prospective extraditee is not a flight risk and will abide by all the orders and processes of the extradition court.

At bottom, after reexamining *Purganan*, the *Olalia* Court was not prepared to lay down a doctrine that will shed new light into existing jurisprudence on extradition, which the Court itself acknowledged to be still in its infancy. In fact, *Purganan* and *Olalia* are the same in principle — there is no right to bail in an extradition proceeding, but bail may be granted as a matter of discretion upon a clear and convincing showing of certain circumstances.

If at all, *Olalia* only modified *Purganan* in that it no longer required a prospective extraditee applying for bail to prove by clear and convincing evidence that there existed special, humanitarian, and compelling circumstances including, as a matter of reciprocity, those cited by the highest court in the requesting State when it grants provisional liberty in extradition cases therein. *Olalia* held that clear and convincing evidence that the potential extraditee is not a flight risk is enough to warrant admission to bail. In truth, human rights advocates ought not to be jubilant just yet. *Olalia* leaves much to be desired.

Regulatory Transition in Employee Stock Options as Exempt Transactions from the Securities Regulation Code

*Allan Verman Y. Ong**

I. INTRODUCTION

Compensating members of the board of directors and officers of public corporations[1] with stock options, rather than through cash or fringe benefits,

* '04 J.D., *with honors*, Ateneo de Manila University School of Law. The author is an Associate in SyCip Salazar Hernandez & Gatmaitan Law Office where he is currently on leave to pursue graduate studies in Peking University.

Atty. Ong was a member of the *Journal's* Editorial Staff of Volume 46, Editor of Volume 47, Executive Editor of Volume 48, and Lead Editor for the first issue of Volume 48. His previous works published in the *Journal* include *Foreign Investment Law: Studying the Administrative Treatment of Legislative Restrictions*, 51 ATENEO L.J. 314 (2006); *Infusing Principles of Corporate Governance in Corporate Law: A Proposed Hierarchy of Director Accountabilities to Various Stockholders*, 50 ATENEO L.J. 479 (2005); *Upholding The Right to Freedom From Fear: An Examination of the Jurisprudential Response of Criminal Procedure and the Law on Public Offices to the Threat of Kidnapping for Ransom*, 48 ATENEO L.J 1260 (2004); *The Commercial Ends That Motivate the Legal Profession: An Alternative Model to Understanding the Rules that Govern the Practice of Law*, 48 ATENEO L.J. 749 (2003); *The Implication of the Principles of Corporate Governance on the Doctrine of Piercing the Veil of Corporate Fiction: Rethinking MR Holdings v. Bajar*, 48 ATENEO L.J. 209 (2003) and *Judicial Policy in the Law on Public Offices*, 47 ATENEO L.J. 71 (2002).

is a powerful way of making corporate directors and officers align their interests with shareholders' interests. By enhancing the value of the corporation, which may be achieved through the increase of the market value of the shares in stock exchanges and accumulating retained earnings for distribution to shareholders, directors will be rewarding themselves when the options to acquire the shares are exercised. Ultimately, the beneficiaries of the efforts of the directors and officers will be themselves — a classic situation of reaping what one sows.

Under Philippine Securities Law, the grant of stock options to the corporation's board members, officers, and other qualified recipients under an Employee Stock Option Plan (ESOP) is exempt from the registration requirement of the Securities Regulation Code (SRC).[2] Corporations who wish to grant stock options to its directors will not need to undergo the tedious, lengthy, and expensive process of filing registration statements and obtaining registration for the shares to be issued as stock options under a corporation's ESOP. The issuance of stock options to directors was a relatively straightforward process of obtaining a confirmation of exemption or the filing of a notice of exemption before the Securities and Exchange Commission (SEC).

Recently, however, while the issuance of stock options still qualify as an exempt transaction under the SRC, the process of obtaining a confirmation of the exemption is now beset with more restriction and regulation. Ostensibly, the tightening of the regulations appears to be beneficial for the directors and officers who may be counting on the exercise of their stock options as part of their compensation package. Directors and officers will want to make sure that there *are* actual options which can be exercised to acquire shares, especially when it is a foreign parent corporation granting shares to the directors or officers of their Philippine subsidiaries. In addition, the increased restrictions appear to have been triggered by a wave of recent controversies in corporate America where accounting fraud in the grant of

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1. Under the Code of Corporate Governance, public corporations are corporations whose shares are listed, and "any corporation with a class of equity securities listed in an Exchange or with assets in excess of Fifty Million Pesos (P50,000,000.00) and having two hundred (200) or more stockholders each holding at least one hundred (100) shares of a class of its securities."
2. The Securities Regulation Code [SECURITIES REGULATION CODE], Republic Act No. 8799 (2000).

stock options have led to restatement of financial statements in millions of dollars, to the detriment of the shareholders.

This article seeks to determine the direction that reforms will take in the matter of regulating the issuance of shares under ESOPs.[3] A closer look at the new regulations of the SEC on the exemption of issuance of shares under ESOPs reveals that the link between the new reforms and the aims sought to be achieved is weak based on a logical evaluation of the reforms and the experiences of practitioners. In addition, the regulations are ineffective to countermand stock option controversies that have transpired in corporate America, if the same should happen in the Philippines.

II. STATE OF THE REGULATIONS ON ESOP GRANTS

As provided under the Amended Implementing Rules and Regulations of the SRC[4] (SRC Rules), "options" are contracts that give the buyer the right, but not the obligation, to buy or to sell an underlying security at a predetermined price, called the *exercise* or *strike price,* on or before a predetermined date, called the expiry date.[5] As such, options fall within the definition of "securities" as defined in the SRC.[6]

3. The structure of this study is patterned from the structure of the article by Robert Charles Clark on *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too. See,* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too* (Harvard Law and Economics Discussion Paper No. 525, Dec. 5, 2005), Dec. 5, 2005, http://ssrn.com/abstract=808244 (last accessed July 27, 2007).
4. Amended Implementing Rules and Regulations of the Securities Regulation Code [SRC Rules] (2003).
5. SRC Rules, rule 3, ¶ 1F (1).
6. Section 3.1 of the Securities Regulation Code provides:

> "securities" are shares, participation or interests in a corporation or in a commercial enterprise or profit-making venture and evidenced by a certificate, contract, instrument, whether written or electronic in character. It includes: (a) shares of stock, bonds, debentures, notes, evidences of indebtedness, asset-backed securities; (b) investment contracts, certificates of interest or participation in a profit sharing agreement, certificates of deposit for a future subscription; (c) fractional undivided interests in oil, gas or other mineral rights; (d) derivatives like options and warrants; (e) certificates of assignments, certificates of participation, trust certificates, voting trust certificates or similar instruments; (f) proprietary or nonproprietary membership certificates in corporations; and (g) other instruments as may in the future be determined by the Commission.

A. How Employees Earn through Stock Options

Upon the grant of the stock option to an employee, the employee is given the right to buy a determined number of the company's shares, at the date and price set by the company. The date when the employee may exercise the option to purchase the shares is usually set at a distant future time, which may vest upon the employee attaining certain employment milestones or upon meeting certain performance standards.

The price at which the shares may be acquired (called the exercise price) is usually set at the market price of the stock at the date when the employee is granted the option. During the period between the grant of the option and the exercise of the option, the employee, director or officer may act in order to increase the market value of the corporation's shares, with the view towards enjoying a gain at the time of the exercise of the option.

B. Obtaining Exemptions from the Registration Requirement

Under the SRC, securities shall not be sold or offered for sale or distribution within the Philippines without a registration statement duly filed with and approved by the SEC.[7] In certain cases however, the grant of options under an ESOP, may be exempted from the registration requirement. Professor Rafael Morales of the University of the Philippines states:

> There is reason to resort to an exempt transaction if available. Considering that the registration process is expensive and time-consuming, and may itself give rise to liability to purchasers of the registered securities if the registration statement contains any material misstatement or omission, it may be advisable or desirable to proceed under an available exemption from the registration requirement.[8]

The following are the usual routes taken by companies in order to exempt the grant of options under an ESOP.

1. Private Placement of Shares

Private placement of securities, or the sale of securities by an issuer to fewer than 20 persons[9] in the Philippines during any 12-month period, is exempt

7. SECURITIES REGULATION CODE, § 8.

8. RAFAEL M. MORALES, THE PHILIPPINE SECURITIES REGULATION CODE ANNOTATED 88 (2005).

9. SRC Rules, rule 10.1, ¶ 3C (iii) (c) (provides that these persons must be "non-qualified buyers," or persons who are not (i) banks; (ii) registered investment houses; (iii) insurance companies; (iv) pension funds or retirement plans maintained by the Government of the Philippines or any political subdivision thereof or managed by a bank or other persons authorized by the Central Bank to engage in trust functions; (v) investment companies (or mutual fund corporations); and (vi) such other persons as the SEC may by rule determine as qualified buyers, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial and business matters, or amount of assets under management).

from the registration requirement.[10] A company wishing to offer stock options to employees may take the private placement route if the grantees are less than 20 persons.

The company seeking the issuance of options to be exempted under the private placement route should provide the persons to whom it offers for sale or sells securities in reliance upon such exemption a written disclosure containing the following information:

> (a) The provision of Section 10.1 of the SRC under which exemption from registration is claimed (in this case, Section 10.1(k) for the private placement);
>
> (b) Whether the SEC's confirmation that such offer or sale qualifies as an exempt transaction has been obtained; and
>
> (c) The following statement in bold face, prominent type:
>
> THE SECURITIES BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE THEREOF IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.[11]

Under the private placement route, the company may obtain a confirmation from the SEC confirming that the shares are exempt from the registration requirement. While the grant is exempt even without the confirmation, the company claiming an exemption under this route has the burden, if challenged, to establish that the exemption is available, if no confirmation was obtained.[12] The SEC may challenge the exemption at any given time.[13]

To obtain a confirmation or declaration of exemption, a duly accomplished SEC Form 10-1 should be filed before the SEC attaching the following documents: (a) an authenticated copy of the ESOP; (b) a copy of the letter of the corporate secretary of the issuer addressed to all existing stockholders and new subscribers containing relevant information on the grants under the ESOP; (c) authenticated copies of the Board of Directors'

10. SECURITIES REGULATION CODE, § 10 (k).

11. SRC Rules, rule 10.1, ¶ 1.

12. *Id.* ¶ 7A.

13. *Id.*

resolutions adopting the ESOP; and (d) authenticated copies of the stockholders' resolutions, approving the ESOP, if applicable.[14] Furthermore, the company must pay the corresponding filing fee, which is 1/10 of one percent of the maximum aggregate price or issued value of the securities.[15]

Whether or not a confirmation was obtained from the SEC, a notice of exemption from the registration requirements under section 8 of the SRC is required to be filed within 10 days after the sale of the securities which are the subject thereof. The notice of exemption is likewise done by filing a duly-accomplished SEC Form 10-1. No filing fee is required for the notice of exemption.

Note that a *prima facie* presumption of circumvention of the registration requirements of the SRC arises when the number of non-qualified investors shall exceed 19 within one year.[16] Furthermore, if the initial purchasers shall resell the securities, the registration requirements of the SRC shall apply, notwithstanding the exemption of their issuances, unless such succeeding sale shall qualify as an exempt transaction.[17] The exemptive relief is also subject to certain terms and conditions under section 10.1 (k).[18]

14. The adoption of an ESOP is not among the matters requiring shareholder approval. *See,* The Corporation Code of the Philippines [CORPORATION CODE], Batas Pambansa Blg. 68, § 6 (1980)). As a matter of practice, however, a certification of shareholder approval is submitted to the SEC as part of the attachments of SEC Form 10-1.

15. SECURITIES REGULATION CODE, § 10.3.

16. SRC Rules, rule 10.1, ¶ 3C (i).

17. *Id.* ¶ 3C (ii).

18. SECURITIES REGULATION CODE, § 10.1 (k).

> (a) The issuer claiming such relief shall not engage in any form of general solicitation or advertising in connection with the private placement;
>
> (b) Securities sold in any such transaction may only be sold to persons purchasing for their own account;
>
> (c) Sale may be made to no more than 19 "non-qualified" buyers. A corporation, partnership or other entity shall be counted as one buyer; provided, however, that if the entity is organized for the specific purpose of acquiring the securities offered and is not a qualified buyer under Section 10.1(l) of the Code, then each beneficial owner of equity securities in the entity shall count as a separate buyer; and
>
> (d) The issuer provides any person to whom they offer for sale or sell securities pursuant thereto with the following information:
>
> (i) exact name of the issuer and its predecessor, if any;

Moving forward, if the employees who exercise the options and acquire the shares will resell their shares to more than 19 non-qualified buyers or investors, the registration requirements under the SRC shall apply.[19] If, however, the employees will merely realize their gain by reselling the shares to an individual purchaser, then the registration requirement should not apply.

2. Public Offering of a Limited Character

If the grantees under an ESOP exceed 19, the company may seek the exemption of the issuance of the options under section 10.2 of the SRC. Under this provision, the SEC may exempt the transaction, "if it finds that the requirements of registration under this Code is not necessary in the public interest or for the protection of the investors such as by reason of the small amount involved or the limited character of the public offering."[20] In an application filed for and on behalf of Intel Corporation requesting the

> (ii) address of its principal executive office;
>
> (iii) place of incorporation
>
> (iv) exact title and class of the security;
>
> (v) par or issue value of the security;
>
> (vi) number of shares or total amount of securities outstanding as of the end of the issuer's most recent fiscal year;
>
> (vii) name and address of the transfer agent;
>
> (viii) nature of the issuer's business;
>
> (ix) nature of products or services offered;
>
> (x) nature and extent of the issuer's facilities;
>
> (xi) name of the chief executive officers and members of the board of directors;
>
> (xii) issuer's most recent financial statements for each of the two preceding fiscal years or such shorter period as the issuer (including its predecessor) has been in existence;
>
> (xiii) whether the person offering or selling the securities is affiliated, directly or indirectly, with the issuer;
>
> (xiv) whether the offering is being made directly or indirectly on behalf of the issuer, or any director, officer or person who owns directly or indirectly more than ten percent (10%) of the outstanding shares of any equity security of the issuer and, if so, the name of such person; and
>
> (xv) the required disclosures to investors.

19. SRC Rules, rule 3D.

20. SECURITIES REGULATION CODE, § 10.2.

exemption from registration for its proposed issuance of common shares to qualified employee-participants of its Philippine subsidiaries pursuant to Intel Corporation's ESOP, it was held:

> In view of the fact that the said securities shall be issued solely to the aforementioned qualified participants, the Commission resolved, in its meeting of April 19, 2007, that the said offering is limited in character and that prior registration of the subject securities is not necessary in the public interest or for the protection of the investors and, therefore, exempt from the registration requirement pursuant to Section 10.2 of the Securities Regulation Code.[21]

A company must file a letter-request before the SEC explaining the nature of the proposed grant, and attaching documents similar to those filed together with SEC Form 10-1 to obtain an exemption from the registration requirement under section 10.2 of the SRC. A filing fee of 1/10 of one percent of the maximum aggregate price or issued value of the securities is also required.[22]

The corporation need not file a notice of exemption upon the SEC's issuance of a resolution granting the exemption.

C. Recent Developments in the Regulations

In 2006, the SEC began enforcing the following additional requirements to requests for exemptions, particularly under requests seeking exemptive relief under section 10.2 of the SRC:[23]

(a) The articles of incorporation of the issuer, containing the primary purpose for its incorporation;

(b) The articles of incorporation of the primary purpose of the subsidiary and date of its registration with the SEC;

(c) List of optionees with their respective positions in the subsidiary;

(d) Copy of the ESOP or other documents indicating the terms and conditions for the issuance of the securities;

(e) Exercise price of the securities to the optionees;

(f) Latest trading price or market price of the shares of the issuer;

(g) Guidelines on how to dispose shares to local optionees;

21. Securities and Exchange Commission, Resolution No. 65, s. of 2007.

22. SECURITIES REGULATION CODE, § 10.3.

23. The imposition of these requirements was not attended with the passage of a formal circular. Rather, the Corporation Finance Division of the SEC distributes a list containing these requirements to interested parties who visit their offices.

(h) Certification of stockholders' and board of directors' approval of the ESOP;

(i) Copy of latest financial statements of the issuer with a certification as to its authenticity;

(j) Certification of the human resource department or union president that, to enable the optionees-employees availing of the plans to make an informed decision, all the relevant information as regards the plans have been made available to the optionees-employees;

(k) Tabular summary of the details and status of previous exemptions granted by the SEC containing the exercise price at which the shares were purchased; and

(l) Such other documents as may be necessary to support the request.

Compliance with these requirements can be a complicated process. For instance, the requirement of submitting the (a) incorporation documents of the issuer and its subsidiary (such as in the case of a foreign parent granting shares to the employees of its Philippine subsidiary), (b) the latest financial statements of the issuer, and (c) certifications of stockholder's and board of directors' approval, will all require a certification on the authenticity from the proper authorized personnel of the issuer.[24] If these certifications are executed abroad, they must be authenticated before a Philippine consular office where the certification was executed.

Another major reform is the change in the filing fees. Section 10.3 of the SRC which imposes the filing fee provides that the fee shall be "equivalent to one-tenth (1/10) of one percent (1 %) of the *maximum aggregate price or issued value* of the securities."[25] The "maximum aggregate price or issued value" was previously computed based on the *market value of the shares on the date of the filing of the request,* unless the exercise price was otherwise set. To wit, the formula would be:

> Filing Fee = (1/10 of 1%) x (number of shares to be exempted) x (latest market price or the exercise price set)

Nevertheless, the SEC has recently interpreted section 10.3 of the SRC as requiring the filing fee to be 1/10 of one percent of the *exercise price of the*

24. The question of who the proper authorized personnel are may present conflict of law issues. Under Philippine Corporate Law, the proper corporate officer that should certify to the authenticity of the incorporation documents and the certification of stockholder and board of director approval is the corporate secretary, and the corporate treasurer should certify the authenticity of the financial statements. Foreign company law may require a different set of corporate officers to issue the certifications.

25. SECURITIES REGULATION CODE, § 10.3.

shares. The exercise price of the shares is usually based on the market value on the date of the grant of the options. As such, this exercise price often cannot be determined on the date of the filing of the request. The filing fee becomes a variable amount. For instance, if the market price at the date of the filing of the request for exemption is US$1.00 and the exercise price is US$3.00, the filing fee should be based on US$3.00.

The SEC requires two additional submissions in order to enforce the payment of filing fees based on this new interpretation of section 10.3 of the SRC. First, it requires the submission of an undertaking from the issuer[26] that the applicant will pay any difference between the filing fee paid, and the fees as may be calculated based on the actual issued value of the securities, should the latter be more than the amount that had been paid to the SEC.[27] Second, in order to be able to check compliance by the issuer of its undertaking, the resolution approving the exemption now contains a requirement that the issuer make an annual report before the SEC which will contain the names of the employee-participants and the number of shares actually subscribed by them.[28]

Lastly, even as the Corporation Finance Division (CFD) of the SEC continues to have the responsibility of registering securities before they are offered for sale or sold to the public and ensuring that adequate information is available about the said securities,[29] it is now the Commission *en banc* that passes upon the requests for exemption. Action on the requests will now require the consideration of the Commission *en banc* in its meetings where a quorum is present.[30]

26. In practice, since the issuer may be a foreign corporation, an undertaking to pay the difference filed by issuer's Philippine counsel on behalf of the issuer is accepted by the SEC.

27. In the event that the issue price is less than the market price used for the computation of the filing fee, the SEC will not refund the "excess" filing fee.

28. As contained in SEC Resolution No. 65, s. of 2007. Curiously, the resolution does not require the statement of the grant price at which the employees purchased the shares, which grant price would have been necessary to determine whether there is a difference between the grant price and the market value of the shares on the date of filing. While the SEC could impose this reportorial requirement subsequently, in SEC Resolution No. 65, s. of 2007, the statement of the grant price was not imposed as a "continuing condition" to the grant of the exemption. It appears that the only way for the SEC to police compliance with the undertaking to pay any possible deficiency in the filing fee is if the same issuer will again seek exemption of the issuance of shares, since request for exemption will require, as part of the requirements, a summary of the details and status of previous exemptions granted by the SEC containing the grant price at which the shares were purchased.

29. SRC Rules, rule 4, ¶ 1B.

III. EVALUATING THE WISDOM OF THE REFORMS

The reforms implemented on the exemption of issuances under ESOPs can be classified based on the probable result sought to be achieved. They will be analyzed and examined based on such projected end-result.

A. Strengthening Capability of Investors to Make an Informed Decision

As observed by Professor Morales, SRC's aim is to compel the disclosure of a sufficient amount of information in order that those dealing in securities of companies will have adequate information to protect their own interests:

> The Securities Regulation Code is a "truth-in-securities law," because its aim, based on the state policy declared in SRC Section 2, is to "ensure full and fair disclosure [of information] about securities," with a view to enabling the public to make an informed investment decision in respect of the securities offered for sale. ... To borrow the language of the U.S. Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963), the SRC has the "fundamental purpose... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *The SRC, however, exempts from the registration requirement certain types of securities and transactions.*[31]

SEC's additional requirements for the exemption of ESOP, appears to extend this level of protection granted to ordinary investors to the issuer's directors, officers, and employees who may exercise their stock options and purchase the shares. To be sure, the documents to be attached to a request for exemption under the SRC do not amount to the intricate requirements imposed on issuers seeking registration of their shares. Even then, the new requirements — the purpose clauses of the issuer and the Philippine subsidiary if applicable, the corporate profile of the issuer requiring information that includes the purpose clause, the capital structure of the issuer and the composition of its board of directors, and the latest financial statements of the issuer — appear to be the information required by the SEC to ascertain that the issuer will not promise its employees the "blue skies" and later leave these employees empty-handed.

The additional requirements appear to be for SEC's assurance that the issuer is a true and existing entity and its securities listed and marketable; and this purpose is in line with the underlying philosophy of the SRC to require

30. *See*, Securities and Exchange Commission, Resolution No. 65, s. of 2007.

31. MORALES, *supra* note 8, at 61 (emphasis supplied).

full disclosure. It is clear, however, that the thrust of the SRC is for information on the issuer to be disclosed, for the protection of the investing public. While the information required to be submitted is disclosed to the SEC, this disclosure is done for an entirely different purpose, which is regulatory — the SEC makes no cash outlay and is not in danger of being financially prejudiced. Nevertheless, unlike in the registration of securities, where a prospectus is made available to the investing public which will contain relevant information regarding the issuer, in the case of securities issued under an ESOP, no prospectus will be made available to employees who will purchase shares upon the exercise of their option.

While an application for exemption under SRC section 10.2 requires the human resource department head or union president to certify that all the relevant information on the ESOP have been made available to the optionee-employees to enable them to make an informed decision, no similar counterpart exists for the optionees under SRC section 10.1 (k). Also, since the certification is merely one issued by the human resource department head or the union president, it is only such person who executed the certification under oath who would be penalized for perjury should it later turn out that the optionees received insufficient information and as such, were deceived and financially prejudiced.

It may be a logical assumption by the SEC that the optionees will already be in a good position to determine the financial standing of the issuer, since the issuer will usually be either the employer-company or the parent of such company. The SRC's prevailing philosophy, however, is contrary to such an assumption. It is precisely the presumption that the investing public does not have the financial sophistication to undertake securities transactions that gives rise to the myriad of regulations and disclosure requirements.

B. Increase of Filing Fees

As previously discussed, the SEC now interprets section 10.3 of the SRC of the filing fee of "one-tenth (1/10) of one percent (1 %) of the *maximum aggregate price or issued value* of the securities" as 1/10 of one percent of the *exercise price of the shares*. The initial computation of the filing fee is the market value of the issuer's shares on the day of filing. On the other hand, the exercise price is usually the market value of the issuer's shares on the grant date. As such, the exercise price can be determined after a long period of time from the payment of the initial filing fee. Since it is envisioned that, through the efforts of the optionees — the directors, officers and employees —, the market value of the shares will rise, then there will always be a discrepancy between the initial market value of the shares upon filing of the application and upon grant of the options. The SEC requires the filing of an undertaking from the issuer to make good any possible "deficiency" of the filing fee. Unless the efforts of the directors and employees fail, leading to the fall in market value of the issuer's shares and the refusal to exercise the stock options, there will always be a need to make good on the undertaking.

A filing fee that is 1/10 of one percent of the maximum aggregate price of the shares computed at the date of filing is already a huge financial burden that must be incurred by companies who wish to grant benefits to their employees. Given the new interpretation of section 10.3 of the SRC, it may be possible that if the filing fee becomes unbearable because of the exercise price, the company might not be able to grant the stock options anymore because of the large amount of filing fee that will be incurred. This would contravene the efforts of the employees who work to increase the market value of the company, if at such time when they can already enjoy the stock options, the filing fee may have become too onerous for the company to bear.

It should also be noted that the filing fee imposed under section 10.3 of the SRC is analogous to a license fee. A license fee is imposed to regulate an activity.[32] Time and again, the Supreme Court has ruled that the amount of a license fee must only be of a sufficient amount to include expenses of (a) issuing the license and (b) conducting necessary inspection or police surveillance.[33] Under the current regulatory framework of the SEC for stock options, there is no need for continued monitoring of the stock grants after the determination that the issuance is an exempt transaction. The SEC should not have any interest, from the standpoint of the exempt nature of the stock grants, on the increase of the market value of the shares. While the SEC may need to monitor stock prices, it would not be done pursuant to the ESOP grants, but in the exercise of its general or other special regulatory functions.

The new interpretation of section 10.3 of the SRC on the filing fee, therefore, which allows the possibility of endlessly increasing the filing fee as it is now imposed on the exercise price, may give rise to inquiries as to the nature of such fees compared to license fees and may also encourage companies to backdate the grant date of the options to a date when the share prices are lower than the market price on the filing date. The backdating of the grant dates of stock options will be discussed together with the potential evils that may arise therefrom.

32. *See,* Victorias Milling Co., Inc. v. Muncipality of Victorias, 25 SCRA 192 (1968).

33. *See,* Cu-Unjieng v. Patstone, 42 Phil. 818 (1922); City of Iloilo v. Villanueva, 105 Phil. 337 (1959).

C. Review by the Commission En Banc

Applications for exemption of stock grants from the registration requirement are now granted by the Commission *en banc*. This means that a longer internal review process is undertaken within the SEC. While the SEC's CFD has the responsibility of registering securities before they are offered for sale or sold to the public and ensuring that adequate information is available about the said securities,[34] its duties are now limited to conducting the initial examination of the application as filed and making a recommendation on the action to be taken before the Commission *en banc*.[35]

The SEC is a collegial body, composed of a Chairperson and four Commissioners.[36] The Commission *en banc* is required to hold meetings at least once a week for the conduct of business, or as often as may be necessary upon the call of the Chairperson or upon the request of three Commissioners.[37] In practice, the Commission *en banc* meets only once a week on Thursdays. During the session, the Director of the CFD makes a presentation of the applications and recommendations on the action to be taken.

The Commission *en banc* has a wide jurisdiction in the implementation of the Securities Regulation Code[38] and in the performance of other specific functions.[39] As such, it might not possess the knowledge and expertise regarding details of exempt transactions. The CFD possesses the mandate of registering securities and, corollarily, determining when securities transactions need not be registered. It has acquired expertise and knowledge on this particular jurisdiction over the years. Hence, rather than a true review of the CFD's actions, it appears that the main intended effect of the shift from approval by CFD to the Commission *en banc* is to have the CFD officers focus on their functions and make them more diligent and assiduous[40] as their recommendation will be subject to the review of the Commission *en banc*. Anecdotes from practitioners in the field indeed suggest

34. SRC Rules, rule 4, ¶ 1B.

35. The actual process of evaluation is less clinical than merely making a recommendation on the action to be taken on the application. The usual procedure is that the examining attorney assigned to the application will communicate closely with the applicant-potential issuer on issues that may arise upon the examination of the applications, such as any deficiencies in form or requests for clarifications on the nature of the ESOP.

36. SECURITIES REGULATION CODE, § 4.1.

37. *Id.* § 4.5.

38. *Id.* § 4.1.

39. *Id.* § 5.1.

40. Clark, *supra* note 3 (phrasing adopted).

that the CFD has become more stringent in the examination of requests for exemption.

Nevertheless, this stringency has come at the expense of a protracted delay in the processing of applications. Previous processing only took a month's time. Recent experience has, however, extended the processing time up to four or five months, accompanied by various requests for additional information or clarification in anticipation of any possible questions by the Commission.

Thus, while the intended effect of a review of the CFD's initial recommendation may be beneficial, the actual effect has been to extend the processing period of a request. Additional and stricter monitoring is indeed required for stock option grants, but not in the initial step of exempting the grant to the optionees. Regulation, at this point, does not bring about additional benefit. The CFD, with its expertise in the registration of securities, is already in a competent position to examine the applications for exemption. Thus, an initial recommendation to the Commission *en banc* only unduly extends the period for the evaluation of the application.

IV. THE UNCHARTED TERRITORY IN STOCK OPTION GRANTS

A study of the historical background against which the regulatory reforms arose may be helpful in providing context.

Sometime in 2002, the American stock markets crashed. Scandals emerged — accounting fraud or manipulations occurred, executives were discovered to have engaged in major self-dealing transactions, and bankruptcies or serious financial troubles rose in number. It was during this period that the Sarbanes-Oxley Act of 2002[41] (SOX) was passed. This law enacted sweeping changes in American corporate governance.

The world over, countries responded by adopting or strengthening their own guidelines on corporate governance. Following scandals in the Philippine corporate scene and spurred by the enactment of SOX, the SEC passed the Code of Corporate Governance, as a Philippine counterpart of SOX, which adopted several of the reforms mandated by the SOX for American public companies.

While the occurrence of the Philippines catching up on corporate and securities regulations with other developed markets is a familiar one, and can be observed not only in the adoption of the Code of Corporate Governance

41. Public Company Accounting Reform and Investor Protection Act of 2002, otherwise known as the Sarbanes-Oxley Act of 2002 [SOX], Pub. L. No. 107-204, 116 Stat. 745 (2002).

but also in other Philippine commercial laws,[42] new regulations on corporate governance now emerge as responses to crises and scandals as they arise. The Philippine practice now is to enact preventive measures in anticipation that future crises and scandals will emerge as they have in developed markets.

The tightening of regulations on stock option grants follows this phenomenon. As of 2007, the United States SEC has investigated more than 100 companies based on stock option fraud, particularly on the practice of backdating the grant of stock options.[43]

Despite the complex series of requirements now imposed by the SEC, large areas in the stock option granting remains to be free from regulation. None of the regulations passed by the SEC prevent the backdating of stock options or prevent the possibility of hiding the grant of large income and compensation to directors and officers through stock options.

A. Non-Regulation of Stock Option Backdating

The backdating of stock option grants is the practice of selecting a previous date when the market value of the shares is low and pegging the exercise price to that date. The exercise price at which the optionee can purchase is the market price of the shares on the grant date. Hence, the profit to be acquired from the resale of the shares would be greater if the exercise price of the option is lower. Professor Erik Lie of the College of Business of the University of Iowa observes that, under American securities law, the backdating of stock options is not illegal, provided all the following conditions concur:

- *No documents have been forged.*
- *Backdating is clearly communicated to the company's shareholders.* This is essential because the difference between the exercise price and the market value of the shares is paid out of corporate funds, cutting into potential shareholder dividends.
- *Backdating is properly reflected in earnings.* If a date with a lower market price of the shares is selected, the options are effectively in-the-money on the decision date, and the reported earnings should be reduced for the fiscal year of the grant.

42. *See,* Cesar L. Villanueva, *The Evolution of the Philippine Commercial Law System*, 50 ATENEO L.J. 690 (2005).

43. *Backdating stock optioned prompts boom in US work*, GLOBAL FORENSICS, Feb. 2007, issue 4, at 2, http://www.navigantconsulting.com/A559B1/navigantnew.nsf/vGNCNTByDocKey/PP98CDBF804621/$FILE/GlobalForensics.pdf (last accessed July 27, 2007).

- *Backdating is properly reflected in taxes.* The exercise price affects the basis that is used for estimating both the company's compensation expense for tax purposes and any capital gain for the option recipient.[44]

Lie observes that these conditions are rarely met when stock option grant dates are backdated. Thus, backdating becomes illegal due to accounting fraud. Lie goes on to argue that if all the foregoing conditions are met, there would be little reason to backdate options, because the company can simply grant in-the-money options instead.[45] One study shows that backdating has occurred in as much as 23% of stock option grants in the United States between 1996 to August 2002.[46]

Upon the enactment of SOX, stricter rules were enacted in the United States that seek to prevent the backdating of option grants. Section 403 of SOX requires a statement of the amount of all equity securities of such issuer and any changes in such ownership and any such purchase and sales of security-based swap agreements that have occurred since the most recent filing "before the end of the second business day following the day on which the subject transaction has been executed ...."[47]

44. Erik Lie, *Backdating of Executive Stock Option (ESO) Grants, available at* http://www.biz.uiowa.edu/faculty/elie/backdating.htm (last accessed July 27, 2007). Note that SOX 403 now requires the reporting of the grant of stock options within two days from the date of grant.

45. *Id.*

46. Randall A. Heron & Erik Lie, *What fraction of stock option grants to top executives have been backdated or manipulated?*, Nov. 1, 2006, *available at* http://www.biz.uiowa.edu/faculty/elie/Grants-11-01-2006.pdf (last accessed July 27, 2007). The more prominent examples of controversies that arose from stock option backdating, cited by Professor Lie, are: Comverse Technology, Inc., where federal prosecutors have started a criminal investigation of stock-option-granting practices leading to the restatement of five years of financial results and the resignation of three senior officials; UnitedHealth Group Inc., where many forms of its senior executive pay, including stock options, were suspended and a shareholder suit was filed alleging that shareholders were harmed by backdated option grants; and Vitesse Semiconductor Corp., where its Chief Executive Officer and two other top executives on administrative were placed on leave and three years of financial results were restated. In all these, the common problem was that the companies backdating the issuance of the stock options failed to (a) make a full disclosure to shareholders, (b) pay extra applicable taxes, and (c) file correct earnings statements that reflect the modified grant dates.

47. SOX, § 403.

Scholars have found that the new reporting requirement under SOX:

> (a) Deters the opportunistic granting of unscheduled awards after bad news announcements and reduces, but does not eliminate, the opportunistic granting of unscheduled awards before good news announcements;
>
> (b) Deters the delaying of good news announcements after scheduled option awards; and
>
> (c) Greatly reduces the apparent use of backdating of option grants to lower the strike price.[48]

Philippine securities law currently does not have a counterpart provision requiring the reporting of stock option grants within a short period from the grant thereof. The SRC imposes mandatory reportorial requirements on certain companies:

> The reportorial requirements ... shall apply to the following:
>
> (a) An issuer which has sold a class of its securities pursuant to a registration under Section 12 hereof;
>
> (b) An issuer with a class of securities listed for trading on an Exchange; and
>
> (c) An issuer with assets of at least Fifty million pesos (P50,000,000.00) or such other amount as the Commission shall prescribe, and having two hundred (200) or more holders each holding at least one hundred (100) shares of a class of its equity securities.[49]

Unless the company issuing the stock option grants falls within the foregoing, there is no mandatory imposition of disclosure of events under the SRC. Even assuming that the company falls within the class of issuers covered by the mandatory reportorial requirements, they would only be required to disclose certain matters.[50]

48. Daniel W. Collins, *et al.*, *The Effect of the Sarbanes-Oxley Act on the Timing Manipulation of CEO Stock Option Awards*, Nov. 16, 2005, http://www.ssrn.com/abstract=850564 (last accessed July 27, 2007).

49. SECURITIES REGULATION CODE, § 17.2.

50. *Id.* § 17.

> *Periodic and Other Reports of Issuers.* -17.1. Every issuer satisfying the requirements in Subsection 17.2 hereof shall file with the Commission:
>
> xxx (b) Such other periodical reports for interim fiscal periods and current reports on significant developments of the issuer as the Commission may prescribe as necessary to keep current information on the operation of the business and financial condition of the issuer (emphasis supplied).

The following provisions of the SRC Rules are applicable:

> Reportorial Requirements
>
> 1. Reporting and Public Companies
>
> A. Every issuer set forth in paragraph 1 hereof, shall file with the Commission:
>
> iii. 1. A current report on SEC Form 17-C, as necessary, to make a full, fair and accurate disclosure to the public of every material fact or event that occurs, which would reasonably be expected to affect investors' decisions in relation to those securities. In the event a news report appears in the media involving an alleged material event, a current report shall be made within the period prescribed herein, in order to clarify said news item, which could create public speculation if not officially denied or clarified by the concerned company.
>
> ...
>
> 3. An illustrative, non-all inclusive, list of events which shall be reported pursuant to this paragraph is contained in SEC Form 17-C. Merely because an event does not appear in that list does not mean that it does not have to be reported if, in fact, it is material.[51]

The required disclosures mandated by the SRC contemplate situations when scandal has already erupted. These matters are not yet present upon the backdating of the stock options. Thus, no disclosure of the options backdating needs to be made under the current securities regulations.

The reforms set in place by the SEC on stock options were potentially triggered by the controversies that arose from American stock option grants. Nevertheless, the reforms — imposing additional requirements on the issuer applying for the exemption to strengthen the capability of the optionees to make an informed investment, the increase of the regulatory fees, and the review by the Commission *en banc* of the actions of the CFD — focus on a determination of the exempt character of the options and do not address the potential dangers of backdating. No step has been taken to prevent the backdating of stock options, and its attendant risks of accounting fraud, to

51. SRC Rules, § 17.1, ¶ 1A. Among the illustrative instances in the non-all inclusive list of events in SEC Form 17-C are:

> (a) losses of a significant part of the issuer's net worth.
>
> (b) acts and facts of any nature that might seriously obstruct the development of corporate activities, specifying its implications on the issuer's business.
>
> (c) facts of any nature that materially affect or might materially affect the economic, financial or equity situation of those companies controlling, or controlled by the issuer including the sale or the constitution of pledges on an important part of such issuer's assets.

the prejudice of the company's shareholders. Unlike in the SOX, there is no reportorial requirement that is required immediately upon the grant of options, which makes backdating more difficult to accomplish.

In recent exemptions granted by the SEC, it now requires that the issuer should make an annual report before the SEC which will contain the names of the employee-participants and the number of shares actually subscribed by them.[52] As earlier discussed, this particular requirement is imposed with a view to policing the compliance of the issuer with the undertaking to make good any possible deficiencies of the filing fee, based on the new interpretation of section 10.3 of the SRC. The annual report does not require that the date when the options were acquired should be stated, nor the price at which these shares were issued. It will be impossible to determine from this annual report whether the issuer backdated the stock option grants in order to favor the employees.

B. Absence of Safeguards on Director and Officer Compensation

Apart from the potential hazards that can be brought about by the backdating of options, another potential issue that may arise is the grant of excessively large compensation to directors and officers.

On the compensation of directors, the section 30 of the Corporation Code provides that any compensation, other than reasonable per diems, may be granted to directors by the vote of the stockholders representing at least a majority of the outstanding capital stock at a regular or special stockholders' meeting. Nevertheless, in no case shall the total yearly compensation of directors, as such, exceed 10% of the net income before income tax of the corporation during the preceding year.[53]

The compensation that has to be approved includes the grant of stock options to the directors. A cap on the compensation is set at 10% of net income before tax. Thus, the stockholders cannot exceed this limit and grant larger compensation to the directors even if they vote otherwise.

The difference between stock options and other forms of direct compensation, such as cash or other fringe benefits, is that the portion which is to be contributed by the company upon the exercise of the option remains variable and indeterminate until the option is exercised. If the exercise price that a director has on his shares is US$1.00 when the market price is US$3.00, then the company will be contributing US$2.00 for every share that is purchased by the director by exercising his options. If the director

52. As contained in SEC Resolution No. 65, s. of 2007. In practice, this annual report may be filed by issuer within a reasonable period from the end of the issuer's fiscal year.

53. CORPORATION CODE, § 30.

engages in the practice of backdating the grant date of the option, to when the exercise price was, say, US$0.50, then the company's contribution becomes greater.

Currently, it is not clear whether the 10% cap under section 30 of the Corporation Code covers the grant of stock options. While it has been observed that courts of law will meddle into business determination when it comes to the area of compensation of directors if they find the compensation unreasonable — serving to invalidate or render unenforceable such determination[54] —, it is difficult for courts to determine whether the exercise of the stock option grant is unreasonable. After all, compensation by means of stock options could potentially lead to the optionee not receiving anything. Furthermore, stock option grants are advocated as means of tying up the director's performance with his reward. If the director is able to raise the market value of the shares through his diligent efforts, the exercise of his options is the end that he seeks to achieve for himself, after having satisfied his obligation to the corporation.

On the other hand, the Corporation Code does not provide a cap for the compensation to be given to officers, a fact which can pose potential abuse of stock option grants. A dishonest chief executive officer can time the release of information that will trigger the plunge of stock prices before options are granted. On the other hand, he can time the release of information that will cause the rise of stock prices, before the exercise of his options, a practice that is called "spring-loading."

A tight disclosure requirement similar to that of SOX 403 may address the issue of the erring officer who may be tempted to backdate or spring-load. The greater unresolved issue, however, would be the treatment of stock options as compensation to directors. Compensating directors with stock options allows for the potential of aligning the interest of the directors and the shareholders. Directors would, in the end, be serving their own interest by their efforts, in view of the shares that they may acquire by exercising their stock options. It is not clear, however, how courts will decide on the applicability of the 10% cap on stock options.

V. THE FUTURE OF STOCK OPTION REGULATION: SOME CONCLUSIONS

At first glance, the tightening of the regulations appears to be beneficial for the directors and officers who may be assured that they are receiving *bona fide* shares. Furthermore, given the stringency of the documentary requirements and the approval process to exempt ESOP grants from the registration requirement of the SRC, some good arises. Thus, the regulations that call for the disclosure of information, such as the purpose clauses and capital

54. CESAR L. VILLANUEVA, PHILIPPINE CORPORATE LAW 309 (2001 ed.).

structure of the issuer and the issuer's latest financial statements, may have the effect of strengthening and giving meaning to the optionees' power to make an informed decision as to the option grants. Requiring the review by the Commission *en banc* of the CFD's initial action on the application may also serve to ensure diligence and assiduousness of the CFD regarding exempt transactions.

Nevertheless, it is argued that the regulations do not achieve the intended goals. The information that is required to be disclosed upon the application for exemption is disclosed to the regulator and not the investing public. The study on backdating in fact shows that in the case of directors and officers, as optionees, there is great potential for abusing stock option grants. The second level of evaluation by the Commission *en banc* has served to lengthen the processing of applications by several months. The new interpretation on the filing fee is anathema to the concept of regulatory or license fees to which the filing fee is analogous, and may in fact encourage backdating.

The regulations are also inadequate to address issues that may arise from the backdating of stock options and excessive compensation grant to directors and officers. These are the more prominent issues, and while the regulation of stock options has been tightened, this tightening has not resulted in the plugging of avenues whereby directors and officers may take undue advantage of the inadequacies of the system.

The future of regulations in the matter of stock option grants suggests that more regulations are forthcoming. The stock option is a relatively new concept in the Philippines and it is possible that the directors and officers themselves are not yet fully aware of the income potential given by stock options — that with stock options, their professional efforts can have a direct impact on their compensation, above and beyond the salaries that they receive. Given its novelty, the SEC regulations on the matter reflect the hesitation that usually confronts new concepts, in legislation and regulation. Current legislation and regulation err on the side of the optionees, as potential investors. As non-qualified purchasers, they are not viewed as having financial sophistication perceived to be needed when investing in securities.

The use of stock options will, however, become more popular in the Philippines. Stock options have the potential effect of hindering the turnover of corporate officers and even high-level employees who will have to wait for the option period before the option can be exercised. Companies will seek to benefit from the human resources training that has been invested in the employees as well as the synergy created by having the same set of employees working together in various projects, in the form of greater efficiency and developed expertise. While the cash component of compensation packages will remain a consideration, the financial realized

value of the options, as well as the aspirational value of being part-owner of the company, may serve as incentives for the talented officers and employees to stay. On the part of the directors, stock options will serve to concretize the principle that the greatest reward that they can receive for a job well done is in the increase of the shares they hold, beyond the qualifying share they need to possess as directors.

Given the impending increase in compensation by means of stock options in the Philippines and the fraud controversies that have erupted in other jurisdictions, the future of the forthcoming regulations should be in the form of safeguards to the corporate shareholders, against potential abuses by the optionees.

Regulations on stock options must be meaningful enough in order to rationalize the grant of exemptions in recognition of the exempt status of ESOP transactions. At the same time, the SEC, as a regulatory body, should draw from the experiences in other developed countries and adapt regulations that can prevent accounting fraud related to stock options from reaching Philippine shores.