares at a price below the current net asset value of such Common Shares, exclusive of any distributing commission or discount.

Use of Proceeds

The net proceeds of this offering will be invested in accordance with the Fund's investment objective and policies as set forth in the accompanying Prospectus. It is presently anticipated that the Fund will be able to invest substantially all of the net proceeds of this offering in accordance with its investment objective and policies within approximately 30 days of receipt by the Fund, depending on the amount and timing of proceeds available to the Fund as well as the availability of investments consistent with the Fund's investment objective and policies, and except to the extent proceeds are held in cash to pay dividends or expenses or for temporary defensive purposes. See "Use of Proceeds" in this Prospectus Supplement.

Summary of Fund Expenses

The following table is intended to assist investors in understanding the fees and expenses (annualized) that an investor in Common Shares of the Fund would bear, directly or indirectly, as a result of an offering. The table reflects the use of leverage attributable to the Fund's outstanding Preferred Shares and reverse repurchase agreements in an amount equal to 22.88% of the Fund's total managed assets (including assets attributable to such leverage), which reflects approximately the percentage of the Fund's total managed assets attributable to such leverage as of January 31, 2018, and shows Fund expenses as a percentage of net assets attributable to Common Shares. The percentage above does not reflect the Fund's use of other forms of economic leverage, such as credit default swaps or other derivative instruments. The table and example below are based on the Fund's capital structure as of January 31, 2018. The extent of the Fund's assets attributable to leverage following an offering, and the Fund's associated expenses, are likely to vary (perhaps significantly) from these assumptions.

Shareholder Transaction Expenses

Sales load (as a percentage of offering price)	1.00% ⁽¹⁾
Offering Expenses Borne by Common Shareholders (as a percentage of offering price)	0.04%
Dividend Reinvestment Plan Fees	None ⁽²⁾

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1 Represents the maximum commission with respect to the Common Shares being sold in this offering that the Fund may pay to JonesTrading in connection with sales of Common Shares effected by JonesTrading in this offering. This is the only sales load to be paid in connection with this offering. There is no guarantee that there will be any sales of Common Shares pursuant to this Prospectus Supplement and the accompanying Prospectus. Actual sales of Common Shares under this Prospectus Supplement and the accompanying Prospectus, if any, may be less than as set forth in this table. In addition, the price per share of any such sale may be greater or less than the price set forth in this table, depending on the market price of the Common Shares at the time of any such sale.

2 You will pay brokerage charges if you direct your broker or the plan agent to sell your Common Shares that you acquired pursuant to a dividend reinvestment plan. You may also pay a pro rata share of brokerage commissions incurred in connection with open-market purchases pursuant to the Fund's Dividend Reinvestment Plan. See "Dividend Reinvestment Plan" in the accompanying Prospectus.

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	Percentage of Net Assets Attributable to Common Shares (reflecting leverage attributable to ARPS and reverse repurchase agreements)
Management Fees ⁽¹⁾	1.03%
Dividend Cost on Preferred Shares ⁽²⁾	0.40%
Interest Payments on Borrowed Funds ⁽³⁾	0.22%
Other Expenses ⁽⁴⁾	0.02%
Total Annual Expenses	1.68%

1 Management Fees include fees payable to the Investment Manager for advisory services and for supervisory, administrative and other services. The Fund pays for the advisory, supervisory and administrative services it requires under what is essentially an all-in fee structure (the "unified management fee"). Pursuant to an investment management agreement, PIMCO is paid a Management Fee of 0.83% based on the Fund's average weekly total managed assets. "Total managed assets" includes the total assets of the Fund (including any assets attributable to any preferred shares or other forms of leverage that may be outstanding) minus accrued liabilities (other than liabilities representing leverage). The Fund (and not PIMCO) will be responsible for certain fees and expenses, which are reflected in the table above, that are not covered by the unified management fee under the investment management agreement. Please see "Management of the Fund — Investment Manager" in the accompanying prospectus for an explanation of the unified management fee.

2 Reflects the Fund's outstanding Preferred Shares as of January 31, 2018, which represented 11.62% of the Fund's total managed assets (including the liquidation preference of outstanding Preferred Shares and assets attributable to reverse repurchase agreements) as of that date, at an estimated annual dividend rate to the Fund of 3.20% (based on the Preferred Share dividend rates as of July 31, 2018) and assumes the Fund will continue to pay Preferred Share dividends at the "maximum applicable rate" called for under the Fund's Bylaws due to the ongoing failure of auctions for the ARPS. The actual dividend rate paid on the ARPS will vary over time in accordance with variations in market interest rates. See "Use of Leverage" and "Description of Capital Structure" in the accompanying Prospectus.

3 Reflects the Fund's use of leverage in the form of reverse repurchase agreements as of January 31, 2018 which represented 11.26% of the Fund's total managed assets (including the liquidation preference of outstanding Preferred Shares and assets attributable to reverse repurchase agreements) as of that date, at an estimated annual interest rate cost to the Fund of 2.02% (based on market interest rates as of July 31, 2018). See "Leverage—Effects of Leverage" in the accompanying Prospectus. The actual amount of interest expense borne by the Fund will vary over time in accordance with the level of the Fund's use of reverse repurchase agreements, dollar rolls and/or borrowings and variations in market interest rates. Borrowing expense is required to be treated as an expense of the Fund for accounting purposes. Any associated income or gains (or losses) realized from leverage obtained through such instruments is not reflected in the Annual Expenses table above, but would be reflected in the Fund's performance results.

4 Other expenses are estimated for the Fund's current fiscal year ending July 31, 2019.

Example

The following example illustrates the expenses that you would pay on a \$1,000 investment in Common Shares of the Fund (including an assumed total sales load or commission of 1.00%) and the other estimated costs of this offering to be borne by the Common Shareholders of 0.04%), assuming (1) that the Fund's net assets do not increase or decrease, (2) that the Fund incurs total annual expenses of 1.68% of net assets attributable to Common Shares in years 1 through 10 (assuming outstanding Preferred Shares and reverse repurchase agreements representing 22.88% of the Fund's total managed assets) and (3) a 5% annual return⁽¹⁾:

	1 Year	3 Years	5 Years	10 Years
Total Expenses Incurred	\$17	\$54	\$93	\$202

1 The example above should not be considered a representation of future expenses. Actual expenses may be higher or lower than those shown. The example assumes that the estimated Interest Payments on Borrowed Funds, Dividend Cost on Preferred Shares and Other Expenses set forth in the Annual Expenses table are accurate, that the rate listed under Total Annual Expenses remains the same each year and that all dividends and distributions are reinvested at net asset value. Actual expenses may be greater or less than those assumed. Moreover, the Fund's actual rate of return may be greater or less than the hypothetical 5% annual return shown in the example.

Use of Proceeds

Sales of the Common Shares, if any, under this Prospectus Supplement and the accompanying Prospectus may be made in negotiated transactions or transactions that are deemed to be "at the market" as defined in Rule 415 under the 1933 Act, including sales made directly on the NYSE or sales made to or through a market maker other than on an exchange. There is no guarantee that there will be any sales of the Common Shares pursuant to this Prospectus Supplement and the accompanying Prospectus. Actual sales, if any, of the Common Shares under this Prospectus Supplement and the accompanying Prospectus may be less than as set forth in this paragraph. In addition, the price per share of any such sale may be greater or less than the price set forth in this paragraph, depending on the market price of the Common Shares at the time of any such sale. As a result, the actual net proceeds the Fund receives may be more or less than the amount of net proceeds estimated in this Prospectus Supplement. Assuming the sale of all of the Common Shares offered under this Prospectus Supplement and the accompanying Prospectus, at the last reported sale price of \$10.70 per share for the Common Shares on the NYSE as of July 31, 2018, the Fund estimates that the net proceeds of this offering will be approximately \$121,546,813 after deducting a sales load of 1.00% and the estimated offering expenses payable by the Fund.

The net proceeds of this offering will be invested in accordance with the Fund's investment objective and policies as set forth in the accompanying Prospectus. It is currently anticipated that the Fund will be able to invest substantially all of the net proceeds in accordance with its investment objective and

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policies within approximately 30 days of receipt by the Fund, depending on the amount and timing of proceeds available to the Fund as well as the availability of investments consistent with the Fund's investment objective and policies, and except to the extent proceeds are held in cash to pay dividends or expenses or for temporary defensive purposes. Pending such investment, it is anticipated that the proceeds of this offering will be invested in high grade, short-term securities, credit-linked trust certificates, and/or high yield securities, index futures contracts or similar derivative instruments designed to give the Fund exposure to the securities and markets in which it intends to invest while PIMCO selects specific investments.

Capitalization

Pursuant to the Sales Agreement, the Fund may offer and sell up to 11,500,000 Common Shares, par value \$0.00001 per share, from time to time through JonesTrading as its agent for the offer and sale of the Common Shares under this Prospectus Supplement and the accompanying Prospectus. There is no guarantee that there will be any sales of the Common Shares pursuant to this Prospectus Supplement and the accompanying Prospectus. The table below assumes that the Fund will sell 11,500,000 Common Shares at an assumed price of \$10.70 per share (the last reported sale price per share of the Common Shares on the NYSE on July 31, 2018). Actual sales, if any, of the Common Shares, and the actual application of the proceeds thereof, under this Prospectus Supplement and the accompanying Prospectus may be different than as set forth in the table below. In addition, the price per share of any such sale may be greater or less than \$10.70, depending on the market price of the Common Shares at the time of any such sale. To the extent that the market price per share of the Common Shares on any given day is less than the net asset value per share on such day, the Fund will instruct JonesTrading not to make any sales on such day.

The following table sets forth the Fund's capitalization at July 31, 2018:

on a historical basis, and

and on a pro forma basis as adjusted to reflect (i) the assumed sale of the 11,500,000 Common at an assumed price of \$10.70 per share, in an offering under this Prospectus Supplement and the accompanying Prospectus⁽¹⁾, and (ii) the investment of net proceeds assumed from such offering in accordance with the Fund's investment objective and policies, after deducting the assumed commission of \$1,230,500 (representing an estimated commission paid to JonesTrading of 1.00% of the gross proceeds in connection with sales of Common Shares effected by JonesTrading in this offering) and estimated offering expenses payable by the Fund of \$272,687.50.

1 Under the Fund's current shelf registration statement, the Fund may not issue Common Shares in an aggregate amount greater than \$175,000,000. The Fund will not sell any Common Shares beyond such limit unless and until a subsequent registration statement or an amendment to the current shelf registration statement increasing such aggregate amount and relating to such Common Shares is declared effective.

	At January 31, 2018 (unaudited)	
	Actual	As Adjusted
Preferred Shares, (\$0.00001 par value and \$25,000 liquidation preference per share applicable to an aggregate of 3,698 shares issued and outstanding)	\$92,450,000	\$92,450,000
Composition of Net Assets:		
Common Shares:	\$59	\$70
Common Shares, par value \$0.00001 per share, unlimited shares authorized (59,495,000 shares outstanding as of January 31, 2018, and		

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70,995,000 shares estimated issued and outstanding as adjusted)

Paid-in-capital in excess of par	\$887,129,000	\$1,008,675,802
Under/(over) distributed net investment income	\$(2,496,000)	\$(2,496,000)
Accumulated net realized loss	\$(341,133,000)	\$(341,133,000)
Net unrealized appreciation of investments	\$70,378,000	\$70,378,000
Net Assets Applicable to Common Shareholders	\$613,878,059	\$735,424,872
Capitalization	\$706,328,059	\$827,874,872

Market and Net Asset Value Information

The following table sets forth, for each of the periods indicated, the high and low closing market prices of the Fund's Common Shares on the NYSE, the high and low Net Asset Value ("NAV") per Common Share and the high and low premium/discount to NAV per Common Share. See "Net Asset Value" in the accompanying Prospectus for information as to how the Fund's NAV is determined.

Quarter	Common share market price ⁽¹⁾		Common share net asset value		Premium (discount) as a % of net asset value	
	High	Low	High	Low	High	Low
Quarter ended July 31, 2018	\$10.75	\$10.43	\$10.11	\$9.94	7.40%	3.87%
Quarter ended April 30, 2018	\$10.51	\$10.08	\$10.32	\$10.05	4.16%	(0.69)%
Quarter ended January 31, 2018	\$10.75	\$10.18	\$10.42	\$10.21	3.27%	(0.88)%

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Quarter	Common share market price ⁽¹⁾		Common share net asset value		Premium (discount) as a % of net asset value	
	High	Low	High	Low	High	Low
Quarter ended October 31, 2017	\$10.85	\$10.30	\$10.44	\$10.23	4.93%	0.49%
Quarter ended July 31, 2017	\$10.76	\$10.27	\$10.33	\$10.06	4.37%	1.58%
Quarter ended April 30, 2017	\$10.37	\$9.64	\$10.12	\$9.80	3.01%	(2.43)%
Quarter ended January 31, 2017	\$9.79	\$8.89	\$9.83	\$9.54	(0.31)%	(6.81)%
Quarter ended October 31, 2016	\$9.72	\$9.20	\$9.70	\$9.42	0.94%	(3.95)%

1 Such prices reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

The Fund's NAV per Common share at the close of business on July 31, 2018 was \$10.04 and the last reported sale price of a Common Share on the NYSE on that day was \$10.70, representing a 6.57% premium to such NAV. As of July 31, 2018, the net assets of the Fund attributable to Common Shares were \$599,263,606 and the Fund had outstanding 59,684,499 Common Shares and 3,698 Preferred Shares.

Plan of Distribution

Under the Sales Agreement among the Fund, the Investment Manager and JonesTrading, upon written instructions from the Fund, JonesTrading will use its commercially reasonable efforts consistent with its normal sales and trading practices, to sell the Fund's Common Shares, under the terms and subject to the conditions set forth in the Sales Agreement. JonesTrading's solicitation will continue until the Fund instructs JonesTrading to suspend the solicitations and offers or the solicitation is otherwise terminated in accordance with the Sales Agreement. The Fund will instruct JonesTrading as to the amount of Common Shares to be sold by JonesTrading. The Fund may instruct JonesTrading not to sell the Common Shares if the sales cannot be effected at or above the price designated by the Fund in any instruction. The Fund or JonesTrading may suspend the offering of Common Shares upon proper notice and subject to other conditions.

JonesTrading will provide written confirmation to the Fund not later than the opening of the trading day on the NYSE following the trading day on which the Common Shares are sold under the Sales Agreement. Each confirmation will include the number of shares sold on the preceding day, the net proceeds to the Fund and the compensation payable by the Fund to JonesTrading in connection with the sales.

The Fund will pay JonesTrading commissions for its services in acting as agent in the sale of the Common Shares. JonesTrading will be entitled to compensation of up to 1.00% of the gross proceeds with respect to sales of Common Shares actually effected by JonesTrading under the Sales Agreement. There is no guarantee that there will be any sales of the Common Shares pursuant to this Prospectus Supplement and the accompanying Prospectus.

Actual sales, if any, of the Common Shares under this Prospectus Supplement and the accompanying Prospectus may be less than as set forth in this paragraph. In addition, the price per share of any such sale may be greater or less than the price set forth in this paragraph, depending on the market price of the Shares at the time of any such sale. Assuming the 11,500,000 Common Shares offered hereby are sold at a market price of \$10.70 per share (the last reported sale price per share of the Common Shares on the NYSE on July 31, 2018), we estimate that the total expenses for the offering, excluding compensation payable to JonesTrading under the terms of the Sales Agreement, would be approximately \$272,687.50.

Settlement for sales of any Common Shares will occur on the second business day following the date on which such sales are made, or on such earlier date that is agreed upon by the Fund and JonesTrading in connection with a particular transaction, whereupon the net proceeds of the sales will be delivered to the Fund. There is no arrangement for funds to be received in an escrow, trust or similar arrangement.

In connection with the sale of the Common Shares on behalf of the Fund, JonesTrading may, and will with respect to sales effected in an "at the market" offering, be deemed to be an "underwriter" within the meaning of the 1933 Act, and the compensation of JonesTrading may be deemed to be underwriting commissions or discounts. The Fund has agreed to provide indemnification and

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contribution to JonesTrading against certain civil liabilities, including certain liabilities under the 1933 Act.

The offering of Common Shares pursuant to the Sales Agreement will terminate upon the earlier of (1) the sale of all Common Shares subject the Sales Agreement or (2) termination of the Sales Agreement. The Sales Agreement may be terminated by the Fund in its sole discretion at any time by giving notice to JonesTrading. In addition, JonesTrading may terminate the Sales Agreement under the circumstances specified in the Sales Agreement and in its sole discretion by giving notice to us at any time following the period of twelve (12) months after the date of the Sales Agreement.

The Fund and its affiliates may engage in brokerage and other dealings with JonesTrading in the ordinary course of business for which JonesTrading may receive customary fees and commissions for its services on these transactions.

The principal business address of JonesTrading is 757 3rd Avenue, 23rd Floor, New York, New York 10017.

Legal Matters

Certain legal matters will be passed on for the Fund by Ropes & Gray LLP, Boston, Massachusetts.

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Additional Information

This Prospectus Supplement and the accompanying Prospectus constitute part of a Registration Statement filed by the Fund with the SEC under the 1933 Act and the 1940 Act. This Prospectus Supplement and the accompanying Prospectus omit certain of the information contained in the Registration Statement, and reference is hereby made to the Registration Statement and related exhibits for further information with respect to the Fund and the Common Shares offered hereby. Any statements contained herein concerning the provisions of any document are not necessarily complete, and, in each instance, reference is made to the copy of such document filed as an exhibit to the Registration Statement or otherwise filed with the SEC. Each such statement is qualified in its entirety by such reference. The complete Registration Statement may be obtained from the SEC upon payment of the fee prescribed by its rules and regulations or free of charge through the SEC's website (<http://www.sec.gov>).

September 7, 2018 | **SUPPLEMENT S-9**

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Base Prospectus

September 7, 2018

PIMCO Income Strategy Fund II

\$175,000,000 Common Shares of Beneficial Interest

Common
Shares

PIMCO Income Strategy Fund II

PFN

PIMCO Income Strategy Fund II (the "Fund") is a diversified, closed-end management investment company that commenced operations on October 29, 2004, following the initial public offering of its common shares.

Investment Objective. The Fund's primary investment objective is to seek high current income, consistent with the preservation of capital. The Fund cannot assure you that it will achieve its investment objective, and you could lose all of your investment in the Fund.

Investment Strategy. The Fund seeks to achieve its investment objective by utilizing a dynamic asset allocation strategy that focuses on duration management, credit quality analysis, risk management techniques and broad diversification among issuers, industries and sectors. The Fund normally invests in a diversified portfolio of floating and/or fixed rate debt instruments. On behalf of the Fund, Pacific Investment Management Company LLC, the Fund's investment manager ("PIMCO" or the "Investment Manager") employs an active approach to allocation among multiple fixed-income sectors based on, among other things, market conditions, valuation assessments and economic outlook, credit market trends and other economic factors. The Fund focuses on seeking the best income generating investment ideas across multiple fixed income sectors, with an emphasis on seeking opportunities in developed and emerging global credit markets.

(continued on following page)

The Fund's common shares (the "Common Shares") are listed on the New York Stock Exchange ("NYSE") under the symbol "PFN." The last reported sale price of the Common Shares, as reported by the NYSE on July 31, 2018, was \$10.70 per Common Share. The net asset value ("NAV") of the Common Shares at the close of business on July 31, 2018, was \$10.04 per Common Share.

Investment in the Fund's common shares involves substantial risks arising from, among other strategies, the Fund's ability to invest in debt instruments that are, at the time of purchase, rated below investment grade (below Baa3 by Moody's Investors Service, Inc. ("Moody's") or below BBB- by either S&P Global Ratings, a division of The McGraw-Hill Company, Inc. ("S&P") or Fitch, Inc. ("Fitch")) or unrated but determined by PIMCO to be of comparable quality, the Fund's exposure to foreign and emerging markets securities and currencies and to mortgage-related and other asset-backed securities,

Neither the U.S. Securities and Exchange Commission ("SEC") nor the U.S. Commodity Futures Trading Commission ("CFTC") has approved or disapproved of these securities or determined that this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

PIMCO Income Strategy Fund II

and the Fund's use of leverage. Debt securities of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and to repay principal, and are commonly referred to as "high yield" securities or "junk bonds." The Fund's exposure to foreign securities and currencies, and particularly to emerging markets securities and currencies, involves special risks, including foreign currency risk and the risk that the securities may decline in response to unfavorable political and legal developments, unreliable or untimely information or economic and financial instability. Mortgage-related and other asset-backed securities are subject to extension and prepayment risk and often have complicated structures that make them difficult to value. Because of the risks associated with investing in high yield securities, foreign and emerging market securities (and related exposure to foreign currencies) and mortgage-related and other asset-backed securities, and using leverage, an investment in the Fund should be considered speculative. Before investing in the Common Shares, you should read the discussion of the principal risks of investing in the Fund in "Principal Risks of the Fund." Certain of these risks are summarized in "Prospectus Summary-Principal Risks of the Fund."

(Continued from previous page)

Under normal circumstances, the Fund will have a short to intermediate average portfolio duration (i.e., within a zero to eight year range), as calculated by the Investment Manager, although it may be shorter or longer at any time or from time to time depending on market conditions and other factors. PIMCO believes that maintaining duration within this range offers flexibility and the opportunity for above-average returns while potentially limiting exposure to interest rate volatility and related risks.

Portfolio Contents. The Fund seeks to achieve its investment objective by ordinarily investing in a diversified portfolio of floating- and/or fixed-rate debt instruments. The Fund may invest a substantial portion of its floating-rate assets in floating-rate loans. Other floating-rate debt instruments in which the Fund may invest include catastrophe and other event-linked bonds, bank capital securities, unsecured bank loans, corporate bonds and other debt securities, money market instruments and certain types of mortgage-backed and other asset-backed securities that pay interest at rates that adjust whenever a specified interest rate changes and/or reset on predetermined dates (such as the last day of a month or calendar quarter). The Fund also considers floating-rate assets to include securities with durations of less than or equal to one year and fixed-rate securities with respect to which the Fund has entered into derivative instruments to effectively convert the fixed-rate interest payments into floating-rate interest payments. The Fund also may invest in a wide variety of fixed-rate debt securities, including corporate bonds and mortgage-backed and other asset-backed securities issued on a public or private basis, including mortgage pass-through securities, collateralized mortgage obligations ("CMOs"), commercial or residential mortgage-backed securities, mortgage dollar rolls, CMO residuals, stripped mortgage-backed securities ("SMBSs") and other securities that directly or indirectly represent a participation in, or are secured by and payable from, mortgage loans on real property. The Fund may make use of a variety of other instruments, including collateralized debt obligations, preferred securities, commercial paper, zero-coupon and inflation-indexed bonds issued by both governments and corporations, bank certificates of deposit, fixed time deposits and bankers' acceptances, real estate investment trusts (REITs), bonds, debentures, notes, and other debt securities of U.S. and foreign (non-U.S.) corporate and other issuers; obligations of foreign governments or their sub-divisions, agencies and government sponsored enterprises and obligations of international agencies and supranational entities; municipal securities and other debt securities issued by states or local governments and their agencies, authorities and other government-sponsored enterprises, including taxable municipal securities (such as Build America Bonds); structured notes, including hybrid or indexed securities; credit-linked notes; structured credit products; bank loans (including, among others, senior loans, delayed funding loans, revolving credit facilities and loan participations and assignments); convertible debt securities (i.e., debt securities that may be converted at either a stated price or stated rate into underlying shares of common stock), including synthetic convertible debt securities (i.e., instruments created through a combination of separate securities that possess the two principal characteristics of a traditional convertible security, such as an income-producing security and the right to acquire an equity security) and contingent convertible securities. Certain debt instruments, such as convertible bonds, also may include the right to participate in equity appreciation. The principal and/or interest

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rate on some debt instruments may be determined by reference to the performance of a benchmark asset or market, such as an index of securities, or the differential performance of two assets or markets, such as the level of exchange rates between the U.S. dollar and a foreign currency or currencies. The Fund may invest in debt securities of stressed issuers. Subject to the Fund's investment limitations, at any given time and from time to time, substantially all of the Fund's portfolio may consist of below investment grade securities. The Fund may invest in any level of the capital structure of an issuer of mortgage-backed or asset-backed securities, including the equity or "first loss" tranche. The rate of interest on an income-producing security may be fixed, floating or variable.

The Fund invests predominantly in U.S. dollar-denominated debt securities, which may include those issued by foreign corporations or supra-national government agencies. The Fund may invest up to 25% of its total assets in securities denominated in foreign currencies, including obligations of non-U.S. governments and their respective sub-divisions, agencies and government-sponsored enterprises, except that the Fund may invest without limit in investment grade sovereign debt denominated in the relevant country's local currency with less than 1 year remaining to maturity ("short-term investment grade sovereign debt"), including short-term investment grade sovereign debt issued by emerging market issuers. The Fund may invest up to 40% of its total assets in securities and instruments that are economically tied to "emerging market" countries other than investments in short-term investment grade sovereign debt issued by emerging market issuers, where as noted above there is no limit. The Fund may also invest directly in foreign currencies, including local emerging market currencies.

The Fund may invest up to 20% of its total assets in common stocks and other equity securities from time to time, including those it has received through the conversion of a convertible security held by the Fund or in connection with the restructuring of a debt security.

Table of Contents**PIMCO Income Strategy Fund II**

The Fund may, but is not required to, utilize various derivative strategies (both long and short positions) involving the purchase or sale of futures and forward contracts (including foreign currency exchange contracts), call and put options, credit default swaps, total return swaps, basis swaps and other swap agreements and other derivative instruments for investment purposes, leveraging purposes or in an attempt to hedge against market, credit, interest rate, currency and other risks in the portfolio. The Fund may purchase and sell securities on a when-issued, delayed delivery or forward commitment basis and may engage in short sales. The Fund may also seek to obtain market exposure to the securities in which it invests by entering into a series of purchase and sale contracts.

The Fund has a policy not to concentrate investments in any particular industry, but may (consistent with that policy) invest up to 25% of its total assets in any particular industry, and may invest a substantial portion of its assets in companies in related sectors, such as those in the banking or financial services sectors, which may share common characteristics and are often subject to similar business risks and regulatory burdens.

The Fund may invest without limit in debt securities that are, at the time of purchase, rated below investment grade (commonly referred to as "high yield" securities or "junk bonds") and may also invest without limit in investment grade securities. However, the Fund will not normally invest more than 20% of its total assets in debt instruments, other than mortgage-related and other asset-backed securities, that are, at the time of purchase, rated CCC or lower by S&P and Fitch and Caa1 or lower by Moody's, or that are unrated but determined by PIMCO to be of comparable quality. The Fund may invest without limit in mortgage-related and other asset-backed securities regardless of rating—i.e., of any credit quality.

The Fund may invest in securities that have not been registered for public sale in the U.S. or relevant non-U.S. jurisdictions, including without limit securities eligible for purchase and sale pursuant to Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), or relevant provisions of applicable non-U.S. law, and other securities issued in private placements. The Fund may also invest in securities of other investment companies, including, without limit, exchange-traded funds ("ETFs"). The Fund may invest in real estate investment trusts ("REITs"). The Fund may invest in securities of companies of any market capitalization, including small and medium capitalizations.

The Fund may invest without limit in illiquid securities (i.e., securities that the Fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the securities).

Leverage. The Fund utilizes leverage through its outstanding auction rate preferred shares ("ARPS" and, together with any other preferred shares the Fund may have outstanding, "Preferred Shares") and may obtain additional leverage through the use of reverse repurchase agreements, dollar rolls or borrowings, such as through bank loans or commercial paper and/or other credit facilities. The Fund may also enter into transactions other than those noted above that may give rise to a form of leverage including, among others, credit default swaps, futures and forward contracts (including foreign currency exchange contracts), total return swaps and other derivative transactions, loans of portfolio securities, short sales and when-issued, delayed delivery and forward commitment transactions. Although it has no current intention to do so, the Fund may also determine to issue other types of preferred shares. Depending upon market conditions and other factors, the Fund may or may not determine to add leverage following an offering to maintain or increase the total amount of leverage (as a percentage of the Fund's total assets) that the Fund currently maintains, taking into account the additional assets raised through the issuance of Common Shares in such offering. The Fund utilizes certain kinds of leverage, such as reverse repurchase agreements and credit default swaps, opportunistically and may choose to increase or decrease, or eliminate entirely, its use of such leverage over time and from time to time based on PIMCO's assessment of the yield curve environment, interest rate trends, market conditions and other factors. The Fund may also determine to decrease the leverage it currently maintains through its outstanding Preferred Shares through Preferred Share redemptions or tender offers and may or may not determine to replace such leverage through other sources. If the Fund determines to add leverage following an offering, it is not possible to predict with accuracy the precise amount of leverage that would be added, in part because it is not possible to predict the number of Common Shares that ultimately will be sold in an offering or series of offerings. To the extent that the Fund does not add additional leverage following an offering, the Fund's total

amount of leverage as a percentage of its total assets will decrease, which could result in a reduction of investment income available for distribution to holders of the Fund's Common Shares ("Common Shareholders"). The Investment Company Act of 1940, as amended, and the rules and regulations promulgated thereunder (the "1940 Act"), also generally limits the extent to which the Fund may utilize uncovered reverse repurchase agreements and borrowings, together with any other senior securities representing indebtedness, to 331/3% of the Fund's total net assets at the time utilized. See "Use of Leverage." By using leverage, the Fund will seek to obtain a higher return for holders of common shares than if the Fund did not use leverage. Leveraging is a speculative technique and there are special risks and costs involved. There can be no assurance that a leveraging strategy will be used or that it will be successful during any period in which it is employed. See "Use of Leverage" and "Principal Risks of the Fund—Leverage Risk."

This prospectus is part of a registration statement that the Fund has filed with the U.S. Securities and Exchange Commission (the "SEC"), using the "shelf" registration process. The Fund may offer, from time to time, in one or more offerings, up to either 11,500,000 Common Shares or \$110,976,150 of the Common Shares on terms to be determined at the time of the offering. This prospectus provides you with a general description of the Common Shares that the Fund may offer. Each time the Fund uses this prospectus to offer Common Shares, the Fund will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. You should read this prospectus and the applicable prospectus supplement, which contain important information about the Fund, carefully before you invest in the Common

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Prospectus

Shares. Common Shares may be offered directly to one or more purchasers, through agents designated from time to time by the Fund, or to or through underwriters or dealers. The prospectus supplement relating to an offering will identify any agents, underwriters or dealers involved in the sale of Common Shares, and will set forth any applicable purchase price, fee, commission or discount arrangement between the Fund and its agents or underwriters, or among the Fund's underwriters, or the basis upon which such amount may be calculated. See "Plan of Distribution." The Fund may not sell any Common Shares through agents, underwriters or dealers without delivery or deemed delivery of a prospectus supplement describing the method and terms of the particular offering of the Common Shares.

You should retain this prospectus and any prospectus supplement for future reference. A Statement of Additional Information, dated September 7, 2018, containing additional information about the Fund has been filed with the SEC and is incorporated by reference in its entirety into this prospectus. You can review the table of contents of the Statement of Additional Information on page 89 of this prospectus. You may request a free copy of the Statement of Additional Information, request the Fund's most recent annual and semiannual reports, request information about the Fund and make shareholder inquiries by calling toll-free (844)-337-4626 or by writing to the Fund at c/o Pacific Investment Management Company LLC, 1633 Broadway, New York, New York 10019. You may also obtain a copy of the Statement of Additional Information (and other information regarding the Fund) from the SEC's Public Reference Room in Washington, D.C. by calling (202) 551-8090. The SEC charges a fee for copies. The Fund's Statement of Additional Information and most recent annual and semiannual reports are available, free of charge, on the Fund's website (<http://www.pimco.com>). You can obtain the same information, free of charge, from the SEC's web site (<http://www.sec.gov>).

The Common Shares do not represent a deposit or obligation of, and are not guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency.

You should rely only on the information contained or incorporated by reference in this prospectus and any related prospectus supplement. The Fund has not authorized any other person to provide you with inconsistent information. If anyone provides you with inconsistent information, you should not assume that the Fund has authorized or verified it. The Fund is not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should not assume that the information contained in this prospectus or any prospectus supplement is accurate as of any date other than the dates on their respective front covers. The Fund's business, financial condition, results of operations and prospects may have changed since the date of this prospectus or the date of any prospectus supplement.

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PIMCO Income Strategy Fund II

Prospectus Summary

This is only a summary. This summary may not contain all of the information that you should consider before investing in the Fund's common shares of beneficial interest (the "Common Shares"). You should review the more detailed information contained in this prospectus and in any related prospectus supplement and in the Statement of Additional Information, especially the information set forth under the heading "Principal Risks of the Fund."

The Fund

PIMCO Income Strategy Fund II (the "Fund") is a diversified, closed-end management investment company. The Fund commenced operations on October 29, 2004, following the initial public offering of its Common Shares. Effective March 1, 2010, the Fund changed its name from PIMCO Floating Rate Strategy Fund to its current name, PIMCO Income Strategy Fund II.

The Common Shares are listed on the New York Stock Exchange ("NYSE") under the symbol "PFN." As of July 31, 2018, the net assets of the Fund attributable to Common Shares were \$599,263,606 and the Fund had outstanding 59,684,499 Common Shares and 3,698 auction rate preferred shares of beneficial interest ("ARPS" and, together with any other preferred shares issued by the Fund, "Preferred Shares"). The last reported sale price of the Common Shares, as reported by the NYSE on July 31, 2018, was \$10.70 per Common Share. The net asset value ("NAV") of the Common Shares at the close of business on July 31, 2018, was \$10.04 per Common Share. See "Description of Capital Structure."

The Offering

The Fund may offer, from time to time, in one or more offerings, up to either 11,500,000 Common Shares or \$110,976,150 of the Common Shares on terms to be determined at the time of the offering. The Common Shares may be offered at prices and on terms to be set forth in one or more prospectus supplements. You should read this prospectus and the applicable prospectus supplement carefully before you invest in the Common Shares. Common Shares may be offered directly to one or more purchasers, through agents designated from time to time by the Fund, or to or through underwriters or dealers. The prospectus supplement relating to an offering will identify any agents, underwriters or dealers involved in the sale of Common Shares, and will set forth any applicable purchase price, fee, commission or discount arrangement between the Fund and its agents or underwriters, or among the Fund's underwriters, or the basis upon which such amount may be calculated. See "Plan of Distribution." The Fund may not sell any Common Shares through agents, underwriters or dealers without delivery or deemed delivery of a prospectus supplement describing the method and terms of the particular offering of the Common Shares.

Use of Proceeds

The net proceeds of an offering will be invested in accordance with the Fund's investment objective and policies as set forth below. It is currently anticipated that the Fund will be able to invest substantially all of the net proceeds of an offering in accordance with its investment objective and policies within approximately 30 days of receipt by the Fund, depending on the amount and timing of proceeds available to the Fund as well as the availability of investments consistent with the Fund's investment objective and policies, and except to the extent proceeds are held in cash to pay dividends or expenses, or for temporary defensive purposes. See "Use of Proceeds."

Investment Objective and Policies

The Fund's investment objective is to seek high current income, consistent with the preservation of capital. The Fund seeks to achieve its objective by ordinarily investing in a diversified portfolio of floating- and/or fixed-rate debt instruments. The Fund may invest a substantial portion of its floating-rate assets in floating-rate loans. Other floating-rate debt instruments in which the Fund may invest include catastrophe and other event-linked bonds, bank capital securities, unsecured bank loans, corporate bonds and other debt securities, money market instruments and certain types of mortgage-backed and other asset-backed securities that pay

interest at rates that adjust whenever a specified interest rate changes and/or reset on predetermined dates (such as the last day of a month or calendar quarter). The Fund may invest in investment-grade debt securities and below investment grade debt securities (commonly referred to as "high yield" securities or "junk bonds"), including securities of stressed issuers. The types of securities and instruments in which the Fund may invest are summarized under "Portfolio Contents" below. The Fund cannot assure you that it will achieve its investment objective, and you could lose all of your investment in the Fund.

Portfolio Management Strategies

Dynamic Allocation Strategy. On behalf of the Fund, the Fund's investment manager, Pacific Investment Management Company LLC ("PIMCO" or the "Investment Manager"), employs an active approach to allocation among multiple fixed income sectors based on, among other things, market conditions, valuation assessments, economic outlook, credit market trends and other economic factors. With PIMCO's macroeconomic analysis as the basis for top-down investment decisions, including geographic and credit sector emphasis, the Fund focuses on seeking the best income generating investment ideas across multiple fixed income sectors, with an emphasis on seeking opportunities in developed and emerging global credit markets. The Fund has the flexibility to allocate assets in varying proportions among floating- and fixed-rate debt instruments, as well as among investment-grade and non-investment grade securities. It may focus more heavily or exclusively on an asset class at any time, based on assessments of relative values, market conditions and other factors. PIMCO may choose to focus on particular countries/regions (e.g., U.S. vs. foreign), asset classes, industries and sectors to the exclusion of others at any time and from time to time based on market conditions and other factors. The relative value assessment within fixed-income sectors draws on PIMCO's regional and sector specialist expertise. The Fund will observe various investment guidelines as summarized below.

Investment Selection Strategies. Once the Fund's top-down, portfolio positioning decisions have been made as described above, PIMCO selects particular investments for the Fund by employing a bottom-up, disciplined credit approach which is driven by fundamental, independent research within each sector/asset class represented in the Fund, with a focus on

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Prospectus

identifying securities and other instruments with solid and/or improving fundamentals.

PIMCO utilizes strategies that focus on credit quality analysis, duration management and other risk management techniques. PIMCO attempts to identify, through fundamental research driven by independent credit analysis and proprietary analytical tools, debt obligations and other income-producing securities that provide current income and/or opportunities for capital appreciation based on its analysis of the issuer's credit characteristics and the position of the security in the issuer's capital structure.

Consideration of yield is only one component of the portfolio managers' approach in managing the Fund. PIMCO also attempts to identify investments that may appreciate in value based on PIMCO's assessment of the issuer's credit characteristics, forecast for interest rates and outlook for particular countries/regions, currencies, industries, sectors and the global economy and bond markets generally.

Credit Quality. The Fund may invest without limit in debt securities that are, at the time of purchase, rated below investment grade or that are unrated but judged by PIMCO to be of comparable quality (commonly referred to as "high yield" securities or "junk bonds"). The Fund will not normally invest more than 20% of its total assets in debt instruments, other than mortgage-related and other asset-backed securities, that are, at the time of purchase, rated CCC or lower by S&P Global Ratings ("S&P") and Fitch, Inc. ("Fitch") and Caa1 or lower by Moody's Investors Services Inc. ("Moody's"), or that are unrated but determined by PIMCO to be of comparable quality to securities so rated. The Fund may invest without limit in mortgage-related and other asset-backed securities regardless of rating (i.e., of any credit quality). Subject to this 20% restriction, the Fund may invest in issuers of any credit quality (including debt securities in the lowest ratings categories and securities that are in default or the issuers of which are in bankruptcy) if PIMCO determines that the particular obligation is undervalued or offers an attractive yield relative to its risk profile. For purposes of applying the foregoing policies, in the case of securities with split ratings (i.e., a security receiving two different ratings from two different rating agencies), the Fund will apply the higher of the applicable ratings. Subject to the aforementioned investment restrictions, the Fund may invest in securities of stressed issuers, which include securities at risk of being in default as to the repayment of principal and/or interest at the time of acquisition by the Fund or that are rated in the lower rating categories by one or more nationally recognized statistical rating organizations (for example, Ca or lower by Moody's or CC or lower by S&P or Fitch) or, if unrated, are determined by PIMCO to be of comparable quality. Debt instruments of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and to repay principal, and are commonly referred to as "high yield" securities or "junk bonds." Debt instruments in the lowest investment grade category also may be considered to possess some speculative characteristics. The Fund may, for hedging, investment or leveraging purposes, make use of credit default swaps, which are contracts whereby one party makes periodic payments to a counterparty in exchange for the right to receive from the counterparty a payment equal to the par (or other agreed-upon) value of a referenced debt obligation in the event of a default or other credit event by the issuer of the debt obligation.

Independent Credit Analysis. PIMCO relies primarily on its own analysis of the credit quality and risks associated with individual debt instruments considered for the Fund, rather than relying exclusively on rating agencies or third-party research. The Fund's portfolio managers utilize this information in an attempt to minimize credit risk and to identify issuers, industries or sectors that are undervalued or that offer attractive yields relative to PIMCO's assessment of their credit characteristics. This aspect of PIMCO's capabilities will be particularly important to the extent that the Fund invests in floating rate loans, high yield securities and in securities of emerging market issuers.

Duration Management. It is expected that the Fund normally will have a short to intermediate average portfolio duration (i.e., within a zero to eight year (0 to 8) range), as calculated by PIMCO, although it may be shorter or longer at any time or from time to time depending on market conditions and other factors. While the Fund seeks to maintain a short to intermediate average portfolio duration, there is no limit on the maturity or duration of any individual security in which the Fund may invest. PIMCO believes that maintaining duration within this range offers flexibility and the opportunity for above-average returns while potentially limiting exposure to interest rate volatility and related risk. Duration is a measure used to determine the sensitivity of a security's price to changes in interest rates. The Fund's duration strategy may entail maintaining a negative average portfolio duration from time to time, which would potentially benefit the portfolio in an environment of rising market interest rates, but would generally adversely impact the portfolio in an environment of falling or neutral market interest rates. PIMCO may also utilize certain strategies, including without limit investments in structured notes or interest rate futures contracts or swap, cap, floor or collar transactions, for the purpose of reducing the interest rate sensitivity of the Fund's portfolio, although there is no assurance that it will do so or that such strategies will be successful.

Portfolio Contents

The Fund seeks to achieve its investment objective by ordinarily investing in a diversified portfolio of floating- and/or fixed-rate debt instruments. The Fund may invest a substantial portion of its floating-rate assets in floating-rate loans. Other floating-rate debt instruments in which the Fund may invest include catastrophe and other event-linked bonds, bank capital securities, unsecured bank loans, corporate bonds and other debt securities, money market instruments and certain types of mortgage-backed and other asset-backed securities that pay interest at rates that adjust whenever a specified interest rate changes and/or reset on predetermined dates (such as the last day of a month or calendar quarter). The Fund also considers floating-rate assets to include securities with durations of less than or equal to one year and fixed-rate securities with respect to which the Fund has entered into derivative instruments to effectively convert the fixed-rate interest payments into floating-rate interest payments. The Fund also may invest in a wide variety of fixed-rate debt securities, including corporate bonds and mortgage-backed and other asset-backed securities issued on a public or private basis, including mortgage pass-through securities, collateralized mortgage obligations ("CMOs"), commercial or residential mortgage-backed securities, mortgage dollar rolls, CMO residuals, stripped mortgage-backed securities ("SMBSs") and other securities that directly or indirectly represent a participation in, or are secured by and payable from,

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PIMCO Income Strategy Fund II

mortgage loans on real property. The Fund may make use of a variety of other instruments, including collateralized debt obligations, preferred securities, commercial paper, zero-coupon and inflation-indexed bonds, bank certificates of deposit, fixed time deposits and bankers' acceptances, real estate investment trusts (REITs), bonds, debentures, notes, and other debt securities of U.S. and foreign (non-U.S.) corporate and other issuers; obligations of foreign governments or their sub-divisions, agencies and government sponsored enterprises and obligations of international agencies and supranational entities; municipal securities and other debt securities issued by states or local governments and their agencies, authorities and other government-sponsored enterprises, including taxable municipal securities (such as Build America Bonds); inflation-indexed bonds issued by both governments and corporations; structured notes, including hybrid or indexed securities; credit-linked notes; structured credit products; bank loans (including, among others, senior loans, delayed funding loans, revolving credit facilities and loan participations and assignments); preferred securities and convertible debt securities (i.e., debt securities that may be converted at either a stated price or stated rate into underlying shares of common stock), including synthetic convertible debt securities (i.e., instruments created through a combination of separate securities that possess the two principal characteristics of a traditional convertible security, such as an income-producing security and the right to acquire an equity security) and contingent convertible securities. Certain debt instruments, such as convertible bonds, also may include the right to participate in equity appreciation. The principal and/or interest rate on some debt instruments may be determined by reference to the performance of a benchmark asset or market, such as an index of securities, or the differential performance of two assets or markets, such as the level of exchange rates between the U.S. dollar and a foreign currency or currencies. The Fund may invest in debt securities of stressed issuers. Subject to the Fund's investment limitations, at any given time and from time to time, substantially all of the Fund's portfolio may consist of below investment grade securities. The Fund may invest in any level of the capital structure of an issuer of mortgage-backed or asset-backed securities, including the equity or "first loss" tranche. The rate of interest on an income-producing security may be fixed, floating or variable.

The Fund invests predominantly in U.S. dollar-denominated debt securities, which may include those issued by foreign corporations or supra-national government agencies. The Fund may invest up to 25% of its total assets in securities denominated in foreign currencies, including obligations of non-U.S. governments and their respective sub-divisions, agencies and government-sponsored enterprises, except that the Fund may invest without limit in investment grade sovereign debt denominated in the relevant country's local currency with less than 1 year remaining to maturity ("short-term investment grade sovereign debt"), including short-term investment grade sovereign debt issued by emerging market issuers. The Fund may invest up to 40% of its total assets in securities and instruments that are economically tied to "emerging market" countries other than investments in short-term investment grade sovereign debt issued by emerging market issuers, where as noted above there is no limit. The Fund may also invest directly in foreign currencies, including local emerging market currencies.

The Fund may invest up to 20% of its total assets in common stocks and other equity securities from time to time, including those it has received through the conversion of a convertible security held by the Fund or in connection with the restructuring of a debt security.

The Fund may, but is not required to, utilize various derivative strategies (both long and short positions) involving the purchase or sale of futures and forward contracts (including foreign currency exchange contracts), call and put options, credit default swaps, total return swaps, basis swaps and other swap agreements and other derivative instruments for investment purposes, leveraging purposes or in an attempt to hedge against market, credit, interest rate, currency and other risks in the portfolio. The Fund may purchase and sell securities on a when-issued, delayed delivery or forward commitment basis and may engage in short sales. The Fund may also seek to obtain market exposure to the securities in which it invests by entering into a series of purchase and sale contracts.

The Fund has a policy not to concentrate investments in any particular industry, but may (consistent with that policy) invest up to 25% of its assets in any particular industry, and may invest a substantial portion of its assets in companies in related sectors, such as those in the banking or financial services sectors, which may share common characteristics and are often subject to similar business risks and regulatory burdens.

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The Fund may invest without limit in debt securities that are, at the time of purchase, rated below investment grade and may also invest without limit in investment grade securities. The Fund will not normally invest more than 20% of its total assets in debt instruments, other than mortgage-related and other asset-backed securities, that are, at the time of purchase, rated CCC or lower by S&P and Fitch and Caa1 or lower by Moody's, or that are unrated but determined by PIMCO to be of comparable quality. The Fund may invest without limit in mortgage-related and other asset-backed securities regardless of rating—i.e., of any credit quality.

The Fund may invest in securities that have not been registered for public sale in the U.S. or relevant non-U.S. jurisdictions, including without limit securities eligible for purchase and sale pursuant to Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), or relevant provisions of applicable non-U.S. law, and other securities issued in private placements. The Fund may also invest in securities of other investment companies, including, without limit, exchange-traded funds ("ETFs"). The Fund may invest in real estate investment trusts ("REITs"). The Fund may invest in securities of companies of any market capitalization, including small and medium capitalizations.

The Fund may invest without limit in illiquid securities (i.e., securities that the Fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the securities).

Upon PIMCO's recommendation, for temporary defensive purposes or during the period in which the net proceeds of this offering are being invested, the Fund may deviate from its investment strategy by investing some or all of its total assets in investments such as high grade debt securities, including high quality, short-term debt securities, and cash and cash equivalents. The Fund may not achieve its investment objective when it does so.

Leverage

The Fund utilizes leverage through its outstanding Preferred Shares and may obtain additional leverage through reverse repurchase agreements, dollar rolls or borrowings, such as through bank loans or commercial paper or other credit facilities. Information regarding the terms and features of the ARPS is provided under "Description of Capital Structure" in this Prospectus.

The Fund may also enter into transactions other than those noted above that may give rise to a form of leverage including, among others, credit default swaps, futures and forward contracts (including foreign currency exchange contracts), total return swaps and other derivative transactions, loans of portfolio securities, short sales and when-issued, delayed delivery and forward commitment transactions. Although it has no current intention to do so, the Fund may also determine to issue other types of preferred shares.

Depending upon market conditions and other factors, the Fund may or may not determine to add leverage following an offering to maintain or increase the total amount of leverage (as a percentage of the Fund's total assets) that the Fund currently maintains, taking into account the additional assets raised through the issuance of Common Shares in such offering. The Fund utilizes certain kinds of leverage, such as reverse repurchase agreements and credit default swaps, opportunistically and may choose to increase or decrease, or eliminate entirely, its use of such leverage over time and from time to time based on PIMCO's assessment of the yield curve environment, interest rate trends, market conditions and other factors. The Fund may also determine to decrease the leverage it currently maintains through its outstanding Preferred Shares through Preferred Shares redemptions or tender offers and may or may not determine to replace such leverage through other sources. If the Fund determines to add leverage following an offering, it is not possible to predict with accuracy the precise amount of leverage that would be added, in part because it is not possible to predict the number of Common Shares that ultimately will be sold in an offering or series of offerings. To the extent that the Fund does not add additional leverage following an offering, the Fund's total amount of leverage as a percentage of its total assets will decrease, which could result in a reduction of investment income available for distribution to Common Shareholders.

The Fund's net assets attributable to its Preferred Shares and the net proceeds the Fund obtains from reverse repurchase agreements or other forms of leverage utilized, if any, will be invested in accordance with the Fund's investment objective and policies as described in this prospectus and any prospectus supplement. So long as the rate of return, net of applicable Fund expenses, on the debt obligations and other investments purchased by the Fund exceeds the dividend rates payable on the Preferred Shares together with the costs to the Fund of other leverage it utilizes, the investment of the Fund's net assets attributable to leverage will generate more income than will be needed to pay the costs of the leverage. If so, and all other things being equal, the excess may be used to pay higher dividends to Common Shareholders than if the Fund were not so leveraged.

Regarding the costs associated with the Fund's ARPS, the terms of the ARPS provide that they would ordinarily pay dividends at a rate set at auctions held every seven days, normally payable on the first business day following the end of the rate period, subject to a maximum applicable rate calculated as a function of the ARPS' then-current rating and a reference interest rate. However, the weekly auctions for the ARPS, as well as auctions for similar preferred shares of other closed-end funds in the U.S., have failed since February 2008, and the dividend rates on the ARPS since that time have been paid at the maximum applicable rate (i.e., the greater of a multiple of or a spread plus a reference rate, which is the greater of the applicable LIBOR rate or the applicable Treasury Index Rate)). In September 2011, Moody's, a ratings agency that provides ratings for the Fund's ARPS, downgraded its rating of the ARPS from "Aaa" to "Aa2," citing persistently thin asset coverage levels, increased NAV volatility and concerns about secondary market liquidity for some assets supporting rated obligations. In July 2012, Moody's downgraded its rating of the ARPS from "Aa2" to "Aa3" pursuant to a revised ratings methodology adopted by Moody's. See "Use of Leverage" and "Description of Capital Structure." The Fund expects that the ARPS will continue to pay dividends at the maximum applicable rate for the foreseeable future and cannot predict whether or when the auction markets for the ARPS may resume normal functioning. See "Use of Leverage," "Principal Risks of the Fund—Leverage Risk," "Principal Risks of the Fund—Additional Risks Associated with the Fund's Preferred Shares" and "Description of Capital Structure" for more information.

Under the Investment Company Act of 1940, as amended, and the rules and regulations thereunder (the "1940 Act"), the Fund is not permitted to issue new preferred shares unless immediately after such issuance the value of the Fund's total net assets (as defined below) is at least 200% of the liquidation value of the outstanding Preferred Shares and the newly issued preferred shares

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plus the aggregate amount of any senior securities of the Fund representing indebtedness (i.e., such liquidation value plus the aggregate amount of senior securities representing indebtedness may not exceed 50% of the Fund's total net assets). In addition, the Fund is not permitted to declare any cash dividend or other distribution on its Common Shares unless, at the time of such declaration, the value of the Fund's total net assets satisfies the above-referenced 200% coverage requirement.

The 1940 Act also generally prohibits the Fund from engaging in most forms of leverage representing indebtedness other than preferred shares (including the use of reverse repurchase agreements, dollar rolls, bank loans, commercial paper or other credit facilities, credit default swaps, total return swaps and other derivative transactions, loans of portfolio securities, short sales and when-issued, delayed delivery and forward commitment transactions, to the extent that these instruments are not covered as described below) unless immediately after the issuance of the leverage the Fund has satisfied the asset coverage test with respect to senior securities representing indebtedness prescribed by the 1940 Act; that is, the value of the Fund's total assets less all liabilities and indebtedness not represented by senior securities (for these purposes, "total net assets") is at least 300% of the senior securities representing indebtedness (effectively limiting the use of leverage through senior securities representing indebtedness to 33 1/3% of the Fund's total net assets, including assets attributable to such leverage). In addition, the Fund is not permitted to declare any cash dividend or other distribution on its Common Shares unless, at the time of such declaration, this asset coverage test is satisfied. The Fund may (but is not required to) cover its commitments under reverse repurchase

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agreements, dollar rolls, derivatives and certain other instruments by the segregation of liquid assets, or by entering into offsetting transactions or owning positions covering its obligations. To the extent that certain of these instruments are so covered, they will not be considered "senior securities" under the 1940 Act and therefore will not be subject to the 1940 Act 300% asset coverage requirement otherwise applicable to forms of senior securities representing indebtedness used by the Fund. However, reverse repurchase agreements and other such instruments, even if covered, represent a form of economic leverage and create special risks. The use of these forms of leverage increases the volatility of the Fund's investment portfolio and could result in larger losses to Common Shareholders than if these strategies were not used. See "Principal Risks of the Fund—Leverage Risk." To the extent that the Fund engages in borrowings, it may prepay a portion of the principal amount of the borrowing to the extent necessary in order to maintain the required asset coverage. Failure to maintain certain asset coverage requirements could result in an event of default.

Leveraging is a speculative technique and there are special risks and costs involved. The Fund cannot assure you that its Preferred Shares and use of any other forms of leverage (such as the use of reverse repurchase agreements or derivatives strategies), if any, will result in a higher yield on your Common Shares. When leverage is used, the NAV and market price of the Common Shares and the yield to Common Shareholders will be more volatile. See "Principal Risks of the Fund—Leverage Risk." In addition, dividend, interest and other costs and expenses borne by the Fund with respect to its Preferred Shares and its use of any other forms of leverage are borne by the Common Shareholders (and not by the holders of Preferred Shares) and result in a reduction of the NAV of the Common Shares. In addition, because the fees received by the Investment Manager are based on the average weekly total managed assets of the Fund ("total managed assets" includes the total assets of the Fund (including any assets attributable to any preferred shares or other forms of leverage that may be outstanding) minus accrued liabilities (other than liabilities representing leverage), the Investment Manager has a financial incentive for the Fund to have preferred shares outstanding and to utilize other forms of leverage, which may create a conflict of interest between the Investment Manager, on the one hand, and the Common Shareholders, on the other hand.

The Fund's ability to utilize leverage is also limited by asset coverage requirements and other guidelines imposed by rating agencies (currently Moody's and Fitch) that provide ratings for the Preferred Shares, which may be more restrictive than the limitations imposed by the 1940 Act noted above. See "Description of Capital Structure" for more information.

The Fund also may borrow money in order to repurchase its shares or as a temporary measure for extraordinary or emergency purposes, including for the payment of dividends or the settlement of securities transactions which otherwise might require untimely dispositions of portfolio securities held by the Fund.

Investment Manager

Pacific Investment Management Company LLC ("PIMCO" or the "Investment Manager") serves as the investment manager of the Fund. Subject to the supervision of the Board of Trustees of the Fund (the "Board") PIMCO is responsible for managing the investment activities of the Fund and the Fund's business affairs and other administrative matters. Alfred Murata and Mohit Mittal are jointly and primarily responsible for the day-to-day management of the Fund.

The Investment Manager receives an annual fee from the Fund, payable monthly, in an amount equal to 0.830% of the Fund's average weekly "total managed assets." "Total managed assets" includes the total assets of the Fund (including any assets attributable to any preferred shares or other forms of leverage that may be outstanding) minus accrued liabilities (other than liabilities representing leverage). For purposes of calculating average weekly total managed assets, the Fund's derivative instruments will be valued based on their market value. PIMCO is located at 650 Newport Center Drive, Newport Beach, CA, 92660. Organized in 1971, PIMCO provides investment management and advisory services to private accounts of institutional and individual clients and to registered investment companies. PIMCO is a majority-owned indirect subsidiary of Allianz SE, a publicly traded European insurance and financial services company. As of June 30, 2018, PIMCO had approximately \$1.71 trillion in assets under management.

Dividends and Distributions

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The Fund makes regular monthly cash distributions to Common Shareholders at a rate based upon the past and projected net income of the Fund. Subject to applicable law, the Fund may fund a portion of its distributions with gains from the sale of portfolio securities and other sources. Distributions can only be made from net investment income after paying any accrued dividends to holders of the Preferred Shares. The dividend rate that the Fund pays on its Common Shares may vary as portfolio and market conditions change, and will depend on a number of factors, including without limit the amount of the Fund's undistributed net investment income and net short- and long-term capital gains, as well as the costs of any leverage obtained by the Fund (including the amount of the expenses and dividend rates on the Preferred Shares and any other preferred shares issued by the Fund and interest or other expenses on any reverse repurchase agreements, credit default swaps, dollar rolls and borrowings). As portfolio and market conditions change, the rate of distributions on the Common Shares and the Fund's dividend policy could change. For a discussion of factors that may cause the Fund's income and capital gains (and therefore the dividend) to vary, see "Principal Risks of the Fund." There can be no assurance that a change in market conditions or other factors will not result in a change in the Fund distribution rate or that the rate will be sustainable in the future.

The Fund generally distributes each year all of its net investment income and net short-term capital gains. In addition, at least annually, the Fund generally distributes net realized long-term capital gains not previously distributed, if any. The net investment income of the Fund consists of all income (other than net short-term and long-term capital gains) less all expenses of the Fund (after it pays accrued dividends on the outstanding Preferred Shares). The Fund may distribute less than the entire amount of net investment income earned in a particular period. The undistributed net investment income would be available to supplement future distributions. As a result, the distributions paid by the Fund for any particular monthly period may be more or less than the amount of net investment income

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actually earned by the Fund during the period. Undistributed net investment income will be additive to the Fund's NAV and, correspondingly, distributions from undistributed net investment income will be deducted from the Fund's NAV.

The tax treatment and characterization of the Fund's distributions may vary significantly from time to time because of the varied nature of the Fund's investments. The Fund may enter into opposite sides of interest rate swap and other derivatives for the principal purpose of generating distributable gains on the one side (characterized as ordinary income for tax purposes) that are not part of the Fund's duration or yield curve management strategies ("paired swap transactions"), and with a substantial possibility that the Fund will experience a corresponding capital loss and decline in NAV with respect to the opposite side transaction (to the extent it does not have corresponding offsetting capital gains). Consequently, Common Shareholders may receive distributions and owe tax at a time when their investment in the Fund has declined in value, which tax may be at ordinary income rates, and which may be economically similar to a taxable return of capital. The tax treatment of certain derivatives in which the Fund invests may be unclear and thus subject to recharacterization. Any recharacterization of payments made or received by the Fund pursuant to derivatives potentially could affect the amount, timing or character of Fund distributions. In addition, the tax treatment of such investment strategies may be changed by regulation or otherwise.

To the extent required by the 1940 Act and other applicable laws, absent an exemption, a notice will accompany each monthly distribution with respect to the estimated source (as between net income and gains) of the distribution made. If the Fund estimates that a portion of one of its dividend distributions may be comprised of amounts from sources other than net income, the Fund will notify shareholders of record of the estimated composition of such distribution through a Section 19 Notice. For these purposes, the Fund estimates the source or sources from which a distribution is paid, to the close of the period as of which it is paid, in reference to its internal accounting records and related accounting practices. If, based on such accounting records and practices, it is estimated that a particular distribution does not include capital gains or paid-in surplus or other capital sources, a Section 19 Notice generally would not be issued. It is important to note that differences exist between the Fund's daily internal accounting records and practices, the Fund's financial statements presented in accordance with U.S. GAAP, and recordkeeping practices under income tax regulations. For instance, the Fund's internal accounting records and practices may take into account, among other factors, tax-related characteristics of certain sources of distributions that differ from treatment under U.S. GAAP. Examples of such differences may include, among others, the treatment of paydowns on mortgage-backed securities purchased at a discount and periodic payments under interest rate swap contracts. Accordingly, among other consequences, it is possible that the Fund may not issue a Section 19 Notice in situations where the Fund's financial statements prepared later and in accordance with U.S. GAAP and/or the final tax character of those distributions might later report that the sources of those distributions included capital gains and/or a return of capital.

The tax characterization of the Fund's distributions made in a taxable year cannot finally be determined until at or after the end of such taxable year. As a result, there is a possibility that the Fund may make total distributions during a taxable year in an amount that exceeds the Fund's net investment income and net realized capital gains for the relevant year (including as reduced by any capital loss carry-forwards). For example, the Fund may distribute amounts early in the year that are derived from short-term capital gains, but incur net short-term capital losses later in the year, thereby offsetting short-term capital gains out of which the Fund has already made distributions. In such a situation, the amount by which the Fund's total distributions exceed net investment income and net realized capital gains would generally be treated as a tax-free return of capital up to the amount of a shareholder's tax basis in his or her Common Shares, with any amounts exceeding such basis treated as gain from the sale of Common Shares. In general terms, a return of capital would occur where the Fund distribution (or portion thereof) represents a return of a portion of your investment, rather than net income or capital gains generated from your investment during a particular period. Although return of capital distributions are not taxable, such distributions would reduce the basis of a shareholder's Common Shares and therefore may increase a shareholder's capital gains, or decrease a shareholder's capital loss, upon a sale of Common Shares, thereby potentially increasing a shareholder's tax liability. The Fund will prepare and make available to shareholders detailed tax information with respect to the Fund's distributions annually. See "Tax Matters."

The 1940 Act currently limits the number of times the Fund may distribute long-term capital gains in any tax year, which may increase the variability of the Fund's distributions and result in certain distributions being comprised more or less heavily than others of long-term capital gains currently eligible for favorable income tax rates. The Fund, as well as several other PIMCO-managed closed end funds, has received exemptive relief from the SEC permitting it to make a greater number of capital gains distributions to holders of the ARPS than would otherwise be permitted by Section 19(b) of the 1940 Act and Rule 19b-1 under the 1940 Act.

Unless a Common Shareholder elects to receive distributions in cash, all distributions of Common Shareholders whose shares are registered with the plan agent will be automatically reinvested in additional Common Shares of the Fund under the Fund's Dividend Reinvestment Plan. See "Distributions" and "Dividend Reinvestment Plan."

Shareholder Servicing Agent, Custodian and Transfer Agent

The Investment Manager, at its own expense, has retained Merrill Lynch & Co., Merrill Lynch, Pierce, Fenner & Smith, Incorporated, and UBS Securities LLC to serve as shareholder servicing agents for the Fund. State Street Bank and Trust Company serves as custodian of the Fund's assets and also provides certain fund accounting and sub-administrative services to the Investment Manager on behalf of the Fund. American Stock Transfer & Trust Company, LLC serves as the Fund's transfer agent and dividend disbursement agent. See "Shareholder Servicing Agent, Custodian and Transfer Agent."

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PIMCO Income Strategy Fund II

Listing

The Fund's outstanding Common Shares are listed on the NYSE under the trading or "ticker" symbol "PFN," as will be the Common Shares offered in this prospectus, subject to notice of issuance.

Market Price of Shares

Shares of closed-end investment companies frequently trade at prices lower than NAV. Shares of closed-end investment companies have during some periods traded at prices higher than NAV and during other periods traded at prices lower than NAV. The Fund cannot assure you that Common Shares will trade at a price equal to or higher than NAV in the future. NAV will be reduced immediately following an offering by any sales load and/ or commissions and the amount of offering expenses paid or reimbursed by the Fund. See "Use of Proceeds." In addition to NAV, market price may be affected by factors relating to the Fund such as dividend levels and stability (which will in turn be affected by Fund expenses, including the costs of any leverage used by the Fund, levels of interest payments by the Fund's portfolio holdings, levels of appreciation/depreciation of the Fund's portfolio holdings, regulation affecting the timing and character of Fund distributions and other factors), portfolio credit quality, liquidity, call protection, market supply and demand and similar factors relating to the Fund's portfolio holdings. See "Use of Leverage," "Principal Risks of the Fund," "Description of Shares" and "Repurchase of Common Shares; Conversion to Open-End Fund" in this prospectus, and see "Repurchase of Common Shares; Conversion to Open-End Fund" in the Statement of Additional Information. The Common Shares are designed for long-term investors and should not be treated as trading vehicles.

Principal Risks of the Fund

The following is a summary of the principal risks associated with an investment in Common Shares of the Fund. Investors should also refer to "Principal Risks of the Fund" in this prospectus and "Investment Objective and Policies" in the Statement of Additional Information for a more detailed explanation of these and other risks associated with investing in the Fund.

Market Discount Risk

As with any stock, the price of the Fund's Common Shares will fluctuate with market conditions and other factors. If you sell your Common Shares, the price received may be more or less than your original investment. Net asset value of the Fund's Common Shares will be reduced immediately following an offering by any sales load and/or commissions and offering expenses paid or reimbursed by the Fund in connection with such offering. The completion of an offering may result in an immediate dilution of the NAV per Common Share for all existing Common Shareholders. The Common Shares are designed for long-term investors and should not be treated as trading vehicles. Shares of closed-end management investment companies frequently trade at a discount from their NAV. The Common Shares may trade at a price that is less than the offering price for Common Shares issued pursuant to an offering. This risk may be greater for investors who sell their Common Shares relatively shortly after completion of an offering.

Credit Risk

The Fund could lose money if the issuer or guarantor of a debt security (including a security purchased with securities lending collateral), or the counterparty to a derivatives contract, repurchase agreement or a loan of portfolio securities, is unable or unwilling, or is perceived (whether by market participants, rating agencies, pricing services or otherwise) as unable or unwilling, to make timely principal and/or interest payments, or to otherwise honor its obligations. The downgrade of the credit of a security held by the Fund may decrease its value. Securities are subject to varying degrees of credit risk, which are often reflected in credit ratings. Measures such as average credit quality may not accurately reflect the true credit risk of the Fund. This is especially the case if the Fund holds securities with widely varying credit ratings. Therefore, if the Fund has an average credit rating that suggests a certain credit quality, the Fund may in fact be subject to greater credit risk than the average would suggest. This risk is greater to the extent the Fund uses leverage or derivatives in connection with the management of the Fund. Municipal bonds are subject to the risk that litigation, legislation or other political events, local business or economic conditions, or the bankruptcy of the issuer could have a significant effect on an issuer's ability to make payments of principal and/or interest.

High Yield Securities Risk

In general, lower rated debt securities carry a greater degree of risk that the issuer will lose its ability to make interest and principal payments, which could have a negative effect on the NAV of the Fund's Common Shares or Common Share dividends. Securities of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and repay principal, and are commonly referred to as "high yield" securities or "junk bonds." High yield securities involve a greater risk of default and their prices are generally more volatile and sensitive to actual or perceived negative developments, such as a decline in the issuer's revenues or revenues of underlying borrowers or a general economic downturn, than are the prices of higher grade securities. Debt securities in the lowest investment grade category also may be considered to possess some speculative characteristics by certain rating agencies. The Fund may purchase distressed securities that are in default or the issuers of which are in bankruptcy, which involve heightened risks. See "Principal Risks of the Fund—Distressed and Defaulted Securities Risk." An economic downturn could severely affect the ability of issuers (particularly those that are highly leveraged) to service their debt obligations or to repay their obligations upon maturity. Lower-rated securities are generally less liquid than higher-rated securities, which may have an adverse effect on the Fund's ability to dispose of a particular security. For example, under adverse market or economic conditions, the secondary market for below investment grade securities could contract further, independent of any specific adverse changes in the condition of a particular issuer, and certain securities in the Fund's portfolio may become illiquid or less liquid. As a result, the Fund could find it more difficult to sell these securities or may be able to sell these securities only at prices lower than if such securities were widely traded. See "Principal Risks of the Fund—Liquidity Risk." To the extent the Fund focuses on below investment grade debt obligations, PIMCO's capabilities in analyzing credit quality and associated risks will be particularly important, and there can be no assurance that PIMCO will be

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successful in this regard. See "Portfolio Contents— High Yield Securities" for additional information. Due to the risks involved in investing in high yield securities, an investment in the Fund should be considered speculative.

The Fund's credit quality policies apply only at the time a security is purchased, and the Fund is not required to dispose of a security in the event that a rating agency or PIMCO downgrades its assessment of the credit characteristics of a particular issue. In determining whether to retain or sell such a security, PIMCO may consider factors including, but not limited to, PIMCO's assessment of the credit quality of the issuer of such security, the price at which such security could be sold and the rating, if any, assigned to such security by other rating agencies. Analysis of creditworthiness may be more complex for issuers of high yield securities than for issuers of higher quality debt securities.

Market Risk

The market price of securities owned by the Fund may go up or down, sometimes rapidly or unpredictably. Securities may decline in value due to factors affecting securities markets generally or particular industries represented in the securities markets. The value of a security may decline due to general market conditions that are not specifically related to a particular company, such as real or perceived adverse economic conditions, changes in the general outlook for corporate earnings, changes in interest or currency rates, adverse changes to credit markets or adverse investor sentiment generally. The value of a security may also decline due to factors that affect a particular industry or industries, such as labor shortages or increased production costs and competitive conditions within an industry. During a general downturn in the securities markets, multiple asset classes may decline in value simultaneously. Equity securities generally have greater price volatility than fixed income securities. Credit ratings downgrades may also negatively affect securities held by the Fund. Even when markets perform well, there is no assurance that the investments held by the Fund will increase in value along with the broader market. In addition, market risk includes the risk that geopolitical events will disrupt the economy on a national or global level. For instance, terrorism, market manipulation, government defaults, government shutdowns, political changes or diplomatic developments, and natural/environmental disasters can all negatively impact the securities markets, which could cause the Fund to lose value. Any market disruptions could also prevent the Fund from executing advantageous investment decisions in a timely manner. To the extent the Fund focuses its investments in a region enduring geopolitical market disruption, it will face higher risks of loss. Thus, investors should closely monitor current market conditions to determine whether a specific Fund meets their individual financial needs and tolerance for risk.

Current market conditions may pose heightened risks with respect to funds that invest in fixed income securities. As discussed more under "—Interest Rate Risk," interest rates in the U.S. are near historically low levels. However, continued economic recovery, the end of the Federal Reserve Board's quantitative easing program, and an increased likelihood of a rising interest rate environment increase the risk that interest rates will continue to rise in the near future. Any further interest rate increases in the future could cause the value of the Fund to decrease. As such, fixed income securities markets may experience heightened levels of interest rate, volatility and liquidity risk.

Exchanges and securities markets may close early, close late or issue trading halts on specific securities, which may result in, among other things, the Fund being unable to buy or sell certain securities or financial instruments at an advantageous time or accurately price its portfolio investments.

Interest Rate Risk

Interest rate risk is the risk that fixed-income securities and other instruments in the Fund's portfolio will decline in value because of a change in interest rates. As nominal interest rates rise, the value of certain fixed-income securities held by the Fund is likely to decrease. A nominal interest rate can be described as the sum of a real interest rate and an expected inflation rate. Interest rate changes can be sudden and unpredictable, and the Fund may lose money as a result of movements in interest rates. The Fund may not be able to hedge against changes in interest rates or may choose not to do so for cost or other reasons. In addition, any hedges may not work as intended.

A wide variety of factors can cause interest rates to rise (e.g., central bank monetary policies, inflation rates, general economic conditions). **This risk may be particularly acute in the current market environment because market interest rates are currently near historically low levels.** This, combined with recent economic recovery, the Federal Reserve Board's conclusion of its quantitative easing program, and increases in federal funds interest rates in 2015, 2016 and 2017, which had not occurred since 2006, could potentially increase the probability of an upward interest rate environment in the near future. To the extent the Federal Reserve Board continues to raise interest rates, there is a risk that rates across the financial system may rise.

Fixed-income securities with longer durations tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations. Duration is a measure used to determine the sensitivity of a security's price to changes in interest rates that incorporates a security's yield, coupon, final maturity and call features, among other characteristics. Duration is useful primarily as a measure of the sensitivity of a fixed-income security's market price to interest rate (i.e. yield) movements. All other things remaining equal, for each one percentage point increase in interest rates, the value of a portfolio of fixed-income investments would generally be expected to decline by one percent for every year of the portfolio's average duration above zero. For example, the value of a portfolio of fixed-income securities with an average duration of eight years would generally be expected to decline by approximately 8% if interest rates rose by one percentage point.

Variable and floating rate securities generally are less sensitive to interest rate changes but may decline in value if their interest rates do not rise as much, or as quickly, as interest rates in general. Conversely, floating rate securities will not generally increase in value if interest rates decline. Inverse floating rate securities may decrease in value if interest rates increase. Inverse floating rate securities may also exhibit greater price volatility than a fixed rate obligation with similar credit quality. When the Fund holds variable or floating rate securities, a decrease (or, in the case of inverse floating rate securities, an increase) in market interest rates will adversely

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PIMCO Income Strategy Fund II

affect the income received from such securities and the NAV of the Fund's shares.

During periods of very low or negative interest rates, the Fund may be unable to maintain positive returns. Interest rates in the United States and many parts of the world, including certain European countries, are at or near historically low levels. Certain European countries have recently experienced negative interest rates on certain fixed-income instruments. Very low or negative interest rates may magnify interest rate risk. Changing interest rates, including rates that fall below zero, may have unpredictable effects on markets, may result in heightened market volatility and may detract from Fund performance to the extent the Fund is exposed to such interest rates.

Measures such as average duration may not accurately reflect the true interest rate sensitivity of the Fund. This is especially the case if the Fund consists of securities with widely varying durations. Therefore, if the Fund has an average duration that suggests a certain level of interest rate risk, the Fund may in fact be subject to greater interest rate risk than the average would suggest. This risk is greater to the extent the Fund uses leverage or derivatives in connection with the management of the Fund.

Convexity is an additional measure used to understand a security's or Fund's interest rate sensitivity. Convexity measures the rate of change of duration in response to changes in interest rates. With respect to a security's price, a larger convexity (positive or negative) may imply more dramatic price changes in response to changing interest rates. Convexity may be positive or negative. Negative convexity implies that interest rate increases result in increased duration, meaning increased sensitivity in prices in response to rising interest rates. Thus, securities with negative convexity, which may include bonds with traditional call features and certain mortgage-backed securities, may experience greater losses in periods of rising interest rates. Accordingly, if the Fund holds such securities, the Fund may be subject to a greater risk of losses in periods of rising interest rates.

Rising interest rates may result in a decline in value of the Fund's fixed-income investments and in periods of volatility. Further, while U.S. bond markets have steadily grown over the past three decades, dealer "market making" ability has remained relatively stagnant. As a result, dealer inventories of certain types of bonds and similar instruments, which provide a core indication of the ability of financial intermediaries to "make markets," are at or near historic lows in relation to market size. Because market makers provide stability to a market through their intermediary services, the significant reduction in dealer inventories could potentially lead to decreased liquidity and increased volatility in the fixed-income markets. Such issues may be exacerbated during periods of economic uncertainty. All of these factors, collectively and/or individually, could cause the Fund to lose value.

Issuer Risk

The value of a security may decline for a number of reasons that directly relate to the issuer, such as management performance, financial leverage and reduced demand for the issuer's goods or services, as well as the historical and prospective earnings of the issuer and the value of its assets. A change in the financial condition of a single issuer may affect securities markets as a whole. These risks can apply to the Common Shares issued by the Fund and to the issuers of securities and other instruments in which the Fund invests.

Leverage Risk

The Fund's use of leverage (as described under "Use of Leverage" in the body of this prospectus) creates the opportunity for increased Common Share net income, but also creates special risks for Common Shareholders. To the extent used, there is no assurance that the Fund's leveraging strategies will be successful. Leverage is a speculative technique that may expose the Fund to greater risk and increased costs. The Fund's assets attributable to its outstanding Preferred Shares or the net proceeds that the Fund obtains from its use of reverse repurchase agreements, dollar rolls and/or borrowings, if any, will be invested in accordance with the Fund's investment objective and policies as described in this prospectus. Dividends payable with respect to the Preferred Shares and interest expense payable by the Fund with respect to any reverse repurchase agreements, dollar rolls and borrowings (for dividends payable with respect to Preferred Shares) will generally be based on shorter-term interest rates that would be periodically reset. So long as the Fund's portfolio investments provide a higher rate of return (net of applicable Fund expenses) than the dividend rate on the Preferred Shares and the interest expenses and other costs to the Fund of such other leverage, the investment of the proceeds thereof will generate more income than will be needed to pay the costs of the leverage. If so, and all

other things being equal, the excess may be used to pay higher dividends to Common Shareholders than if the Fund were not so leveraged. If, however, shorter-term interest rates rise relative to the rate of return on the Fund's portfolio, the interest and other costs of leverage to the Fund (including interest expenses on reverse repurchase agreements, dollar rolls and borrowings and the dividend rate on any outstanding preferred shares) could exceed the rate of return on the debt obligations and other investments held by the Fund, thereby reducing return to Common Shareholders. In addition, fees and expenses of any form of leverage used by the Fund will be borne entirely by the Common Shareholders (and not by preferred shareholders, if any) and will reduce the investment return of the Common Shares. Therefore, there can be no assurance that the Fund's use of leverage will result in a higher yield on the Common Shares, and it may result in losses. In addition, any Preferred Shares issued by the Fund are expected to pay cumulative dividends, which may tend to increase leverage risk.

Leverage creates several major types of risks for Common Shareholders, including:

the likelihood of greater volatility of NAV and market price of Common Shares, and of the investment return to Common Shareholders, than a comparable portfolio without leverage;

the possibility either that Common Share dividends will fall if the interest and other costs of leverage rise, or that dividends paid on Common Shares will fluctuate because such costs vary over time; and

the effects of leverage in a declining market or a rising interest rate environment, as leverage is likely to cause a greater decline in the NAV of the Common Shares than if the Fund were not leveraged and may result in a greater decline in the market value of the Common Shares.

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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.

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

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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

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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, 2008	Jun. 30, 2008	Sept. 30, 2008	Dec. 31, 2008	Mar. 31, 2009	Jun 30, 2009	Sept. 30, 2009	Dec. 31, 2009
(in thousands) (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	\$ 0.02	\$ 0.02	\$ 0.02	\$ 0.03	\$ 0.02	\$ 0.03	\$ 0.03	\$ 0.13

share

Diluted net income per share	\$	0.01	\$	0.02	\$	0.02	\$	0.02	\$	0.02	\$	0.03	\$	0.03	\$	0.13
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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 (USD in thousands)				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease obligation	\$ 612	\$ 478	\$ 134	\$ -	\$ -
Other Long-term liabilities reflected on the Company's Balance Sheet - Accrued severance pay	1,050	-	-	-	1,050
Other Long-term asset reflected on the Company's Balance Sheet - severance pay 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,	51	22.8%	5,562,740	76,871 options, at exercise prices ranging

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

Hila Karah, Director(1)(3)	41	<1%	<1%	
Lloyd E. Shefsky, 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, Director (Outside Director) (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, Director (Outside 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)	Vice President, International Sales and Business Development, Commtouch Software Ltd.
Yossi Maslaton	43	(1)	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), Orckit 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.

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.

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 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:

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:

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.

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) 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 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) and through the MAGNA distribution site of the Israeli Securities Authority (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.

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.

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, not 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 proceeds 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.

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, 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 Fees	2008 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.

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

May 1 – May 31	101,165	1.93	101,165	2,544,065
June 1- June 30	169,000	1.96	169,000	2,212,520
July 1 – July 31	98,243	2.35	98,243	1,981,397
August 1- August 31	124,530	2.68	124,530	1,647,721
September 1 – September 30	124,978	2.76	124,978	1,302,754
October 1 – October 31	119,472	3.35	119,472	902,878
November 1 – November 30	155,290	3.23	155,290	401,085
December 1 – 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, 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.

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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

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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 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
March 26, 2010

/s/ Kost, Forer, Gabbay & Kasierer
KOST FORER GABBAY & KASIERER
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
ASSETS		
CURRENT ASSETS:		
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
Total current assets	18,404	21,267
LONG-TERM ASSETS:		
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
Total long-term assets	2,305	3,923
Total assets	\$ 20,709	\$ 25,190

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

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COMMTOUCH SOFTWARE LTD. AND ITS SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

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

	December 31	
	2008	2009
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
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
Total current liabilities	3,557	4,415
LONG-TERM LIABILITIES:		
Long-term deferred revenues	635	848
Accrued severance pay	857	1,050
Total long-term liabilities	1,492	1,898
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY:		
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)
Total shareholders' equity	15,660	18,877
Total liabilities and shareholders' equity	\$ 20,709	\$ 25,190

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

compensation related to options granted to non-employees									
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
Cash flows from operating activities:			
Net income	\$ 2,109	\$ 2,270	\$ 5,160
Adjustments to reconcile net income to net cash provided by operating activities:			
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)
Changes in assets and liabilities:			
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)	-	-
Net cash provided by operating activities	4,115	3,019	5,082
Cash flows from investing activities:			
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)
Net cash provided by (used in) investing activities	(2,975)	325	1,852
Cash flows from financing activities:			
Purchase of treasury shares at cost	-	(1,334)	(3,538)
Proceeds from options and warrants exercised	1,663	844	218
Net cash provided by (used in) financing activities	1,663	(490)	(3,320)
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

Cash and cash equivalents at the end of the year	\$ 10,807	\$ 13,661	\$ 17,275
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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

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

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.

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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.)

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

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.

I. 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

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

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

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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.)

-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
Cost:		
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 shares 2009	Weighted average exercise price 2009	Aggregate intrinsic value 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
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\$ 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
\$ 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 for Ordinary Shares	Exercise price per share	Options exercisable	Exercisable 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
Income:			
Interest on cash and cash equivalents and short term deposit	\$ 575	\$ 434	\$ 108
Capital gain on sale of marketable securities	-	-	38
Expenses:			
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

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.

(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) 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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