

AREL COMMUNICATIONS AND SOFTWARE LTD.
EMPLOYEE SHARE OPTION PLAN 2003/1

A PLAN UNDER SECTION 102 OF THE INCOME TAX ORDINANCE

1. Name and Purpose:

1.1 This plan, as amended from time to time, shall be known as the Arel Communications and Software Limited Employee Share Option Plan 2003/1 (the "**2003/1 Plan**" or the "**Plan**").

1.2 The purpose and intent of the Plan is to provide incentives to employees of Arel Communications and Software Limited (the "**Company**") or any subsidiaries of the Company by providing them with opportunities to purchase shares in the Company, pursuant to a plan approved by the Board of Directors of the Company which is designed to benefit from, and is made pursuant to, the provisions of Section 102 ("Section 102") of the Israeli Income Tax Ordinance (New Version), 1961 as amended from time to time and, most recently, by the Law Amending the Income Tax Ordinance (Number 132) 2002 (as amended, the "Ordinance") and the rules promulgated thereunder.

2. Types of 102 Options and Section 102 Election:

Options granted pursuant to Section 102 shall be granted pursuant to either (a) Section 102(b)(2) thereof as capital gains track options, pursuant to which income resulting from the sale of shares derived from such Options is generally taxed as a capital gain ("**102 Capital Gains Track Options**"), or (b) Section 102(b)(1) thereof as ordinary income track options, pursuant to which income resulting from the sale of shares derived from such Options is taxed as ordinary income ("**102 Ordinary Income Track Options**"; together with 102 Capital Gains Track Options, "**102 Trustee Options**"). The Company may grant only one type of 102 Trustee Option at any given time pursuant to this Plan, and shall file an election with the Israeli Tax Authorities regarding the type of 102 Trustee Option it chooses to grant (the "**Election**"). Once the Company has filed such Election, it may change the type of 102 Trustee Option that it chooses to grant only after the passage of at least 12 months from the end of the calendar year in which the first grant was made in accordance with the previous Election. Until the Election is changed, all 102 Trustee Options shall be issued either as 102 Capital Gain Stock Options or as 102 Ordinary Income Stock Options. The aforementioned election of the Company will be approved by the Committee (as defined in Section 4 below).

3. Scope:

The total number of options (the "**Options**") which can be granted under this Plan are options to purchase up to 515,885 Ordinary Shares of the Company (nominal value NIS 0.001 per share), subject to adjustments as provided in Section 12 below.

4. Administration:

- 4.1 The Plan will be administered by the Board of Directors of the Company, taking into account the recommendations of the Share Option Committee ("the **Committee**"), a sub-committee of the Board of Directors.
- 4.2 The Committee shall consist of such number of Directors of the Company (not less than two in number), as may be fixed from time to time by the Board of Directors of the Company. The Board of Directors shall appoint the members of the Committee, may from time to time remove members from, or add members to, the Committee and shall fill vacancies in the Committee however caused.
- 4.3 The Committee shall select one of its members as its Chairman and shall hold its meetings at such times and places, as it shall determine. Actions at a meeting of the Committee at which a majority are present or acts reduced to, or approved in writing by all members of the Committee, shall be the valid acts of the Committee. The Committee may appoint a Secretary, who shall keep records of its meetings and shall make such rules and regulations for the conduct of its business, as it shall deem advisable.
- 4.4 Subject to the general terms and conditions of this Plan, the Committee shall have full authority in its discretion, from time to time and at any time, to formulate recommendations to the Board of Directors regarding any of the following: (i) the persons to whom Options shall be granted (the "**Grantees**"); (ii) the number of shares to be covered by each Option award; (iii) the time or times at which the same shall be granted; (iv) the schedule and conditions on which such Option may be exercised and on which such shares shall be paid for; and/or (v) any other matter which is necessary or desirable for, or incidental to, the administration of the Plan. In formulating its recommendation regarding the number of shares covered by the Option to be granted to each Grantee, the Committee shall consider, among other things, the Grantee's salary and the duration of the Grantee's employment by the Company.
- 4.5 The Committee may, from time to time, adopt such rules and regulations for carrying out the Plan, as it may deem best. No member of the Committee or of the Board of Directors shall be liable for any action or determination made in good faith with respect to the Plan or any Option granted hereunder.
- 4.6 The interpretation and construction by the Committee of any provision of the Plan or of any Option granted thereunder shall be final and conclusive unless otherwise determined by the Board of Directors.

5. Eligible Grantees:

- [5.1 No Option under this Plan may be granted to any person serving as a member of the Committee at the time of the grant without approval of the Board of Directors of the Company.
- 5.2 Subject to this limitation and any restriction imposed by Section 102 or the Israel Companies Law 1999, Option awards may be granted to any officer, key employee or other employee of the Company or any of its subsidiaries, ("**Employee**"). The grant of an Option to a Grantee hereunder, shall neither entitle such Grantee to participate, nor disqualify him/her from participating, in any other grant of options pursuant to this Plan or any other share incentive or share option plan of the Company or any of its subsidiaries.

6. Trustee:

- 6.1 The Option awards and/or shares in the Company which will be issued upon the exercise of the Options will be held in trust by Mr. Orni Elad, CPA (the "**Trustee**") in accordance with Section 102 and the regulations, rules, orders or procedures promulgated thereunder.
- 6.2 102 Trustee Options and any shares received following exercise of 102 Trustee Options shall be held by the Trustee for the requisite period prescribed by the Ordinance and the Rules, or such other period as may be required or unless otherwise permitted by the Income Tax Authorities (the "**Required Holding Period**") and may not be sold prior to the end of the Required Holding Period.
- 6.3 After the Required Holding Period, the Trustee may release the Options or the Shares or the consideration received from the sale thereof to the Grantee only after (A) the receipt by the Trustee of an acknowledgment from the Income Tax Authority that the Grantee has paid any applicable tax due, or (B) the Trustee withholds any applicable tax due pursuant to the Ordinance and Rules. The Trustee shall not release any Options or Shares issued upon exercise of Options or the consideration received from the sale thereof prior to the full payment of the Grantee's tax liabilities.
- 6.4 The Trustee and each Grantee shall comply with the Ordinance, the Rules, and the terms and conditions of the Trust Agreement entered into between the Company and the Trustee.
- 6.5 In the event a share dividend is declared or other securities are issued as bonus shares (מניות הטבה) on shares which derive from 102 Trustee Options, such share dividend and bonus shares shall also be subject to the provisions of this Section and the Required Holding Period for such share dividend and bonus shares shall be measured from the commencement of the Required Holding Period for the Option from which the share dividend was declared or the bonus shares were issued.

6.6 The Trustee shall not use the voting rights vested in such shares issuable upon exercise of the options, except in cases when, at his discretion and after consulting with the Committee, the Trustee believes that the said rights should be exercised for the protection of the Grantees as a minority among the Company's shareholders.

7. Reserved Shares:

The Company has reserved 515,885 authorized but unissued Ordinary Shares (nominal value NIS 0.001 per share) for purposes of the Plan, subject to adjustments as provided in Section 12 below. Any shares under the Plan, in respect of which the right hereunder of a Grantee to purchase the same shall for any reason terminate, expire or otherwise cease to exist, shall again be available for grant through Option awards under the Plan or under any other incentive plan that the Company may adopt.

8. Option Awards:

8.1. The date of grant of each Option Award shall be the date of the Option Award letter granted to the Grantee. Under the Ordinance, Options may be granted 30 days after the filing of the Plan, however, in the event that this Plan is not approved by the Income Tax authorities as a plan under Section 102, the rights attached to Options granted under this Plan shall be subject to change.

8.2. The instrument granting Option Award shall state, inter alia, the number of Shares covered thereby, the dates when it may be exercised, the option price and such other terms and conditions as the Committee at its discretion may prescribe, provided that they are consistent with this Plan and with Section 102.

8.3. The Options hereunder will not be listed in any stock exchange and are not transferable (except to the Grantee's legal heirs or estate).

9. Options' Exercise Prices:

Unless otherwise approve by the Company's Board of Directors, the purchase price of each Share will be the last reported sales price of the Company's shares as reported by NASDAQ or the principal national securities exchange upon which the Company's shares are listed or traded before the Date of Grant.

10. Vesting and Exercise of Option Award:

10.1 Option awards shall become exercisable (vest) pursuant to the terms under which they were awarded, subject to the terms and conditions of this Plan; provided, however, that in no event shall an Option award be exercisable after the expiration of ten (10) years from the date such Option was granted.

- 10.2 The procedure for exercise of the Options shall be as detailed in Annex 1 to this Plan. The Company may change the procedure for exercise of the Options at its discretion, by giving notice thereof to the Grantees.
- 10.3 Anything herein to the contrary notwithstanding, if any Option award, or any part thereof, has not been exercised within ten (10) years after the date of grant (or any shorter period set forth in the instrument granting such Option award pursuant to Section 8), such Option award, or such part thereof, shall terminate, and all interests and rights of the Grantee in and to the Option award shall expire and, in the event that in connection therewith any shares are held in trust as aforesaid, such trust shall expire and the Trustee shall thereafter hold such shares in an unallocated pool until instructed by the Company that some or all of such shares are again to be held in trust for one or more Grantees.
- 10.4 Each payment for shares under an Option award shall be in respect of a whole number of shares, shall be effected in cash or by a cashier's or certified check payable to the order of the Company, or such other method of payment acceptable to the Company as determined by the Committee, and shall be accompanied by a notice stating the number of shares being paid for thereby.

11. Termination of Employment; Termination of Right to Exercise:

- 11.1 Resignation and Termination without Cause. If a Grantee who is an Employee resigns, or is terminated without cause, such Grantee may, within up to one (1) year (as more fully set forth below) of the cessation of his or her employment (but in no event later than the expiration of the term of the instrument granting his or her Option awards pursuant to Section 8.2 above), exercise any of his or her Option awards that are vested at the date of cessation of such Grantee's employment or may vest within four (4) weeks of the cessation of such Grantee's employment. All of such Grantee's rights with respect to Option awards granted to him or her under the Plan that are not vested at the date of cessation of such Grantee's employment or within four (4) weeks of the cessation of such Grantee's employment, shall terminate and the underlying Shares shall revert to the Plan immediately upon the cessation of such Grantee's employment. If within three (3) months of the cessation of such Grantee's employment, such Grantee does not exercise his or her Option awards, all of such Grantee's rights with respect to any Option awards that have not been exercised shall terminate and the underlying Shares shall revert to the Plan; provided, however, that the Committee shall be authorized to extend such three-month period by up to nine (9) additional months.
- 11.2 Termination for Cause. If a Grantee who is an Employee is terminated for "cause" (as defined in such Grantee's employment agreement, and if such Grantee does not have an employment agreement, as defined in the Company's standard employment agreement), such Grantee may, within three (3) months of the cessation of his or her employment (but in no event later than the expiration of the term of the instrument granting his or her Option awards pursuant to Section 8.2 above), exercise any of his or her Option awards that are vested at

the date of cessation of such Grantee's employment. All of such Grantee's rights with respect to Option awards granted to him or her under the Plan that are not vested at the date of cessation of such Grantee's employment, shall terminate and the underlying Shares shall revert to the Plan immediately upon the cessation of such Grantee's employment. If within one (1) month of the cessation of such Grantee's employment, such Grantee does not exercise his or her Option awards, all of such Grantee's rights with respect to any Option awards that have not been exercised shall terminate and the underlying Shares shall revert to the Plan.

- 11.3 **Death and Disability.** If a Grantee should die, or if a Grantee is unable to continue to be employed by the Company by reason of such Grantee's becoming incapacitated while in the employ of the Company as a result of an accident or illness or other cause which is approved by the Committee, such Grantee (or such Grantee's successors, as the case may be) shall, subject to approval of the Committee (which shall not be unreasonably withheld), continue to enjoy rights under the Plan on such terms and conditions as the Committee in its discretion may determine.
- 11.4 **Deemed Cessation.** In the event of resignation or discharge of a Grantee from the employ of the Company, such Grantee's employment shall, for the purposes of this Section 11, be deemed to have ceased upon delivery to the employee of notice of discharge or the delivery to the Company of the letter of resignation, as the case may be, irrespective of the effective date of such resignation or discharge.

12. Adjustments:

- 12.1 **Bonus Shares:** In the event that the Company shall issue any of its Ordinary Shares or other securities as bonus shares (stock dividend) upon or with respect to any shares which shall at the time be subject to a right of purchase by a Grantee hereunder, each Grantee upon exercising such right shall be entitled to receive (for the purchase price payable upon such exercise), the shares as to which he is exercising such right and, in addition thereto (at no additional cost), such number of shares of the class or classes in which such bonus shares (stock dividend) were declared, as the Grantee would have received had he been the holder of the shares as to which he is exercising his right at all times between the date of the granting of such right and the date of its exercise. No fractional shares will be issued under this Section. All resulting fractional shares may be aggregated and sold by the Company, who will be entitled to the proceeds of the sale thereof.
- 12.2 **Consolidation and Splits:** If the Company consolidates its Ordinary Shares, NIS 0.001 nominal value, into shares having a larger nominal value, or if it splits them into a larger number of shares having a lesser nominal value, then the number of Underlying Shares that is allotted due to the Options' exercise will be decreased or increased, as the case may be, after such an action.

12.3 In any event in which the execution of an adjustment is actually required as detailed in this Section 12, the Committee is authorized to implement the actual adjustment and to execute the required calculations, all subject to the principles in this Section 12 and its determinations shall be conclusive.

13. Continuance of Employment:

Neither the Plan nor the Option Award letter shall impose any obligation on the Company or a subsidiary thereof, to continue any Grantee in its employ, and nothing in the Plan or in any Option Award pursuant thereto shall confer upon any Grantee any right to continue in the employ of the Company or a subsidiary thereof, or restrict the right of the Company or a subsidiary thereof, to terminate such employment at any time.

14. Governing Law:

The Plan and all instruments issued hereunder or in connection therewith, shall be governed by, and interpreted in accordance with, the laws of the State of Israel.

15. Application of Funds:

The proceeds received by the Company from the sale of shares pursuant to Option Awards granted under the Plan will be used for general corporate purposes of the Company or any subsidiary thereof.

16. Tax Consequences:

16.1 Any tax consequences arising from the grant or exercise of any Option Award, from the payment for shares covered thereby or from any other event or act (of the Company or the Grantee) hereunder, shall be borne solely by the Grantee. Furthermore, the Grantee shall agree to indemnify the Company and the Trustee and hold them harmless against and from any and all liability for any such tax or interest or penalty thereon, including without limitation, liabilities relating to the necessity to withhold, or to have withheld, any such tax from any payment made to the Grantee.

16.2 Before any Option Awards are granted, the Grantee will confirm in writing that (1) he/she understands the Options are pursuant to a Plan under Section 102 that is governed by the applicable tax track; (2) the provisions of Section 102, , and (3) the applicable restrictions on selling shares during the Required Holding Period.

17. Miscellaneous

17.1 Maintaining Registered Capital: The Company will maintain a sufficient quantity of Ordinary Shares, NIS 0.001 nominal value, in its registered capital

to ensure the execution of the exercise right hereunder, and if necessary it will cause its registered capital to be increased.

17.2 Share Exchange Transaction: In the event that the Company is a party to any agreement or arrangement for exchanging shares (such as a merger or reorganization) (hereinafter, the “**Exchange Transaction**”), in which the holders of the Company’s ordinary shares are offered the opportunity to exchange their shares for the securities of any other corporation, the Company will use commercially reasonable efforts to demand that such other corporation allot such securities as were offered to its ordinary shareholders as aforesaid to any Grantee who exercises his/her options during the exercise period and subject to the exercise conditions, as if that Grantee was the holder of the Underlying Shares on the determining date for purposes of the said Exchange Transaction.

17.3 Changes in the Options’ Conditions: The Committee is entitled to change the options’ provisions from time to time for the Grantees’ benefit (subject to Section 102), without the need to obtain the consent of the Grantees.

In addition, to the extent that during the period of this plan, new tax legislation applicable to employees' option plans enters into force, the Committee may introduce changes to this plan with respect to options hereunder not yet granted until the date of the change, as well as changes to the terms of options already granted hereunder until the date of the change, to the extent considered desirable by the Committee in order to benefit from such new tax laws, provided that with respect to options already granted, the Committee will not introduce changes that may in certain circumstances prejudice the Grantees, without their consent.

Notice of any changes to the options' terms will be given promptly to the Trustee.

17.4 RESERVED.

17.5 Assignability and Sale of Shares:

17.5.1 No shares purchasable hereunder which were not fully paid for shall be assignable or transferable by the Grantee. For avoidance of doubt, the foregoing shall not be deemed to restrict the transfer of a Grantee’s rights in respect of Option awards or shares purchasable pursuant to the exercise thereof upon the death of such Grantee to his estate or other successors by operation of law or will, whose rights therein shall be governed by paragraph 11.3 hereof.

17.5.2 No option may be transferred other than by will or by the laws of descent and distribution, and during the Grantee’s lifetime only he or she may exercise an Option award.

17.5.3 Securities Act of 1933; Israel Securities Law, 1967; By his exercise of an Option award hereunder, the Grantee agrees not to sell, transfer or otherwise dispose of any of the shares so purchased by him except in compliance with the United States Securities Act of 1933, as amended,

and the rules and regulation thereunder and the Grantee further agrees that all certificates evidencing any of such shares shall be appropriately legended to reflect such restriction. The Company does not obligate itself to register any shares under the United States Securities Act of 1933, as amended. However, the securities being offered an/or issued hereby have been issued in compliance with the Israel Securities Law, 1967.

- 17.6 Terms and Amendment of the Plan: The Plan was adopted by the Board of Directors of the Company on December 23, 2003 and shall expire on December 23, 2013 in accordance with its terms. Subject to applicable law, the Board of Directors may, at any time and from time to time, terminate or amend the Plan.