TRINIDAD AND TOBAGO SECURITIES AND EXCHANGE COMMISSION

ISSUES IN THE REGULATION OF

EMPLOYEE AND MANAGEMENT STOCK OPTION PLANS

ADDRESS BY

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Good Morning, Ladies and Gentlemen

I have been invited this morning to address you on the issue of ESOPs and MSOPs and the approach that the Commission might be taking regarding the regulation of such plans.

By way of background, I was approached in some distress some months ago about the fact that certain foreign owned energy companies were being advised that they could not allow their domestic staff access to their employee stock option plans unless the companies were registered as issuers and the securities to be distributed under these plans were similarly registered. A meeting was subsequently held at the Commission seeking to further pursue the discussion, during which the idea of my making an address to a forum such as this arose, hence my presence here this morning.

I would like, however, to place the discussion of ESOPs and MSOPs in a broader context.

As you may all be aware, the essence of the mandate of the Commission is to seek the protection of investors primarily through ensuring that adequate information exists to enable them to make informed and rational decisions. Thus the key to securities regulation and to the protection of investors lies in disclosure – adequate,

prompt and public disclosure of material changes and information about the fortunes of the securities in which investors have placed their funds. Without an environment of disclosure, investors may be faced with unknown and incalculable risks, including those that could arise from insider trading, market manipulation and other features of unfair trading practices.

In order to achieve an acceptable level of protection for investors, the Commission manages a disclosure regime that includes the registration of issuers and securities issues and of market participants. The Commission also requires the filing of periodic financial information that seeks to provide investors with data on the performance of the securities in which they have invested, the entities that have issued such securities and the market participants through whom investors deal in the securities.

While ESOPs and MSOPs have attained popularity as elements of deferred compensation for the employees, managers and directors of major companies, they involve the issue of securities of the entities and therefore fall properly under the jurisdiction of the Commission. It should also be noted that the issuance of equity securities under employee and management plans do also have a direct impact on the ordinary shareholders of these companies as one of the direct results of the practice is the dilution of the interests of other shareholders in favour of the interests of management and staff. A recent study by the Commission estimated that between 1997 and 2003, ESOPs and MSOPs led to a dilution of 3.0% in the interests of ordinary shareholders.

During this period, the Commission approved the issue of 114,209,537 new ordinary equity shares under such plans. Since such plans are predicated on an

assumption that the exercise price is set some three years previously with a view to achieving an increase in the actual share price on the Stock Market, it is clear that employee and management benefits have been greater than the value recorded at the exercise price. More recent data for the calendar year 2006 show that a total of 8.8 million shares registered under compensation plans had an exercise value of $52.2 million compared with a market value of $84.7 million. Of the thirty-two companies listed on the stock exchange, about nine (9) actively operated such programmes for management and staff.

This certainly suggests that there is substantial market activity from these programmes constituting a major source of new instruments in the market. It would be appropriate to suggest, I would venture, that such plans are of interest not only to the employees, managers and executives that enjoy the benefits that are derived from them, but to all investors in the securities of the companies that issue them. The disclosure issue therefore assumes high significance.

HOW THE OPTION PLANS WORK

Equity-linked compensation plans based on options have been suggested as a possible solution to the agency problem by ensuring the alignment of shareholder and management interests. They achieve this by providing incentives that are directed toward the maximization of shareholder wealth and consequently management wealth, through focus on the share price. Or put another way ESOPs provide incentives that are directed towards:

- Ensuring the commitment of management to creating shareholder value
- Seeking to bind management to the company for a number of years.

Employees who benefit from these plans therefore earn incentive compensation for achieving targeted increases in share prices, typically over a three year period.

The options are issued at the beginning of the period at an exercise price that is related to the price of the stock at that time. At the time of the exercise in three years, the expectation is that the stock price would have achieved or exceeded the target value. At that point, the Commission is asked to register the issue of new shares at the exercise price. Employees then typically take short-term loans to finance the exercise of their options and in most cases immediately resell the new shares at the current market price. The margin between the exercise price and the current market price becomes the compensation value of the options. As indicated above, the effective incentive compensation to employees and managers through such plans totalled some $32.5 million in 2006 – a year in which the stock market continued its decline, the TTSE Composite Index having fallen from 1065 to 970 – a decline of 8.9%.

However, partly on account of the fact that the immediate horizon is a relatively short period of three years, this incentive mechanism has also posed a new form of the agency problem, whereby a management team can potentially be driven by self interest to take measures that artificially increase the share price in the short-term to the detriment of the company's long-term prospects. Of further concern is the extent to which such plans which maintain employee interests in a potentially significant block of shares may further entrench a management team by shifting effective control of a public company from its shareholders to its management.

A number of accounting and taxation issues also arise from the programme, but I shall not attempt to deal with such issues here. There are of course securities regulation issues that also do arise, some of which I will now touch on.

SOME SECURITIES REGULATION ISSUES IN ESOPS AND MSOPS

Although in this market little is made of the fact, **BOTH** the options that are granted and the securities that are eventually issued on exercise of the options are securities. Consequently they both come under the purview of the Securities Industry Act 1995 and are subject to regulation under the Act, including registration, the payment of registration and, recently, market access fees, and public reporting.

This means essentially that the implementation of these securities-based plans statutorily come under the requirements for satisfying certain standards of disclosure in respect of their operations. And this brings us back to the issue of disclosure requirements and compliance with them.

In August 2007, the Commission submitted to the market a draft of a proposed regime for the regulation of ESOP and MSOP programmes. Among the comments that have been received, two relate precisely to the question of disclosure. These are that the guidelines should not be applied to private companies and that semi-annual reporting of financial information is onerous.

Generally speaking, once a company distributes shares to more than 35 persons, then the provisions of the Securities Industry Act begin to apply and one of the requirements of the Act is for financial reporting on an annual and semi-annual

basis. It is remarkable that companies that seek public shareholding find that disclosure of financial information once every six months is onerous.

This perspective applies not only to any reporting that may be required specifically in respect of the ESOP and MSOP programmes but also to the approach of many companies to their disclosure obligations.

You may recall that in 2004/2005 the Commission announced that it had taken enforcement action against some 62 companies, including issuers and market actors, for failure to comply with the semi-annual and annual reporting requirements under the Act. At that time, penalties totalling some $1.2 million were imposed on the offending entities.

In the period since then, while the Commission has been in the process of refining its enforcement procedures, more than 81 entities, including many of the 62 that were penalised in 2004/2005, have racked up over 500 cases of non-compliance with reporting responsibilities, despite the fact that the Commission regularly and routinely alerts entities to the approach of their filing deadlines. Should the Commission impose the maximum penalty of $50,000 in each of these cases in the enforcement actions it is about to commence on these entities, the total penalties would exceed $25 million!

The Commission remains hopeful that the market would take a more positive approach to meeting continuous disclosure and filing obligations, and sincerely hopes that its efforts to educate the market bear fruit and that it would not be necessary to impose millions of dollars in penalties to achieve this objective. But it will not shrink from its duty to do so, if that is what is required.

In this environment of unwillingness to comply with reporting and filing obligations, the risk to investors, that may be posed by employee compensation plans based on the issue of stock options and shares, becomes somewhat sharper

The approach of the Commission, however, is not towards limiting the use and applicability of such plans, but to facilitate their implementation against a background of a much clearer statement of the rules that apply, particularly those related to disclosure and compliance with disclosure requirements.

TOWARDS AN ESOP/MSOP REGIME FOR TRINIDAD AND TOBAGO COMPANIES

The Commission is currently developing a comprehensive regime for the registration and regulation of ESOP and MSOP programmes for Trinidad and Tobago Companies. While I do not intend to deal with the specifics of the regime in this forum I believe that it is appropriate to set out here some of the parameters that are likely to inform the proposed regime. I must indicate to you that the Commission has adopted an open approach of consultation with the marketplace in dealing with its interpretation of the Act and in setting out guidelines for the assistance of the market in many of the areas in which it has recently sought to set such guidelines.

Our approach to setting out the regime for ESOPS and MSOPS involves the same processes of consultation, which have already begun. Among the issues that have been raised is how could stock compensation plans for employees be made available to the local staff of foreign companies. The regime on which the Commission is working on will deal specifically with this question.

I am a little overwhelmed at the size of the turn out here today which suggests that perhaps the range of parties with whom we have consulted so far may need to be broadened before final guidelines are put into operation.

From the thrust of my earlier remarks it would perhaps be obvious to you that the regime that the Commission wishes to propose would rely heavily on the question of disclosure and compliance with disclosure requirements. It is through the insistence on disclosure that the Commission is best able to fulfil its function and purpose of the protection of investors. Investor protection is based primarily on ensuring that investors understand the risks that are attendant on investments in securities, and on ensuring that adequate and timely information is provided on the performance of the securities themselves and/or of the issuers of the securities.

Beyond education and information disclosure, protection is also afforded by the discharge of the Commission's monitoring and surveillance functions and by the implementation of an enforcement regime to deal with incidences of non-compliance.

While the Commission emphasizes disclosure of information, it makes no judgements on the quality or value of any security. We regulate not on the inherent merits of the security, but on the disclosure of adequate and relevant information on the security.

Against this background, the regime that the Commission is considering for the regulation of ESOP and MSOP programmes will be based on the following disclosures and reports:

1. Disclosure of the approval of shareholders for the establishment of the ESOP and MSOP programmes. Each programme is expected to identify the number of shares to be set aside for the programmes and must be approved by shareholders. As part of this disclosure requirement, it would seem to be important to determine what disclosures ought to be made in the documentation that is presented to shareholders for their approval;

2. Disclosure of the mechanism for setting the exercise price of the options and how the options may be converted. This is of importance because we have had evidence of applications being made for the conversion of options into shares when the exercise price was higher than the then current share price. In such circumstances, the logic of paying more for the shares than they could be immediately sold for (as indicated earlier, in most cases the shares are not held but are immediately resold to the market) raises the question of how the benefits are being derived and of whether attempts are being made to provide subsidies or supports that are not contemplated in the programme;

3. Disclosure of the number of options granted, the identities of the beneficiaries, the time of the grant, the exercise price and the vesting period. As the options are themselves securities, issuers will be required to assign a value to the option itself. We are aware that there are a number of mechanisms and methodologies available for pricing such options, but the Commission's approach is not to prescribe any given one, but to establish that any valuation methodology that may be utilised conforms to standard international practice;

4. Disclosure of the number of shares actually taken up by the exercise of options by each beneficiary at the end of the vesting period, the number of shares that were registered for issue at that time and the disposition of any shares that were issued but not taken up.

The registration regime that is being contemplated is expected to include the following:

1. Registration of the ESOP/MSOP plan;
2. Registration of each issue of options;
3. Registration of the shares that are to be issued when the options are exercised at the end of the vesting period.

At registration, fees would be payable on the value of the options – that value having been determined by the issuer using an internationally acceptable methodology - and again on the value of the shares to be issued based on the exercise price of the shares.

In respect of the registration of the shares, the Commission has long been asked to introduce a mechanism whereby issuers will not have to make separate applications for the registration of shares each time a number of options mature. On occasion, we have been asked to approve the issue of just a couple of thousand shares and such requests may come from a single issuer a few times each year.

The Commission is actively considering providing for the automatic issue of the shares on vesting date based on the number of options that would have previously been registered, and requiring the registration of the shares at some subsequent

time. It is with this in mind that some of the reporting requirements have been identified.

We have received comment that reporting on a six-monthly basis would be onerous. Our proposal for such reporting was intended to allow us to manage and control the process without losing sight of the requirement for the registration of all the securities involved. Thus the options would be registered immediately prior to their issue and the shares registered properly subsequent to their issue on the basis of regular routine reporting. In this regard six-monthly reporting is generous, particularly in the context that the international standard for financial and other reporting is at least quarterly and in some cases monthly.

If such reporting requirements are truly considered to be onerous, then the Commission would have to seriously reconsider its attempts to place the issue of these securities on a kind of a "shelf registration" basis as it has been requested to do and to stay with its current requirement of registering each issue of shares as often as the requirement for registration arises.

ISSUES OF OPTIONS BY FOREIGN COMPANIES

My invitation to speak to you today arises out of a concern that foreign companies that may wish to provide their local staff with access to their ESOP and MSOP option plans consider that a requirement for the company to register as a reporting issuer under the Act primarily for this purpose may be onerous because the obligations of a reporting issuer go beyond any obligations that may apply specifically to the operation of its employee stock option programmes. The current regime for regulation of ESOPS and MSOPS makes the implicit assumption that it

applies to companies registered in Trinidad and Tobago for which the operation of its option plans may represent an issue to the public.

For clarity, an issue to the public is an issue of securities to more than 35 persons. Using equity securities for the moment, wherever an issue is to be made to more than 35 persons, that issue becomes an issue to the public and falls under the purview of the Act. One comment we have gotten is to the effect that the regime should not apply to private companies. If by that it is meant that the regime should not apply to companies with fewer than 35 shareholders (including for this purpose the employees and managers that may participate in the ESOP/MSOP) then that is fine because the Act is not intended to apply to such entities. Once, however, the number of shareholders approaches and exceeds that number – 35 – then such companies will fall under the purview of the Act and become subject to all the requirements of the Act, including the proposed ESOP/MSOP regime.

In these circumstances, the Commission is prepared to consider the establishment of a regime that will facilitate the issue of ESOPs and MSOPs by foreign companies to their local employees and managers. In order to do so, the Commission would have to consider:

1. Whether the issue of such options and shares could be considered a matter of domestic concern within the company;
2. Whether the shares that may be issued under such programmes are likely to find their way directly or indirectly into the market and in the hands of persons other than the employees of the company;

3. Whether any conditions might apply that would make such programmes eligible for an exemption under Section 133 from the registration requirements of the Act, and what such conditions might be;
4. Whether the plans are registered and regulated in the companies' home jurisdiction and the value that may be attached to such regulation; and
5. What would constitute an appropriate reporting requirement for the programmes and their operation if registration and filing were either not required or the plans were subject to an exemption from the requirements to register;

One of the considerations in this matter relates to the question of what constitutes an issue to the public and is therefore of relevance to and subject to the provisions of the Securities Industry Act. The Commission is currently considering a number of matters on this question and the determination of its final approach on the question of employee and management stock programmes for local employees of foreign corporations also depends on the determination of some of these other issues that are currently before us.

Indeed the matter would be resolved much more simply if many of these foreign companies, which participate significantly in the economy of Trinidad and Tobago would also participate in its capital and stock markets and register as issuers, indeed as listed issuers on the stock market. Such a development would bring much needed breadth, depth and liquidity to our capital markets and enable the country to more readily achieve the Government's vision of developed country status by 2020.

But that is a subject for another time and perhaps another audience.

I thank you.