

A CONCEPT PAPER ON THE STRATEGIC PLAN ON THE SECURITIES SERVICES IN THE CARICOM SINGLE MARKET AND ECONOMY (CSME)

1. INTRODUCTION

A securities market is one where financial products are traded. An efficient and liquid securities services sector with adequate secondary trading is important in any economy. It is an important catalyst in the overall capital market and its development. A well functioning securities market where equity, fixed income and other instruments are traded, and where actors such as brokers, traders, investment advisers, underwriters and other players exist, promotes price discovery, and the development of an active capital market. Indeed, the securities services sector supports the mobilization of domestic savings by providing investors with alternatives for investment and risk diversification, it allows companies and governments the ability to raise long-term resources and the sector can promote efficiency and competitiveness in the financial system.

2. OVERVIEW OF THE REGIONAL SECTOR

While the various segments of the securities services sector in the region have evolved at different rates, they now find themselves at different stages of development. Government bond markets in the Caribbean are relatively advanced, owing to the traditionally high financing needs of the public sector for infrastructure projects such as ports, airports schools and road construction and various arrangements which force institutional investors to hold Government securities to meet statutory requirements.

Throughout the region steps have been taken to improve the functioning of government bond sector which continues to dominate the market. In recent years, Jamaica, the OECS and Trinidad and Tobago have moved towards an auction system for issuing bonds. This system allows for better pricing based on the values prevailing in the market. Barbados has maintained a tendering system for the purchase of bonds in the primary market

The corporate sector in the Caribbean has traditionally demonstrated a distinct preference for commercial bank loan financing. As a consequence, there has evolved a narrow spectrum of maturities that is characterised by a cluster of issues at the short and long maturities with few intermediate maturity instruments.

The dearth of issues and the tendency for institutional investors (life insurance companies, commercial banks, pension funds, etc.) to purchase and hold issues to maturity in support of their asset-liability management strategies, translates to low levels of activity on secondary markets for the instruments and present significant challenges to the construction of yield curves relating interest rates to maturity structure of different bonds.

Apart from Government bonds, in Trinidad and Tobago, more than in the rest of the region, the major securities issues are equity securities, debt securities debt and credit derivatives, collective investment vehicles and stock options, or more specifically, employee stock options.

Trinidad and Tobago, Jamaica and Barbados are the main focal point for raising debt and equity capital. Trinidad and Tobago established itself as an aspiring regional capital raising center via fixed income securities. From 2003 to 2008 approximately \$US 2.4 billion and \$TT40 billion have been raised via the T&T debt market, while in regional currencies a further \$ECS260 million and \$BBD77 million was also raised. A number of these capital raising initiatives emanated from regional corporations and governments from countries such as Barbados, Jamaica, St Vincent, Aruba and the Turks and Caicos. These investment funds are coming from savings and earnings in Trinidad and Tobago as well as from institutional investors throughout the region.

Collective investment vehicles have become the prominent vehicles for saving in both Trinidad and Jamaica. In Trinidad and Tobago, in particular, funds under management in collective investment schemes are at rough the same level as bank deposits an estimated forty (40) percent of Gross Domestic Product (GDP).

In all the territories in the region, while there has been limited progress in the development of corporate bond markets, as regards equity markets, there have been important strides although serious challenges remain. The three largest local equity

markets in the Caribbean reside in Jamaica, Trinidad and Tobago and Barbados. In all three economies, market capitalisation has increased substantially. The markets have registered rates of return exceeding that of mature markets.

We have also seen changes in rules and regulations to accommodate cross-listings. The markets have moved to electronic trading, and modern settlement systems have been introduced. In the past, the Exchanges operated an open outcry system, but today they are modernized with even the number of days to settlement differ from what existed in the past, i.e., whether it is T+1 or T+2, or as the case may be.

Notwithstanding the foregoing, in all three cases, institutional characteristics and trading patterns have changed little for more than a decade. The markets continue to offer only a limited range of products and are characterized by low liquidity and low turnover. Currently there are forty-five (45) listed companies in Jamaica, thirty-five (35) in Trinidad and Tobago and twenty-three (23) in Barbados. There has been marginal increases in number of listed entities in any of the three markets over the last decade.

The major change in this area has been the cross-listing of eleven companies. But even cross listings have not lived up to expectations. There has been few cross listings on the regional exchanges. Out of a total of 118 shares, only thirteen or eleven percent are cross listed. As regards the menu of offerings, while in more developed markets, debt and debt derivatives, equities, real property securities, and mutual funds, are regular market transactions, on the Caribbean stock exchanges, equities are the main securities traded.

In Trinidad and Tobago, however, we find a more active securities market, where instruments such as commercial paper, collective investment schemes and stock options are actively traded.

Cross Listed Securities on the TTSE

Company	Issued Share Capital	Date Listed	Listed Price (TTD)
CIBC (West Indies) Holdings Limited	177,309,583	01.11.94	3.24
Life of Barbados Limited	43,002,726	08.01.97	3.75
Grace Kennedy & Company Limited	150,410,107	01.12.98	3.30
Barbados Shipping and Trading Co. Ltd	27,570,761	20.04.99	20.00
First Caribbean International Bank Ltd - <i>formerly CIBC (West Indies) Holdings Ltd</i>	1,478,870,312	22.11.02	8.65
Jamaica Money Market Brokers Limited	1,463,386,752	07.02.03	.64
Capital and Credit Merchant Bank Limited	584,500,000	01.10.03	.84
National Commercial Bank of Jamaica	2,466,762,828	21.11.03	1.55
Sagcor Financial Corporation – <i>(Merger of Life of Barbados and Barbados Mutual Life</i>	260,029,748	24.08.04	12.86
Dehring, Bunting & Golding Limited)	276,825,714	12.10.04	2.44

The level of market capitalisation to GDP is often used as an indicator of the relative importance of the stock exchange in an economy. Based on data for the period 1997-2006, this ratio averages seventy-four percent (74%) for Jamaica, Barbados and Trinidad and Tobago, compared with an estimated 150% for the US and the UK and about 140% for Singapore.

One measure of the liquidity of a stock exchange is the turnover ratio which is the value of total shares traded, divided by market capitalisation. Still at an average level of 4 percent, the Caribbean exchanges are considered to be highly illiquid: the comparable average turnover rates are 70 percent for the UK and the US, 84 percent for Singapore and 25 percent for Argentina.

These data tell us unequivocally that while the regional stock markets are providing very high returns for a very small group of investors, their contribution to the regional economy is limited in terms of the creation of new businesses, the widening of share-ownership, and the creation of a savings culture.

3. VENTURE CAPITAL FINANCING

Venture capital finance has recently been touted in the region as well suited for start-up companies, like those in the Small and Medium Enterprise (SME) sector. Venture capital institutions are designed to take risks, and projects are based on prospective cash flows rather than established financial norms and company history. However, venture capital is also not a well established feature of the financial landscape within CARICOM. Financial institutions such as Development Finance Limited (DFL) in Trinidad and Tobago have engaged in venturing to promote the development of SMEs.

DFL provides equity to companies not yet listed on the stock market, and uses instruments such as venture capital, private equity funds, mezzanine investments and leveraged buyouts. However, unlike development banks, DFL is a largely private sector institution focused on the profit motive. Micro small-and medium-sized enterprises (MSMEs) usually use little external equity financing. They stick to bank financing and informal sources, such as internally generated funds and loans from friends and relatives. Trinidad and Tobago has established a special state company, NEDCO, to lend to small businesses, but this is essentially a small business lending facility linked to training. There is, therefore, tremendous scope for equity financing to be provided to these MSMEs, the stock market and the corporate bond market. This will, however, have to be carefully developed and could serve as a major catalyst for the continued development of the securities market.

4. PRESENT AND FUTURE OPPORTUNITIES FOR THE DEVELOPMENT OF THE SECTOR

Notwithstanding the picture above, the regionalization of the securities services sector can provide tremendous benefits to the Caribbean by boosting investor confidence. This would lead to increased demand on the markets which could impact positively on price assuming no insider trading is involved. The result would be higher returns to investors. This is important for pension funds and life insurance companies in particular where rates of returns matter. This is also important in a competitive interest rate environment. Integrating securities markets can help to reduce volatility in stock and bond prices and also in rates of returns and yields.

Moreover, regionalization of the securities markets can provide the impetus for foreign direct investment especially in the current environment where demand is low in the USA and there is a general lack of confidence in the markets, not just in the USA, but in all major markets worldwide on account of the recession in the United States. Movement towards the Caribbean Single Economy and concomitant close economic financial and economic integration which began in 2006 will also provide the following opportunities for the securities market:

- It could lead to harmonization of legislation and the interpretation of standards;
- It could improve information sharing and closer cooperation between securities regulators;
- It could contribute to a widening and deepening of the Caribbean securities markets.

Caribbean securities markets also need to link themselves to major markets. This can help to increase domestic market liquidity thereby providing more and cheaper finance for domestic firms. Furthermore, internationalization allows for diversification of country specific risk, which stabilises returns over time. This can be good news for the Caribbean, where many countries are susceptible to disaster and economic shocks. Internationalization also encourages Foreign Direct Investment which can add to productive capacity and create jobs. But this can only occur where removal of barriers to capital flows occurs.

In summary, a well developed securities services sector, can pose significant opportunities for investors and citizens, providing them with renewed benefits and resources.

5. POLICY FRAMEWORK: IS THE ENVIRONMENT CONDUCIVE TO THE DEVELOPMENT AND GROWTH OF THE SECTOR?

Notwithstanding the improvements and changes to the securities market in CARICOM, there are many environmental impediments that have affected the growth and development of the securities services sector.

One important factor is the large number of small family-owned businesses, where there is little or no effective division of ownership and control. There is a low level of investor education, poor or inadequate regulation by the securities commissions in the region, and inefficiencies in trading systems.

There is also the issue of interlocking directors among the Board of many listed companies on the exchanges. In Trinidad and Tobago for example, from a survey of 30 companies listed on the Trinidad and Tobago Stock Exchange, twenty-five (25) had at least one Director presiding on the Board of another listed company. This translated into 83% of the listed companies with interlocking directors. Interlocking directors introduces the perception of unfairness in the securities services sector.

Another important factor is the limited market making function and weak development of institutional investors to drive the market. In some countries, such as the OECS, market making and underwriting remain underdeveloped thereby limiting trading activity. Moreover, when banks and insurance companies predominate as institutional investors, they provide little impetus to securities market trades, since the securities market is seen as a competitor with the ability to negatively impact their loan and investment portfolios.

Market regulation remains the main bottleneck in the region. Effective regulation and supervision is necessary for good corporate governance, which ensures that investors make a rate of return that is commensurate with the risk that they take and is a deterrent to manipulative practices, including insider trading and other collusive practices. This function guarantees fairness and transparency in the market, and is an important contributor to boosting investor confidence and activity in the capital market.

Caribbean securities markets have Securities and Exchange Commissions that supervise the operations of the equity and debt markets and enforce rules and regulations. One weakness, however, is the limited extent to which these regulatory systems are able to pre-empt new market developments, especially the rise of universal banks that are involved in a range of activities; and financial engineering that allows the creation and/or re-packaging of risky financial instruments.

Other regulatory hurdles need to be overcome to facilitate the smooth operation of a regional capital market. With respect to the incentive framework, the varying levels and relatively high rates of corporate tax encourage companies to provide inaccurate tax information and leads to arbitrage in investing across the region. This is another serious problem which must be tackled.

6. STRATEGIES FOR THE FURTHER DEVELOPMENT OF THE SECURITIES SERVICES SECTOR

The specific needs of the securities services sector vary on the supply and demand side. If these specific needs are attended to, we will see further development and integration of the sector in respect of the CSME. The following strategies are necessary to assist the development of the sector.

On the demand side, measures to boost investor preference for stocks, bonds, venture capital and other securities market instruments are needed. The governments of the CSME will be required to provide investment incentives and to strengthen prudential standards guiding the operations of securities issuers. In short, governments may have to provide fiscal incentives to get institutional investors to further invest in new products, thereby further developing the markets. Pension funds and Insurance companies should be allowed greater latitude to invest in securities, once prudential guidelines are adopted. As currently exists in Trinidad and Tobago, Barbados and the OECS, pension funds face restrictions in investing in securities. These restrictions should be removed and a regional approach should be taken to allow the optimization of the returns from pension funds.

Listing and trading costs impede demand for stocks and bonds, especially in respect of the small family-owned firm. Further, while the listing requirements in the various jurisdictions are not dissimilar in nature, there is still a need for the harmonization of these requirements. The regulatory issues for which regulation must be harmonized include, *inter alia*:

- Listing of securities with restrictions in shareholding;
- Trading days and settlement cycle;
- Currency and settlement cycle;

- Central clearing;
- Minimum aggregate market value of securities;
- Payment of dividends –Ex/Cum dates;
- Withholding tax;
- Certification of all market actors cross-border;
- Regionalization of ownership;
- Take-over code;
- Dispute resolution; and
- The Companies Act

Indeed, regionalization of the securities services sector and mergers, acquisition and competition should provide incentive for small family-owned firms to adopt a mix of debt and equity in their portfolios. It is, therefore, important that the abovementioned issues be addressed.

The region should seek to expand the range of financial products offered to the investing public. Overall, the range of products offered in the region are narrow compared to that in developed markets. Trinidad and Tobago and Jamaica offer a wider menu of products while in Barbados and the OECS products are limited.

On the supply side, the privatization of state enterprises must be considered. Privatization and deregulation can lead to greater efficiency.

Linkages with the international market also hold the prospect for increasing the supply of companies and instruments to invest in. We in the CARICOM need to link actively with markets in the USA such as in New York and London. These well developed markets are experienced in trading in different products on the investment side. Moreover, they bring in much needed technology and can even form mergers and list on the local exchanges. This would certainly be Phillip to the regional exchanges.

In respect of market infrastructure and institutional arrangements, the policy framework for securities markets lacks certain features necessary for the effective regulation of domestic markets. With the trend towards the internationalization of securities transactions regulators have faced particular difficulty in enforcing the

securities legislation across borders, even within their own borders. However, if we are to widen and deepen our securities market in CARICOM, we must strengthen our institutional infrastructure, that is, the legal, taxation, and accounting systems. While the accounting systems are reasonably up-to-date, the legal and tax systems are in need of improvement. If tax and legal systems are unclear, the evaluations of risks of individual products become difficult and uncertain. Credit ratings are also important in this regard and investors must understand ratings if they are to manage risk and return relationships.

The role of Securities Commissions cannot be overlooked in this process. Securities Commissions exist to safeguard markets by establishing minimum standards of capitalization, the registration of securities and market participants, ensuring timely and material disclosure of information, and the provision of effective enforcement of the securities laws. There is a requirement for Commissions to find the middle ground of being strong regulators without being overly intrusive. In CARICOM securities markets, the timely disclosure of material information is often inadequate. The adequacy of disclosure regimes, however, is the determining factor in investors' ability to make well-informed investment decisions. We in the Caribbean have had many instances of improprieties, but yet few, if anyone has been charged or brought to the courts. This is an area that needs further consideration.

7. POLICY FRAMEWORK

A common policy framework for the securities market in the region must address the following issues:

- The regulation of market participants including Self Regulating Organizations;
- The raising of capital, whether by public offerings or a private placement;
- Insider trading rules;
- The issue of new securities as a result of employee bonus or share option schemes;
- Take-over rules;
- Compliance audits and inspections;
- Securities registrations;

- Listing obligations;
- Reporting obligations;
- Disclosure requirements;
- Corporate governance guidelines;
- Fee structure; and.
- The legal recognition of companies with fully dematerialized share registers.

In summary, addressing these broad policy issues would ensure a common regulatory approach in the region. A common regulatory framework is essential to the development of the securities services sector in CARICOM.

8. BROAD STRATEGIC POLICY REQUIREMENTS FOR THE DEVELOPMENT OF THE SECTOR

The following strategies are required for the successful development of the securities services sector.

- Active encouragement of firms to cross-list regionally. Listed firms must follow best practice so as to encourage more firms to go public and apply for listing;
- Facilitation of cross-border equity relationships and the ease of access to cross capital markets;
- There must be adequate intermediary support across the region;
- Interlocking directors should be minimized, or disclosure requirements must be strictly observed;
- Emphasize investor education in the region
- Harmonization of Financial laws, Company laws, Trust laws, Bankruptcy legislation, disclosure requirements and taxation policies.
- Harmonization listing rules and trading procedures and establish Memorandum of Understanding to treat with a number of common issues, including listing fees.
- Coordinate and integrate technology;

9.0 RECOMMENDATIONS: A STRATEGIC PLAN FOR THE SECURITIES SERVICES SECTOR IN CARICOM

The following strategic issues are essential for the Securities services sector of the future.

1. Strengthen the legal framework by upgrading the Securities Industry Laws across the region to ensure that the Securities Commissions are given effective powers to regulate the securities market in accordance with internationally accepted standards.
2. Modernize and consolidate the regulatory framework in accordance with international best practices. Emphasis must be placed on an enforceable take-over code. The CARICOM Financial Services Agreement must see to this issue.
3. Improve Corporate Governance in accordance with international best practice by ensuring that there are rules to deal with interlocking directors, voting rights of trustee and management of collective investment schemes in the region.
4. Ensure that principles-based accounting is introduced as opposed to rules-based accounting in line with international accounting standards so as to reduce the occurrence of creative accounting.
5. Ensure international standards for information disclosure and reporting so as to improve transparency. Amend the relevant laws to allow for information sharing regionally and internationally, to facilitate effective regulation of institutions operating across markets and borders.
6. Redress the fiscal bias that currently supports business development by way of debt financing. This could encourage the use of equity-based financing as a viable alternative and/or complement.
7. Strengthen the human resource base, management of information systems and institutional capacity of the Securities Commissions so that they can enforce compliance.
8. Implement a structured programme of Investor Education across the region.
9. Develop commercial vendors for information
10. Encourage the development of institutional relationships between the various markets actors (regulators, investors, professional intermediaries

and producers of services) of the securities markets regionally and internationally. In this regard, the role of IOSCO and COSRA becomes even more critical.

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