

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

OFFICE OF THE GENERAL COUNSEL

19 April 2011

SEC-OGC Opinion No. 11-26

Re: Section 42 of the Corporation Code;
Control Test and Grandfather Rule;
Disclosures

MR. EDGARDO C. DE LEON

Suite C-101-A-103
Ritz Towers 6745
Ayala Ave., Makati City

Sir:

This refers to your 5 August 2010 letter, as supplemented by your 12 October 2010 letter and its attachments, requesting opinion on certain matters regarding the investment of Philippine Long Distance Telephone Company ("PLDT", for brevity), of which you are a stockholder, in Manila Electric Company ("MERALCO") shares, coursed through the Pilipino Telephone Corporation ("PILTEL").

In your 5 August 2010 letter, you mentioned that: (1) PLDT is a listed company; (2) the controlling interest in PLDT is owned by Metro Pacific Investments Corporation ("MPIC"), a domestic corporation; (3) MPIC is, in turn, owned by First Pacific Co. Ltd. of Hong Kong ("FPCLHK"), a Hong Kong-based Indonesian company; (4) Smart Communications, Inc. ("SMART") is a wholly-owned subsidiary of PLDT; and (5) upon the acquisition in 1998 by MPIC of the controlling interest in PLDT, 99.5% of the shares of PILTEL, also a listed company, is now reported to be owned by SMART.

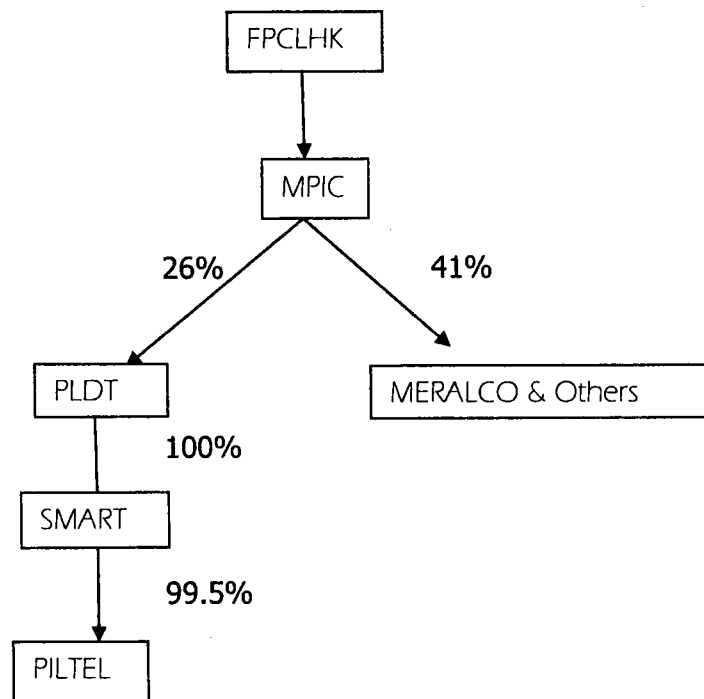
You alleged that the said acquisition by FPCLHK/MPIC of PLDT did not comply with the disclosure requirements of the Commission and of the Philippine Stock Exchange ("PSE"), and thus, caught the public by surprise. According to you, why and how PILTEL became virtually owned by SMART is not fully understood and not publicly known. You expressed concern that the existing public ownership component of PILTEL, i.e., 5%, may be in violation of the Securities Regulation Code ("SRC")¹.

You also alleged that: (1) PLDT, in its Annual Report for 2009, contracted loans principally to fund the 20% equity interest in MERALCO through PILTEL; and (2) earlier, 10.17% equity interest in MERALCO was acquired by the PLDT Beneficial Trust Fund ("BTF"). According to you, PILTEL turned over its entire MERALCO shares to a holding company called Beacon Electric Asset Holding, which, according to press reports, is a unit of MPIC. BTF, on the other hand, gave up its MERALCO shares to MPIC in exchange for MPIC shares.

¹Republic Act No. 8799 (2000).

You further alleged that: (1) the reason why PLDT's acquisition of MERALCO shares was coured through PILTEL was not adequately explained and disclosed to the public, although PLDT Chairman Manuel V. Pangilinan reported that it was done to achieve for PLDT business synergies with MERALCO; and (2) the investment in stocks of MERALCO for purposes of business synergies is not part of the primary business of PLDT; however, the said purchase of MERALCO shares was not submitted for approval by the stockholders of PLDT, as required by Section 42 of the Corporation Code ("the Code")².

In your 12 October 2010 letter, you made the following diagram:



You, thus, posed the following queries:

1. Is the status of PILTEL as virtually a wholly-owned subsidiary of SMART legally made and in compliance with the disclosure rules of the Commission?
2. Was the acquisition of MERALCO shares by PLDT done in accordance with the requirement of Section 42 of the Code?
3. Is not the control, ownership of or investment by MPIC and FPCLHK in PLDT, SMART, PILTEL and MERALCO a violation of the Constitution and laws of the Philippines?

Anent your first query, the records of the Corporation Finance Department ("CFD") of the Commission reveal the following:

²Batas Pambansa Bilang 68 (1980).

"[T]he acquisition of Pilipino Telephone Corporation (Piltel) shares by Smart Communications, Inc. was properly disclosed through the various reports submitted to [the CFD] (i.e., Statement of Initial Beneficial Ownership Report or SEC Form 23-A and Statement of Changes in Beneficial Ownership Report or SEC Form 23-B. Likewise, shareholdings in Piltel were disclosed in the General Information Sheet.

xxx xxx xxx

Regarding the disclosures on the acquisition of Meralco shares, xxx it was actually Piltel that acquired 20% of Meralco shares per Information Statement (SEC Form 20-IS) filed with the Commission on May 14, 2009 xxx. The proposal to invest corporate funds in the amount of P20.070 Billion in shares of stock representing appropriately twenty percent (20%) of the outstanding voting stock of Manila Electric Company was one of the agenda in the June 30, 2009 Annual Stockholders' Meeting of Piltel as disclosed in the Information Statement filed with the CFD.

xxx xxx xxx.³

As to your second query, Section 42 of the Code provides:

"Sec. 42. Power to invest corporate funds in another corporation or business or for any other purpose. — Subject to the provisions of this Code, a private corporation may invest its funds in any other corporation or business or for any purpose other than the primary purpose for which it was organized when approved by a majority of the board of directors or trustees and ratified by the stockholders representing at least two-thirds (2/3) of the outstanding capital stock, or by at least two thirds (2/3) of the members in the case of non-stock corporations, at a stockholder's or member's meeting duly called for the purpose. Written notice of the proposed investment and the time and place of the meeting shall be addressed to each stockholder or member at his place of residence as shown on the books of the corporation and deposited to the addressee in the post office with postage prepaid, or served personally: Provided, That any dissenting stockholder shall have appraisal right as provided in this Code: Provided, however, That where the investment by the corporation is reasonably necessary to accomplish its primary purpose as stated in the articles of incorporation, the approval of the stockholders or members shall not be necessary."

It is now settled that a corporation has a juridical personality separate from those of its stockholders or members. Beyond doubt, PILTEL is a distinct juridical person, with its own set of Board of Directors and stockholders. Considering that it is PILTEL that is acquiring the 20% equity interest in MERALCO, what is required, thus, is the approval of said acquisition by the stockholders of PILTEL, and not by the stockholders of PLDT. Besides, if the transaction was approved by the stockholders of PILTEL, the same can be deemed to have been approved by the stockholders of

³CFD's Memorandum to the Office of the General Counsel dated 7 February 2011.

PLDT, considering that PILTEL is, according to you, 99.5%-owned by SMART, which, in turn, is a wholly-owned subsidiary of PLDT.

As to your third query, please be advised that under **Section 5 of SEC Memorandum Circular No. 15, Series of 2003**, it is provided that:

"5. As a matter of policy, the Commission shall refrain from rendering opinion on the following:

xxx xxx xxx

5.2 Matters which involve the substantive and contractual rights of private parties who would, in all probability, contest the same in court if the opinion turns out to be adverse to their interest;

xxx xxx xxx;

5.4 Questions which are too general in scope or hypothetical, abstract, speculative and anticipatory in character xxx;

xxx xxx xxx

5.8 The resolution of the queries would necessitate the determination of factual issues;

xxx xxx xxx."

Hence, the Commission does not, as a matter of settled policy, render opinions or categorical answers on queries or issues which may require determination of substantial rights and factual issues, and which may eventually be litigated in the future, such as those presented in your letter. The opinion which may be rendered thereon would not be binding upon private parties who would in all probability, if the opinion happens to be adverse to their interest, take issue therewith and contest it before the proper forum. However, **for purposes of information only**, the following may be imparted:

Pursuant to its police power, the State has the power to determine which areas of investment may be opened to foreign participation, and which should be completely reserved to Filipino citizens.

To compute the required percentage of Filipino ownership of a corporation engaged in a particular industry/undertaking, resort must be had to the 1987 Constitution and/or the applicable statutes.

An example of such a constitutional provision is Section 11, Article XII of the 1987 Constitution, which provides for the ownership of grantees of public utility franchises, to wit:

"SECTION 11. No franchise, certificate, or any form of authorization for the operation of a public utility shall be granted except to citizens of the Philippines or to **corporations or associations organized under the laws of the Philippines, at least sixty per centum of whose capital is owned by such citizens**, The participation of foreign investors in the governing body of any public utility enterprise shall be limited to their proportionate share in its capital, and the executive and managing officers of such corporation or association must be citizens of the Philippines." (Emphasis ours).

On the other hand, an example of such a statute is Republic Act ("RA", for brevity) No. 7042 or the Foreign Investments Act of 1991 ("FIA")⁴, Section 8 of which mandates the formulation of a Regular Foreign Investment Negative List ("FINL"). The FINL is a comprehensive enumeration of the investment areas/activities that may be opened to foreign investors and/or reserved to Filipino nationals. It categorizes such investment areas/activities according to the allowable foreign equity participation (i.e. 0%, 40%, 60%, etc.), citing the constitutional and/or statutory bases therefor. To date, the current FINL is the *Eighth Regular Foreign Investment Negative List*⁵, under which, a public utility corporation must at least be 60% Filipino-owned.

The ownership of the shares of stock of a corporation is based on the total outstanding or subscribed/issued capital stock regardless of whether they are classified as common voting shares or preferred shares without voting rights.⁶ It is further said that the test for compliance with the nationality requirement is based on the total outstanding capital stock irrespective of the amount of the par value of shares⁷, and likewise without regard to whether or not such shares have been fully or partially paid.⁸ This is, thus, the general rule, such that when the provision merely uses the term "*capital*" without qualification (as in Section 11, Article XII of the 1987 Constitution, which deals with equity structure in a public utility company), the same should be interpreted to refer to the sum total of the outstanding capital stock, irrespective of the nomenclature or classification as common, preferred, voting or non-voting.⁹

In the recent Department of Justice ("DOJ") Opinion No. 020, series of 2005¹⁰, the DOJ stated the tests in determining the nationality of a corporation engaged in a nationalized business or activity, to wit:

⁴As amended by RA 8179.

⁵Executive Order No. 858.

⁶SEC Opinion No. 04-30 dated 28 April 2004 addressed to Marlene Caluya.

⁷SEC Opinion No. 04-49 dated 22 December 2004 addressed to Atty. Priscilla B. Valer of Romulo Mabanta Buenaventura Sayoc & De Los Angeles.

⁸SEC Opinion No. 06-36 dated 21 September 2006 addressed to Atty. Tadeo F. Hilado of Angara Abello Concepcion Regala & Cruz Law Offices.

⁹SEC-OGC Opinion No. 09-10 dated 19 May 2009 addressed to Cochingyan & Peralta Law Offices, citing SEC-OGC Opinion No. 18-07 dated 28 November 2007 addressed to Rafael C. Bueno, Jr.

¹⁰Dated 5 May 2005 and addressed to then Secretary of the Department of Finance, the Honorable Cesar Purisima.

"Shares belonging to corporations or partnerships at least 60% of the capital of which is owned by Filipino citizens shall be considered as of Philippine nationality, *but if the percentage of Filipino ownership in the corporation or partnership is less than 60%, only the number of shares corresponding to such percentage shall be counted as of Philippine nationality.* Thus, if 100,000 shares are registered in the name of a corporation or partnership at least 60% of the capital stock or capital, respectively, of which belong to Filipino citizens, all of the said shares shall be recorded as owned by Filipinos. But if less than 60%, or say, only 50% of the capital stock or capital of the corporation or partnership, respectively, belongs to Filipino citizens, only 50,000 shares shall be counted as owned by Filipinos and the other 50,000 shares shall be recorded as belonging to aliens.

xxx

xxx

xxx

The above-quoted SEC Rules provide for the manner of calculating the Filipino interest in a corporation for purposes, among others, of determining compliance with nationality requirements (the 'Investee Corporation'). Such manner of computation is necessary since the shares of the Investee Corporation may be owned both by individual stockholders ('Investing Individuals') and by corporations and partnerships ('Investing Corporation'). The said rules thus provide for the determination of nationality depending on the ownership of the Investee Corporation and, in certain instances, the Investing Corporation.

Under the above-quoted SEC Rules, there are two cases in determining the nationality of the Investee Corporation. The first case is the 'liberal rule', later coined by the SEC as the Control Test in its 30 May 1990 Opinion, and pertains to the portion in said Paragraph 7 of the 1967 SEC Rules which states, '*(s)hares belonging to corporations or partnerships at least 60% of the capital of which is owned by Filipino citizens shall be considered as of Philippine nationality.*' Under the liberal Control Test, there is no need to further trace the ownership of the 60% (or more) Filipino stockholdings of the Investing Corporation since a corporation which is at least 60% Filipino-owned is considered as Filipino.

The second case is the Strict Rule or the Grandfather Rule Proper and pertains to the portion in said Paragraph 7 of the 1967 SEC Rules which states, "*but if the percentage of Filipino ownership in the corporation or partnership is less than 60%, only the number of shares corresponding to such percentage shall be counted as of Philippine nationality.*" Under the Strict Rule or Grandfather Rule Proper, the combined totals in the Investing Corporation and the Investee Corporation must be traced (i.e., "grandfathered") to determine the total percentage of Filipino ownership.

Moreover, the ultimate Filipino ownership of the shares must first be *traced* to the level of the Investing Corporation and added to the shares directly owned in the Investee Corporation. xxx.

xxx

xxx

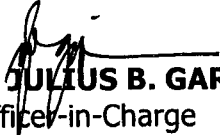
xxx

In other words, based on the said SEC Rule and DOJ Opinion, the **Grandfather Rule** or the second part of the SEC Rule **applies only when the 60-40 Filipino-foreign equity ownership is in doubt** (i.e. in cases where the joint venture corporation with Filipino and foreign stockholders with less than 60% Filipino stockholdings [or 59%] invests in other joint venture corporation which is either 60-40% Filipino-alien or 59% less Filipino). Stated differently, where the 60-40 Filipino-foreign equity ownership is not in doubt, the Grandfather Rule will not apply." (Emphasis supplied).

This opinion is based solely on the facts disclosed in the query and relevant solely to the particular issues raised therein. It shall likewise be understood that the foregoing shall not be used in the nature of a standing rule binding upon the Commission in other cases or upon the courts.¹¹ If, upon investigation, it will be disclosed that the facts relied upon are different, this Opinion shall be rendered void.

Please be guided accordingly.

Very truly yours,


VESPER JULIUS B. GARCIA
Officer-in-Charge

¹¹Paragraph 7, SEC Memorandum Circular No. 15, Series of 2003.