Republic of the Philippines
*Department of Finance*
**Securities and Exchange Commission**
**SEC Bldg., EDSA, Greenhills, Mandaluyong City**

**DIVERSIFIED SECURITIES, INC.,**
*Appellant,*

- *versus* -

**SEC *En Banc* Case No. 01-13-283**

**CAPITAL MARKETS INTEGRITY CORPORATION, 3G HOLDINGS CORPORATION, A2K HOLDINGS CORPORATION, CHEMHOLDINGS CORPORATION, CHEMICAL INDUSTRIES OF THE PHILIPPINES, LMG CHEMICALS CORPORATION, RICARDO CARLOS L. GONZALES, AND KHO CING SIONG**
*Appellees.*

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# DECISION

For the consideration of the Commission *En Banc* is the *Memorandum of Appeal* filed by Diversified Securities, Inc. (DSI) on 28 January 2013 assailing the Decision of the Capital Markets Integrity Corporation (CMIC) dated 24 September 2012 and the Decision dated 3 January 2013, per CMIC Board Resolution No. 41, Series of 2012, which denied DSI's request for reconsideration of, and affirmed, the Decision of the CMIC dated 24 September 2012 rendered in favor of appelllees 3G Holdings Corporation (3G), A2K Holdings Corporation (A2K), Chemholdings Corporation (Chemholdings), Chemical Industries of the Philippines (CIP), LMG Chemicals Corporation (LMG), Ricardo Carlos L. Gonzales and Kho Cing Siong. The assailed Decision dated 24 September 2012 imposed the following penalties against DSI:

1. Monetary penalty of Php 200,000.00 for a first violation of Section 1(h), Article X-B of the Amended Market Regulation Rules (PSE-MRD Rules) for having engaged in the unauthorized disposition of securities entrusted to it in the course of its trading business;
2. Written Reprimand for a first violation of Section 10, Article VI of the PSE-MRD Rules on Short Selling;
3. Written Reprimand for a first violation of Section 1, Article V of the PSE-MRD Rules on Ethical Standards; and
4. To return the shares to herein appellees that were disposed of in violation of their written instructions, or the value thereof, at the time

of the unauthorized disposition, less any amount due to DSI as fees and charges.[1]

DSI is a domestic corporation registered with the Commission under SEC Registration No. 174269. DSI is duly licensed by the Commission to open, operate and maintain a stock brokerage house, to act as a dealer, underwrite and distribute securities, bonds, debentures, products, commodities, and any and all other kinds of properties, either in the Philippines or in any foreign country.[2]

CMIC, formerly the Market Regulation Division of the Philippine Stock Market (PSE-MRD), is an independent entity allowed by the Commission to operate as a Self Regulatory Organization (SRO) and registered with the Commission on 14 March 2011 with SEC Registration No. CS201104274.[3]

3G,[4] A2K,[5] Chemholdings,[6] CIP[7] and LMG[8], collectively known as the "Chemphil Group", are domestic corporations registered with the Commission. CIP and LMG are listed companies in the Philippine Stock Exchange (PSE).

On 30 November 2011, some of the companies in the Chemphil Group, who are stockholders of CIP and LMG, as the case may be, lodged their stock certificates with DSI, in order to comply with the Minimum Public Ownership Rule of the PSE.[9]

On 15 December 2011, each of said stockholders gave written instructions[10] to DSI to effect the assignment of shares via cross-sale to Mr. Gonzales and Mr. Siong as follows:

| Stockholder- Seller | Shares | Buyer |
|---|---|---|
| Chemholdings | 791,215 shares of CIP | Mr. Siong |
| A2K | 238,445 shares of CIP | Mr. Gonzales |
| CIP | 11,017,696 shares of LMG | Mr. Siong |
| 3G | 8,336,772 shares of LMG | Mr. Gonzales |

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1 Decision of the CMIC dated 24 September 2012, p. 2.
2 Second Article of the DSI's Amended Articles of Incorporation.
3 Certificate of Registration of CMIC.
4 SEC Registration No. A200118730.
5 SEC Registration No. CS200340714.
6 SEC Registration No. 0000178074.
7 SEC Registration No. 14812.
8 SEC Registration No. 42020.
9 Stockholders of CIP: (1) Chemholdings with stock certificate no. 769 covering 1,027,432 shares lodged with the DSI ; and (2) A2K with stock certificate no. 1221 covering 1,860,039 shares with the DSI. Stockholders of LMG: (1) CIP with stock certificate no. 1722 covering 143,163,154 shares lodged with the DSI; and (2) 3G with stock certificate no. 1721 covering 50,086,766 shares lodged with the DSI (Decision of the CMIC dated 24 September 2012, p. 3)
10 Reply Memorandum of CMIC, Annex "1" (Letter of Complaint of Chemphil Group, pp. 1-2).

DSI alleged that the Chemphil group represented that the assignment to the buyers Mr. Siong and Gonzalez were for a valuable consideration.[11]

The above-mentioned cross sale transaction as instructed by the Chemphil Group was implemented by DSI on 28 December 2011. DSI claimed that, as a consequence, Mr. Siong and Mr. Gonzales had the obligation to pay the purchase price of the shares to the former within three (3) business days pursuant to Section 5 of Article VI of the PSE-MRD Rules. However, DSI alleged that Mr. Siong and Mr. Gonzales failed to pay DSI the purchase price of the shares within the above-mentioned period.[12]

The Chemphil Group alleged that it *verbally informed* DSI that it had agreed to settle the cross sale transaction with Mr. Gonzales and Mr. Siong in the first week of January. However, the attempt to settle the cross sale transaction failed[13] since Ramon M. Garcia, who is a stockholder and director of Chemphil Manufacturing Corporation (CMC), opposed the plan of CMC to lend money to Mr. Gonzales and Mr. Siong.[14]

On the other hand, Mr. Gonzales alleged that he, A2K, and 3G had agreed to settle the cross sale transaction on or before 29 February 2012.[15]

However, DSI denied that the parties to the cross sale transaction informed it that they had agreed to settle at a later date and that no letter or communication to this effect was given to it.[16]

On 1 February 2012, the Chemphil Group alleged that they reiterated to DSI their instructions that DSI was only authorized to sell their respective shares to Mr. Siong and Mr. Gonzales.[17]

On 3 February 2012, DSI liquidated the shares with substitute buyers since Mr. Gonzalez and Mr. Siong failed to pay their accounts within three (3) days after the transaction date (T+3). The substitute buyers paid on 7 February 2012 the subject shares at the same price when they were cross traded.[18]

On February 9, 2012, DSI delivered the following check payments[19] to A2K, Chemholdings and 3G, representing proceeds of the liquidated shares:

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[11] Memorandum on Appeal, par. 3.1.
[12] *Id.*, pars. 3.3 and 3.5.
[13] Decision of the CMIC dated 24 September 2012, p. 3.
[14] Memorandum on Appeal, par. 3.6.
[15] Reply Memorandum, Annex "2" (Letter-Complaint of Mr. Gonzales dated 14 February 2012).
[16] Decision of the CMIC dated 24 September 2012, pp. 5-6.
[17] *Id*, p. 3.
[18] *Id.*, p. 7.
[19] Reply Memorandum, Annex "1" (Annex "H", "H-1" and "H-2" of the Complaint of the Chemphil Group referring to Checks payable to Chemholdings, A2K and 3G).

| Check Payment | Shares | Seller |
|---|---|---|
| P9,713,379.86 | 238,445 CIP shares | A2K |
| P32,198,057.25 | 791,215 CIP shares | Chemholdings |
| P9,823,510.29 | 8,336,722 LMG shares | 3G |

No payment was delivered for the 11,017,696 LMG shares sold by CIP as DSI claimed that the proceeds for those shares are the subject of a Writ of Attachment issued by the Regional Trial Court of Makati, Branch 61 against CIP.[20]

However, DSI claimed that the Chemphil Group refused to accept the above-mentioned check payments from DSI.[21]

On 13 February 2012, the PSE-MRD received a Letter-Complaint of the Chemphil Group alleging that DSI, as their broker, exceeded its authority in selling their respective shareholdings in CIP and LMG without any written instructions from them.[22] The Chemphil Group prayed, among others, that DSI return the shares that the latter liquidated and to effect the cross-sale transactions as well as to accept the settlement offered by them and Mr. Siong and Mr. Gonzales.[23]

Moreover, a Letter-Complaint of Mr. Gonzales dated 14 February 2012 was sent to the PSE-MRD alleging that he, A2K and 3G agreed to settle the cross sale transaction on or before 29 February 2012 and, as such, he sent the settlement checks to them on 9 February 2012. He alleges, further, that he informed DSI of the settlement on the same date he sent the settlement checks. He claims that DSI exceeded its authority since the Chemphil Group was to sell to him only and did not receive notice from DSI that his shares will be "confiscated".[24]

In response, DSI stated that it had to liquidate the shares pursuant to Section 5(a), Article VI of the PSE-MRD Rules because Mr. Gonzales and Mr. Siong failed to pay within three (3) days from the date the cross sale transaction was implemented. DSI further alleged that the Chemphil Group requested CMC to lend money to Mr. Gonzales and Mr. Siong but the plan failed to materialize.[25]

After an exchange of pleadings between the Chemphil Group, DSI and Mr. Gonzales,[26] Mr. Siong filed his Letter-Complaint on 15 May 2012 assailing the liquidation of shares by DSI. He claimed that he was in negotiations regarding the

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20 Decision of the CMIC dated 24 September 2012, p. 14.
21 Memorandum on Appeal, par. 3.13.
22 Id., par. 3.14.
23 Reply Memorandum, Annex "1" (Letter-Complaint of the Chemphil group).
24 Memorandum on Appeal, Annex "D" (Letter-Complaint of the Mr. Gonzales).
25 Id., par. 3.16.
26 Chemphil Group's Reply to Answer filed on 21 March 2012; Mr. Gonzales' Reply to Answer filed on March 2012; DSI's Rejoinder filed on 12 April 2012.

shares. He prayed that the shares be transferred to him.[27] In response, DSI, in its Answer to Letter-Complaint of Mr. Siong dated 15 June 2012, claimed that the said Letter-Complaint should be dismissed since it was filed at the tail end of the proceedings.[28] Thereafter, the parties submitted their responsive pleadings.[29]

The CMIC rendered the assailed Decision dated 24 September 2012 holding the following: (1) the Letter-Complaint of the complainants-appellees need not be verified contrary to the claim of DSI; (2) DSI violated Article X-B, Section 1(h) of the PSE-MRD Rules for the unauthorized use or disposition of funds or securities entrusted by a client; (3) DSI violated Article VI, Section 10 of the PSE-MRD Rules on Short Selling since RG Holdings, one of DSI's substitute buyers, sold 80,000 LMG shares on 28 December 2011 which was covered by DSI only on February 3, 2012 or a total of twenty six (26) days after settlement date; and (4) DSI violated the rules of ethical standards for failing to act honestly and fairly, with due skill, care and diligence, and in the best interest of its client, when it failed to notify the Chemphil Group of the liquidation of their shares despite regular communications with each other.[30]

A Letter dated 7 October 2012 was filed by DSI with the CMIC requesting reconsideration of its Decision dated 24 September 2012.[31] However, the CMIC denied DSI's request for reconsideration in its Decision dated 3 January 2013.[32]

Hence this appeal.

In its *Memorandum on Appeal*, DSI argues the following: (1) the CMIC erred in failing to dismiss the Letter-Complaints since it did not complete the investigation and resolution within sixty (60) days from receipt thereof which was mandated by the PSE-MRD Rules; (2) the CMIC erred in ordering the return of the shares or the value thereof to Mr. Gonzales and Mr. Siong because they never paid for the shares; (3) the CMIC exceeded its jurisdiction in passing upon the issue of ownership of the shares which falls within the exclusive jurisdiction of the courts; (4) the CMIC erred in holding DSI liable under Section 1 (h), Article X-B of the PSE-MRD Rules for the latter's unauthorized use or disposition of funds or securities entrusted by a client; (5) the CMIC erred in holding DSI liable for short selling since there was no sale of LMG shares on 28 December 2012; (6) the CMIC erred in holding DSI in violation of the rules on ethical standards; and (7) the CMIC erred in holding that Letter-Complaints are not required to be verified under the PSE-MRD Rules.

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[27] Memorandum on Appeal, Annex "K" (Letter-Complaint of Mr. Siong).
[28] Id., Annex "M" (Answer to Complaint of Mr. Kho).
[29] Chemphil Group's comment on DSI's Answer to Letter-Complaint of Mr. Siong dated 9 July 2012; DSI's Opposition dated 9 July 2012;
[30] Decision of the CMIC dated 24 September 2012, pp. 19, 21 and 23.
[31] Memorandum on Appeal, Annex "O" (Letter requesting reconsideration dated 7 October 2014).
[32] Id., Annex "B" (Decision of the CMIC dated 3 January 2013).

In response, CMIC claims the following: (1) it did not err in not dismissing the Letter-Complaints on the ground that it did not complete the investigation and resolution within sixty (60) days from receipt thereof; (2) it did not err when it ordered DSI to return the shares or value thereof to Mr. Gonzales and Mr. Siong; (3) it did not exceed its jurisdiction since it did not pass upon the issue of ownership; (4) it did not err in holding DSI liable for Article X-B, Section 1(h) of the PSE-MRD Rules for the latter's unauthorized use or disposition of funds or securities entrusted by a client; (5) it did not err in holding DSI liable for short selling; (6) it did not err in holding DSI in violation of the rules on ethical standards; and (7) it did not err in holding that the Letter-Complaints are not required to be verified.

We will begin discussing the procedural issues. DSI argues that CMIC should have dismissed the Letter-Complaints since it did not complete the investigation and resolution within sixty (60) days from receipt thereof pursuant to Section 4, Article II of the PSE-MRD Rules.

Section 4, Article II of the PSE-MRD Rules provides that the investigation and resolution of a complaint must be completed within sixty (60) days from receipt thereof. However, Article II, Section 8 of the PSE-MRD Rules also provides that failure of the PSE-MRD, now the CMIC, to do so shall be a ground for the dismissal of the case, unless such failure was not due to its fault or complainants-appellees' fault.

In which case, the failure of the CMIC to resolve the matter within the sixty (60) day period was not due to its fault since DSI filed several requests for extension of time to file the required responsive pleadings or documents which were all granted by the CMIC.[33] Thus, the Letter-Complaints should not be dismissed on this ground.

As to the next procedural issue, DSI claims that the Letter-Complaints are required to be verified under the PSE-MRD Rules. However, a reading of Section 4, Article II of the PSE-MRD Rules[34] reveals that although the rules define and mention a sworn complaint, it is not mandatory that the complaint be sworn for the investigation to proceed. The PSE-MRD is given discretion to determine whether the complaint is sufficient in form and in substance to justify an investigation. Moreover, the PSE-MRD Rules allows investigations to proceed based on mere reports of Trading-related

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[33] The following were the DSI's requests for extension of time to file its responsive pleading or documents: (1) on 28 February 2012, DSI requested for extension of 10 days to submit its Answer; (2) on 27 March 2012, DSI requested for an extension of five (5) days to submit its Rejoinder; (3) on 22 May 2012, DSI requested for an extension of ten (10) days to submit its documents required by the CMIC; (4) on 31 May 2012, DSI requested for an extension of time to submit its documents required by CMIC; and (5) on 9 June 2012, DSI requested for extension of time until 16 June 2012 to file an Answer to the letter-complaint of Mr. Siong.

[34] Article II, Section 4 of the PSE-MRD Rules provides that "an aggrieved or interested party (the 'complainant') may file a ***sworn Complaint*** with the [PSE-]MRD against any Trading Participant and, in a proper case, against an Issuer (the "Respondent") x x x. If the [PSE-]MRD determines the Complaint to be sufficient in form and substance to justify an investigation under these Rules, the [PSE-]MRD shall proceed with the investigation of the Complaint x x x" (Emphasis ours)

irregularities or unusual trading activities as well as on referrals by the Commission, the PSE Board, the Market Integrity Board (MIB), the PSE President and the Disclosure Department of the PSE. The said rules even allow the PSE-MRD to act on anonymous complaints or referrals. Thus, the alleged defect in the Letter-Complaints for not being sworn under oath is not sufficient to warrant their dismissal.

We can now go into the issue as to whether DSI should be held liable under Section 1(h), Article X-B of the PSE-MRD Rules for its alleged unauthorized use or disposition of funds or securities entrusted by a client, and under Section 1, Article V of the PSE-MRD Rules on Ethical Standards.

In its Decision dated 24 September 2012, the CMIC stated that a "substitution" or liquidation was executed by DSI on 3 February 2012 despite written instructions on 1 February 2012 stating that DSI was authorized to sell the shares only to Mr. Siong and Mr. Gonzales. Further, the PSE-MRD Rules on the settlement of shares within three (3) days after the trade date is not absolute since there is an exception, which states "*where purchase is made by the customer with the understanding that payment is to be made upon delivery*". A similar instance includes where the buyer and seller may agree to a settle at a later date, thus negating DSI's argument that it was justified in liquidating the shares, pursuant to the PSE-MRD Rules. Lastly, even assuming that DSI is allowed to liquidate the shares, it did not liquidate the shares within ten (10) days after the last day within which Mr. Gonzales and Mr. Siong should pay as mandated under Section 5(b), Article VI of the PSE-MRD Rules.[35] Thus, as a consequence, CMIC imposed a monetary penalty for violation of Section 1(h), Article X-B of the PSE-MRD Rules for DSI's liquidation of the shares. Moreover, a Written Reprimand for violation of Section 1, Article V of the PSE-MRD Rules on Ethical Standards was imposed on DSI for failing to act honestly and fairly, with due skill, care and diligence and in the best interest of its clients when it failed to notify the Chemphil Group of the liquidation of their shares for failure to settle within T+3.

On the other hand, DSI argues that the cross sale transaction was executed on 28 December 2011 and Mr. Siong and Mr. Gonzales had the obligation to pay the purchase price of the shares to DSI within three (3) days pursuant to Section 5(a), Article VI of the PSE-MRD Rules. However, Mr. Siong and Mr. Gonzales failed to pay the purchase price of the shares within three (3) days from 28 December 2011; thus DSI had to liquidate the shares in order to comply with the PSE-MRD Rules and to maintain its proper standing with the PSE. Moreover, DSI denies that there was an agreement to pay at a later date and that it was furnished or informed about it. Lastly, DSI claims that there were "justifiable reasons" for the shares to be liquidated beyond the ten (10) day period due to the requests of the appellees to be given additional time to raise the funds to pay for the purchase price.

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[35] Decision of the CMIC dated 24 September 2012, pp. 21-22.

The provisions governing the above transactions are Sections 48.2 and 50 of the Securities Regulation Code (SRC)[36] and SRC Rule 50 of its Implementing Rules and Regulations (IRR), which state as follows:

"**Section 48.** *Margin Requirements.* –

x x x

48.2. **No** member of an Exchange or **broker or dealer shall**, directly or indirectly, ***extend* or *maintain credit* or arrange for the extension or maintenance of credit to or for any customer**:

a) **On any security unless such credit is extended and maintained *in accordance with the rules and regulations which the Commission shall prescribe* under this Section including rules setting credit in relation to net capital of such member, broker or dealer**; and

b) Without collateral or any collateral other than securities, except (i) to maintain a credit initially extended in conformity with rules and regulations of the Commission and (ii) in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (a) of this subsection.

x x x"

"**Section 50.** *Enforcement of Margin Requirement and Restrictions on Borrowing.* – To prevent indirect violations of the margin requirements under Section 48, **the broker or dealer shall require the customer in non-margin transactions to pay the price of the security purchased for his account within such period as the Commission may prescribe**, which shall in no case exceed the prescribed settlement date. **Otherwise, the broker shall sell the security purchased starting on the next trading day but *not beyond ten (10) trading days* following the last day for the customer to pay such purchase price, *unless* such sale cannot be effected within said period for *justifiable reasons***. x x x"

"**SRC Rule 50 – Purchase and Sales in Cash Account** [*formerly SRC Rule 50.1*]

1. **Purchases by a customer in a cash account shall be paid in full within three (3) business days after the trade date.**

2. If full payment is not received within the required time period, **the Broker Dealer shall cancel or otherwise LIQUIDATE the transaction, or the unsettled portion thereof, starting on the next business day but not beyond ten (10) business days following the last day for the customer to pay, *unless***

[36] Republic Act 8799 (2000).

> **such sale cannot be effected within such period for justifiable reasons in which case, notification in writing shall be made to the Exchange and the Commission.**
>
> x x x
>
> 5. **Exceptions to paragraphs 1, 2 and 3 include** when the security purchased is unissued or **where purchase is made by the customer with the understanding that payment is to be made upon delivery.**
>
> 6. **Written application for an extension of the period of time required for payment under paragraph 1 may be made by the Broker Dealer to the Exchange in the case of that Exchange** or to the Commission, in the case of a non-member of the Exchange. Applications for the extension must be based on exceptional circumstances and must be filed and acted upon before the expiration of the original payment period or the expiration of any subsequent extension." (Emphasis ours)

Section 48.2 above makes it unlawful for a broker or dealer to extend or maintain credit on any securities other than in conformity with the rules and regulations issued by the Commission. Section 50 lays down the rules to prevent indirect violations of Section 48.2 by brokers or dealers. SRC Rule 50 prescribes in detail the regulations governing cash accounts[37] and lays down the exceptions to the general rule (i.e., that full payment must be made within three [3] days) which includes a situation "where the purchase is made by the customer with the understanding that payment is to be made upon delivery", in which case, a written application for an extension may be made by the broker or dealer. It must be noted that SRC Rule 50(1), (2), and (5) mirror Sections 5(a), (b), and (e), Article VI of the PSE-MRD Rules which is cited by DSI although SRC Rule 50(6) has been omitted from the PSE-MRD Rules.[38]

The Supreme Court in the case of *Abacus Securities Corporation v. Ampil*[39] had the occasion to discuss the general rule and the purpose of margin requirements, to wit:

> "The United States, from which our country's security policies are patterned, abound with authorities explaining the main purpose of the above statute on margin requirements. **[The main purpose of the statute] is to**

[37] *Abacus Securities Corporation v. Ampil*, G.R. No. 160016, 27 February 2006.
[38] Sections 5(a) and (b), Article VI of the PSE-MRD Rules provides, to wit:

> "Section 5. *Purchases and Sales in Cash Account.* (a) Purchases by a customer in a cash account shall be paid in full within three (3) business days after the trade date. (b) If full payment is not received within the required period, the Trading Participant shall cancel or otherwise liquidate the transaction, or the unsettled portion thereof, starting on the next business day but not beyond ten (10) business days following the last day for the customer to pay, unless such sale cannot be effected within said period for justifiable reasons. x x x (e) exceptions to paragraphs (a), (b), and (c) include instances x x x where the purchase is made by the customer with the understanding that payment is to be made upon delivery."

[39] See Note 26.

**regulate the volume of credit flow, by way of speculative transactions, into the securities market and redirect resources into more productive uses.** Specifically, the main objective of the law on margins is explained in this wise:

'The main purpose of these margin provisions x x x is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly – although such a result will be achieved as a byproduct of the main purpose.

x x x

**'The main purpose is to give a [g]overnment credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry x x x.'**

**A related purpose of the governmental regulation of margins is the stabilization of the economy.** Restrictions on margin percentages are imposed 'in order to achieve the objectives of the government with due regard for the promotion of the economy and prevention of the use of excessive credit.'

Otherwise stated, the margin requirements set out in the [SRC] are primarily intended to achieve a macroeconomic purpose -- **the protection of the overall economy from excessive speculation in securities**. Their recognized secondary purpose is to protect small investors.

The law places the burden of compliance with margin requirements primarily upon the brokers and dealers. **[Sections 48.2 and 50 of the SRC and SRC Rule 50], otherwise known as the 'mandatory close-out rule,' clearly vest upon petitioner the OBLIGATION, not just the right, TO CANCEL or otherwise LIQUIDATE a customer's order, if payment is NOT RECEIVED WITHIN THREE DAYS from the date of purchase.** The word "shall" as opposed to the word "may," is imperative and operates to impose a duty, which may be legally enforced. For transactions subsequent to an unpaid order, the broker should require its customer to deposit funds into the account sufficient to cover each purchase transaction prior to its execution. **These duties are imposed upon the broker to ensure faithful compliance with the margin requirements of the law, which forbids a broker from extending undue credit to a customer**.

It will be noted that **trading on credit (or 'margin trading') allows investors to buy more securities than their cash position would normally allow. Investors pay only a portion of the purchase price of the securities; their broker advances for them the balance of the purchase price and keeps the securities as *collateral* for the advance or loan. Brokers take these securities/stocks to their bank and borrow the 'balance' on it, since they have to pay in full for the traded stock. Hence, increasing margins i.e., decreasing the amounts**

**which brokers may lend for the speculative purchase and carrying of stocks is the most direct and effective method of discouraging an abnormal attraction of funds into the stock market and achieving a more balanced use of such resources.**

'x x x [T]he x x x primary concern is the efficacy of security credit controls in preventing speculative excesses that produce dangerously large and rapid securities price rises and accelerated declines in the prices of given securities issues and in the general price level of securities. Losses to a given investor resulting from price declines in thinly margined securities are not of serious significance from a regulatory point of view. When forced sales occur and put pressures on securities prices, however, they may cause other forced sales and the resultant snowballing effect may in turn have a general adverse effect upon the entire market.'

**The nature of the stock brokerage business enables brokers, not the clients, to verify, at any time, the status of the client's account. Brokers, therefore, are in the superior position to prevent the unlawful extension of credit. Because of this awareness, the law imposes upon them the primary obligation to enforce the margin requirements.**

Right is one thing; obligation is quite another. A right may not be exercised; it may even be waived. An obligation, however, must be performed; those who do not discharge it prudently must necessarily face the consequence of their dereliction or omission." (Emphasis ours)

As can be gleaned from the case of *Abacus*, the purpose of the general rule is to regulate the credit flow in the securities market when shares of stock are purchased by an investor, as in this case, when the shares were purchased by Mr. Gonzales and Mr. Siong. As a consequence, brokers and dealers are forbidden from extending credit under Section 48.2 of the SRC, and SRC Rule 50(1) of the IRR obligates them to liquidate a customer's order, if payment is not received within three (3) days from the date of purchase. An exception to this rule is a situation where purchase is made by the customer "*with the understanding that payment is to be made upon delivery*" under SRC Rule 50(5) of the IRR. It must be noted that the rules are also intended to protect the broker and dealer, who obliged to protect the integrity of the capital markets from abusive sellers and buyers.

In its Decision dated 24 September 2012, the CMIC stated that the settlement of shares within three (3) days or T+3 Rule is not absolute since an exception includes "*where purchase is made by the customer with the understanding that payment is to be made upon delivery*", and that a similar instance includes a situation where the buyer and seller may agree to settle at a later date.

The CMIC misconstrued the exception. The exception only covers arrangements between the broker, dealer or trading participant (i.e., DSI) AND buyers (i.e., Mr.

Gonzales and Mr. Siong), not those between principal/sellers (i.e., Chemphil Group) and the buyers (i.e., Mr. Gonzales and Mr. Siong).

It is basic in stock market trading that the broker or dealer also known as the "market intermediary", is the only entity allowed to enter a sell order and/or a buy order transaction in the exchange. The delivery of the securities by the seller is coursed through the broker or dealer, who then delivers the securities to the buyer, while payment by the buyer is coursed through the broker or dealer, who then delivers the payment to the seller net of broker's fees and commission. This simple trade transaction should be settled within three (3) days from the trade date otherwise known as the T+3 Rule.

The exception for buyers not to settle within the T+3 Rule particularly "*where purchase is made by the customer with the understanding that payment is to be made upon delivery*", is an arrangement only between the broker or dealer and buyer since the former is the one who will effect delivery of the shares upon payment. In fact, under SRC Rule 50(6), it also states that the broker or dealer should file for an extension of period of time, if the same is necessary. Moreover, the principal/seller is not mentioned in the procedure for the request for such extension. Clearly, the understanding or agreement is only between the broker or dealer and buyer.

Moreover, the phrase "payment upon delivery" cannot be stretched to include an arrangement for the "payment at a later date" as alluded to by the CMIC since payment at a later date presupposes payment will happen after delivery. In order for the exception to apply, the payment must be made simultaneously with delivery. Otherwise, the broker or dealer will be deemed to be extending or maintaining credit to or for any customer which, as above-stated, is prohibited under Section 48.2 of the SRC.

Lastly, the exception to the T+3 Rule is applicable only when such understanding or agreement (i.e., "that payment is to be made upon delivery) is perfected by the broker or dealer and the buyer <u>at the transaction date or T+0 and not any time thereafter</u>. The reason is that SRC Rule 50(5) provides "*where purchase is made by the customer <u>with</u> the understanding that payment is to be made upon delivery*". Here, the word "*with*" in the exception indicates that the purchase by the customer on the transaction date or T+0 must be accompanied by the understanding or agreement that payment is to be made upon delivery. This is consistent with the rule that all terms of the transaction must be agreed upon in order for the same to be perfected. Moreover, the Exchange and other market participants, such as the Securities Clearing Corporation of the Philippines (SCCP), need to be informed on the transaction date or T+0 of all definite terms of the transaction and other information in order to commence with processing of the documents in relation to the purchase order, and such other activities that they do in the usual course of business. Further, such understanding or agreement that payment is to be made upon delivery cannot be perfected beyond the settlement date or T+3 since such settlement will be deemed to have failed and the broker or dealer must liquidate the shares after the settlement date or T+3. In short, while the simultaneous payment and delivery may be agreed upon by the broker or dealer and buyer to happen beyond T+3, such an understanding or agreement must be perfected at the transaction date or T+0; otherwise the exception will not apply.

Here, the exception to the T+3 Rule does not apply since there is no agreement or understanding executed on T+0 between the broker, DSI, and the buyers, Mr. Gonzales and Mr. Siong, that payment is to made upon delivery, which may happen at a later date than T+3. Records of the case show that there is no allegation, much less proof, that there was an agreement between DSI and the buyers perfected on the transaction date or T+0 to simultaneously deliver and pay, at a date later than T+3.[40]

Thus, DSI was justified in liquidating the shares pursuant to SRC Rule 50(2) and Section 5(b), Article VI of the PSE-MRD Rules since Mr. Gonzales and Mr. Siong failed to tender in full the payment of the shares within three (3) business days from the transaction date. DSI had the clear obligation to liquidate the shares of stock in CIP and LMG on the next business day from the settlement date or T+3 but not beyond ten (10) business days. The reason for the liquidation, as earlier stated, is that DSI is forbidden from extending or arranging for the extension of credit to or for Mr. Gonzales and Mr. Siong on the CIP and LMG shares pursuant to the margin requirements under Section 48 of the SRC. The purpose of the margin requirements is to protect the economy from excess stock market speculations and to regulate the volume of credit flow, by way of speculative transactions, into the securities market and redirect resources into more productive uses.[41]

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[40] Letters dated 15 December 2011 of 3G, A2K, Chemholdings and CIP addressed to DSI to effect cross sale transaction (Reply Memorandum, Annex "1" [Letter-Complaint of the Chemphil Group filed with the PSE-MRD, Annexes "B", "B-1", "B-2" and "B-3"]); Request by CIP on 2 January 2012 for a meeting with DSI to discuss cross sale transaction (Memorandum on Appeal, par. 3.8.1); Meeting at CIP office on 4 January 2012 in which it was mentioned to DSI that there are no funds available and the former requested for a few more days prior to remittance of payment (Memorandum on Appeal, par. 3.8.2); Email dated 5 January 2012 of the Chemphil Group addressed to DSI attaching unsigned Loan Agreement between Mr. Gonzales and CMC (Reply Memorandum, Annex "E" [Answer of DSI filed with the PSE-MRD, Annex "1"]); A follow up for the payment by DSI with Alexandra Garcia, the Chief Operating Officer of the Chemphil Group, on 6 January 2012; Email dated 31 January 2012 of Alexandra Garcia addressed to DSI with a plan for the payment of the shares (Memorandum on Appeal, Annex "G" [Rejoinder, Annex "1"]; Letter dated 1 February 2012 of Chemphil Group addressed to DSI stating that the latter is only authorized to sell to Mr. Gonzales and Mr. Siong (Reply Memorandum, Annex "1" [Letter-Complaint of the Chemphil Group filed with the PSE-MRD, Annex "D"); On 2 February 2012, a request for meeting by CIP with DSI to deliver check payments of Mr. Gonzales and Mr. Siong on a "kaliwaan basis"; Letters dated 3 February 2012 of 3G, Chemphil Group, A2K and Chemholdings addressed to DSI requesting for upliftment of shares and for the ledgers of accounts (Reply Memorandum, Annex "1" [Letter-Complaint of the Chemphil Group filed with the PSE-MRD, Annexes "E", "E-1", "E-2" and "E-3"]; Letters dated 9 February 2012 of Mr. Gonzales addressed to DSI alleging that he has paid 3G and A2K for the shares of stock (Reply Memorandum, Annex "2"[Letter Complaint of Mr. Gonzalez, Annexes "C" and "D"]); Informal Conference (Memorandum on Appeal, Annexes "I"and "I-1"); and Letter dated 31 May 2012 of DSI attaching additional correspondences and communications with the Chemphil Group (Memorandum on Appeal, Annex "J-1").

[41] *Abacus case.*

Moreover, there was no violation of Section 1, Article V on Ethical Standards in not notifying the Chemphil Group of the liquidation since they were, and should be, well aware of the consequences of the failure to pay within three (3) days from the transaction date or T+3. Each of the representatives of the corporations of the Chemphil group as well as Mr. Gonzales and Mr. Siong executed a Customer Account Opening Form, which informs them of the consequences of the failure to pay, to wit:

> *" 8. All accounts are considered cash accounts, requiring the amount needed to purchase will be (sic) delivered to the broker before any actual purchase of securities or any other financial instrument may be purchase. If the broker allows a short terms credit facility separate from a margin account,* ***<u>I/We shall deliver the full payment of the purchase price of any securities</u>*** *<u>including commission (inclusive of VAT), transfer fees, documentary stamp taxes, SEC fees, PCD fees and charges and other levies and duties</u>* ***<u>on or before the 3rd working day from the day of purchase."</u>***
>
> *"12. Whenever in its sole discretion, the broker considers it necessary for its own protection, or in the event of my/ death,* ***<u>I hereby specifically authorize and empower the broker TO SELL WITHOUT PRIOR NOTICE TO ME OR US securities in my account(s)</u>*** *<u>(whether carried individually or jointly with others), and herein pledge as collateral for payment of any liability to the broker in said account,</u> to buy and sell securities to cover any short selling in such account(s); to transfer moneys or securities from any one of my account(s) to another and to close any and all outstanding obligation. <u>It is hereby agreed and understood that I/We shall at all times be liable for the payment of indebtedness on unpaid balances owing, in any of my accounts together with interest, other acts herein provided and that I/ We shall remain liable for any deficiency remaining in any such account(s) in the event of Liquidation.</u> Unless otherwise agreed to in writing, any of my/our unpaid accounts shall bear interest at rates indicated in Customer Agreement form 1-B per annum without need of demand. Interest on unpaid balances shall commence on the fifth day after date of purchase and shall continue to take effect until all obligations (unpaid balance plus interest and other charges) are settled.'"*[42] (Emphasis ours)

Clearly, the parties to the cross sale transaction were well aware of the consequences of non-payment within three (3) days or T+3. In fact, SRC Rule 50 and Section 5, Article VI of the PSE Rules are clear and they cannot claim ignorance thereof.

As to the period of the liquidation of shares, SRC Rule 50(2) and Section 5(b), Article VI of the PSE-MRD Rules mandates that the shares be liquidated by DSI within ten (10) business days from the settlement date unless such sale cannot be effected within such period for "justifiable reasons", in which case notification in writing shall be made to the Exchange and the Commission. Here, as correctly pointed out by CMIC, DSI liquidated the CIP and LMG shares after twenty six (26) days from the transaction date,

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[42] Memorandum on Appeal, Annex "J-2" (Customer Opening Account Forms attached to the Letter of DSI dated 6 June 2012 in compliance with the order of the CMIC to furnish certain documents).

or on 3 February 2012, which is well beyond the ten (10) day period.[43] DSI argues that there were "justifiable reasons" for the delay in the liquidation because of the requests of the appellees that they be given additional time to raise the funds to pay for the purchase price. However, despite such reason, DSI did not notify the Exchange or the Commission of its reason for the delay in the liquidation of the shares. As a consequence, DSI is liable for violation of SRC Rule 50(2) and Section 5(b), Article VI of the PSE-MRD Rules for not liquidating the shares within the required period.

As for the directive to return the shares or value thereof, DSI argues that the CMIC erred in ordering the return of the shares or the value thereof to Mr. Gonzales and Mr. Siong which would constitute unjust enrichment since they never paid for the shares.[44] On the other hand, CMIC argues that it did not order the return of the shares to Mr. Gonzales and Mr. Siong and what was ordered was the return of the shares to the complainants, not to Mr. Gonzales and Mr. Siong *only*.[45] However, the Chemphil Group, Mr. Gonzales and Mr. Siong are not entitled to the return of the shares of stocks since, as above-stated, DSI was mandated under SRC Rule 50(2) to liquidate the shares. Moreover, as to the proceeds of the liquidation or its value, the Chemphil Group refused to accept the check payments representing the proceeds of the liquidation from DSI.

As to short selling, DSI argues that CMIC erred in holding DSI liable under Section 10, Article VI of the PSE-MRD Rules for short selling and claimed that there was merely a trader's error and that the shares were bought, not sold on 28 December 2011. On the other hand, CMIC claims that DSI's client and one of the substitute buyers, RG Holdings, engaged in the short selling of the said LMG shares to be covered by assignment of the subject shares on 3 February 2012, or a total of twenty-six (26) days after the settlement date in violation of Section 10, Article VI of the PSE-MRD Rules.

The contention of DSI is without merit. As found by the Trading Participants Regulation Department of the PSE (PSE-MRD-TPRD) in its Special Audit Report of DSI, RG Holdings sold 80,000 LMG shares on 28 December 2011. These were covered by the subject shares on 3 February 2012, or a total of 26 days after settlement date or T+26. Given that the Special Audit Report was based on the Account Ledgers of the Sellers and Buyers covering the period 1 December 2011 to 7 February 2012, we cannot give due course to DSI's assertion absent any proof to the contrary. Thus, we find the CMIC's imposition of the penalty of Reprimand for violation Article VI, Section 10 of the PSE-MRD Rules in order under these circumstances.

**WHEREFORE,** premises considered, the Decision dated 24 September 2011 of the Capital Markets Integrity Corporation is hereby **MODIFIED** as follows:

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[43] Decision of the CMIC dated 24 September 2012, p. 22; Reply Memorandum, par. 77.
[44] Memorandum on Appeal, p. 15.
[45] Reply Memorandum, par. 57.

1. The monetary penalty imposed against Diversified Securities, Inc. for its alleged violation of Section 1(h), Article X-B of the PSE-MRD Rules is **SET ASIDE** for lack of legal basis;

2. The written Reprimand for violation of Section 1, Article V of the PSE-MRD Rules on Ethical Standards for failure to notify appellees 3G Holdings Corporation, A2K Holdings Corporation, Chemholdings Corporation, and Chemical Industries of the Philippines of the liquidation of LMG and CIP shares is **SET ASIDE** for lack of merit;

3. The order directing Diversified Securities, Inc. to return the shares to herein appellees that were disposed of in violation of their written instructions, or the value thereof at the time of the unauthorized disposition, less any amount due to DSI as fees and charges is **SET ASIDE** for lack of merit;

4. The written Reprimand for violation of Section 10, Article VI of the PSE-MRD Rules on short selling is **AFFIRMED**; and

5. A written Reprimand shall now be **IMPOSED** on Diversified Securities, Inc. for violation of SRC Rule 50(2) and Sections 5(b), Article VI of the PSE-MRD Rules for failure to liquidate the LMG and CIP shares within ten (10) business days from the settlement date.

Let a copy of this Decision be furnished to the Markets and Securities Regulation Department for its information and appropriate action.

**SO ORDERED.**

Mandaluyong, Philippines; 3 June 2014.

**TERESITA J. HERBOSA***
Chairperson

**MA. JUANITA E. CUETO**
Commissioner

**MANUEL HUBERTO B. GAITE**
Commissioner

**ANTONIETA F. IBE** *
Commissioner

**EPHYRO LUIS B. AMATONG**
Commissioner

* Away On Official Business

SEC - OGC