ECONOMIC RESEARCH AND TRAINING DEPARTMENT

N O T I C E

TO : All Concerned

SUBJECT : **EXPOSURE DRAFT OF THE BODIES OF KNOWLEDGE FOR PHASE 1 OF THE SEC CERTIFICATION EXAMINATION FOR PROSPECTIVE CAPITAL MARKET PROFESSIONALS**

The public is advised that the Commission En Banc, in its meeting held on 02 April 2024, resolved to expose for public comment the draft Bodies of Knowledge for Phase 1 of the SEC Certification Examination for prospective capital market professionals, including:

- Certified Investment Solicitors;
- Equities Securities Salesmen;
- Fixed Income Market Salesmen; and,
- Compliance Officers/Associated Persons for broker dealers in the Equities Market.

The Bodies of Knowledge will serve as Phase 1 examinees' learning modules on the fundamental principles and practices of securities and investment, and the regulatory framework governing securities markets in the Philippines. Composed of Module 1: Technical Foundation and Module 2: Regulation, the Bodies of Knowledge cover the following topics:

Module 1: Technical Foundation
Topic 1: Fundamentals of Securities
Topic 2: Economic Principles and Market Theories
Topic 3: Risk Management

Module 2: Regulation
Topic 1: Fundamentals of Securities Regulation
Topic 2: Corporate Governance
Topic 3: Anti-Money Laundering

The Commission requests all concerned to submit written comments, suggestions and/or inputs on the draft Bodies of Knowledge through email to certification@sec.gov.ph on or before **22 April 2024.**

Issued on 05 April 2024.

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MODULE 1

TECHNICAL FOUNDATION

SEC M1 Syllabus and BOK, as of 15 March 2024

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Topic 1: Fundamentals of Securities (FS)

The objective of this section is to provide a basic understanding of securities, the securities market, the major participants in the market, and how they function. This section also covers the common types of securities for investments, the mechanics of transacting securities, including various approaches for securities valuation and analysis.

At the end of this section, the learners are expected to have a better view of the capital market, as part of the broader financial market; to understand the wide field of investments; and to be familiar with the movement of capital funds for productive purposes.

Part I. An Introduction to Investments and Securities

In an investor publication[1] made by the Office of Investor Education and Advocacy of the U.S. Securities and Exchange Commission, it was mentioned that investing makes it possible for your money to work for you, it offers opportunities to multiply your fund, but there is also an equal chance that you could lose your principal or the amount you've invested. All investments involve taking on risks. Hence, it is important that you go into any investment in stocks, bonds or mutual funds with a full understanding of what they are and the risks involving them.

In a broader sense, any action that is taken in the hopes of raising future revenue can be considered an investment. It is the commitment of funds made in expectation of some positive rate of return.[2] On the other hand, securities represent an investment and a means by which local or national governments, companies, and other commercial enterprises can raise working capital, additional funding for business expansion, or repayment of debt.

A. What are Securities?

1. Definition of Securities

The term security generally refers to any form of financial instruments; its legal definitions however, varies by jurisdictions. In the Philippines, securities are defined as 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, government securities, commercial papers, 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 interest in oil, gas or other mineral rights;
d. Derivatives like option and warrants;
e. Certificates of assignments, certificates of participation, trust certificates, voting trust certificates or similar instruments;
f. Proprietary or non-proprietary membership certificates in corporations; and
g. Other instruments as may in the future be determined by the Securities and Exchange Commission (SEC).[3]

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[1] U.S. Securities and Exchange Commission Office of Investor Education and Advocacy. 'Saving and Investing', A Roadmap to Your Financial Security Through Saving and Investing, https://www.investor.gov/sites/investorgov/files/2019-02/Saving-and-Investing.pdf
[2] Randell Tiongson, No Non Sense Personal Finance, 2011.
[3] Sec. 3.1 of the Securities Regulation Code.

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Basically, legitimate securities must be indicated in a written or electronic certificate or contract. Without an approved registration statement by the Commission, securities shall not be sold or offered for sale or distribution within the Philippines.

2. Development and History of Securities

History of Philippine Securities

The history of Philippine Securities is traced back to 08 August 1927 when five Manila-based businessmen, namely W. Eric Little, Gordon W. Mackay, John J. Russell, Frank W. Wakefield and W.P.G Elliot founded the Manila Stock Exchange (MSE), the first in the Philippines and one of the oldest in the Far East.

The regulation of securities started when the SEC was established on 26 October 1936 by virtue of Commonwealth Act No. 83 or the Securities Act. Its establishment was prompted by the need to safeguard public interest in view of local stock market boom at that time. Operations began on 11 November 1936 under the leadership of Commissioner Ricardo Nepomuceno. Its major functions include registration of securities, analysis of every registered security, evaluation of the financial condition and operations of applicants for security issue, screening of applications for broker's or dealer's license and supervision of stock and bond brokers as well as the stock exchanges. The agency was abolished during the Japanese occupation and was replaced with the Philippine Executive Commission.

The SEC was reactivated in 1947 with the restoration of the Commonwealth Government. The agency was reorganized on 29 September 1975 as a collegial body with three (3) commissioners and was given quasi-judicial powers under PD902-A. In 1981, the Commission was expanded to include two (2) additional commissioners and two (2) departments, one for prosecution and enforcement and the other for supervision and monitoring. The SEC again underwent reorganization on 01 December 2000 as mandated by R.A. 8799, also known as the Securities Regulation Code (SRC).[4] The establishment of this Code aims to regulate the issuance and trading of equity securities and debt securities in the Philippines. The SRC provided for the SEC reorganization to give greater focus on the Commission's role in capital market development, fostering good corporate governance (CG) and enhancing investor protection.

Development of Security/Stock Exchanges

On 27 May 1963, a second stock exchange, the Makati Stock Exchange (MKSE) was organized by five businessmen. These were Hermenegildo B. Reyes, Bernard Gaberman, Eduardo Ortigas, Aristeo Lat and Miguel Campos. It started its operations on 16 November 1965 and was located in Makati, an emerging center for finance. For about thirty (30) years, the Philippines had two (2) stock exchanges, the MSE and the MKSE. Although the two exchanges remained as separate entities, they basically were trading the same listed securities.

The existence of two stock exchanges in one country caused confusion among (prospective) investors because the two bourses had different policies, different members and, last but not the least, different stock prices for the same listed stocks.

[4] https://www.sec.gov.ph/about-us/history/

The idea to unite the two exchanges and have it managed by a professional group emerged and was attained when the Philippine Stock Exchange, Inc. (PSE) was finally implemented in 1992.[5]

PSE is the only stock exchange in the Philippines and is one of the oldest stock exchanges in Asia. It was incorporated on 14 July 1992 as a non-stock corporation, with the primary objective of providing and maintaining a convenient and suitable market for the exchange, purchase and sale of all types of securities and other instruments. On 04 March 1994, the SEC granted the PSE its license to operate as a securities exchange. A year after the enactment of the Securities Regulation Code, PSE eventually became a stock corporation on 03 August 2001. Its capital stock was listed by way of introduction on 15 December 2003 pursuant to the demutualization mandate of the SRC. At present, the PSE has two fully owned subsidiaries: Securities Clearing Corporation of the Philippines (SCCP), and Capital Market Integrity Corporation (CMIC). PSE owns 20.98% of the Philippine Dealing System (PDS).[6]

In 2003, the Philippine Dealing & Exchange Corp. (PDEx) was incorporated to provide trading infrastructure for the fixed-income (FI) market. As a SEC-registered FI Securities Market, PDEx operates the organized secondary market for the trading of FI securities which includes both government and corporate securities.

PDEx, as a Self-Regulatory Organization (SRO), has been given authority by the SEC to create and enforce its own rules, monitor and enforce compliance with securities laws and regulations, and enforce fair, ethical and efficient practices in the securities market with the primordial objective of investor protection. It enables the maintenance of a level playing field among players in the market, to assure investors of fairness and safety in the marketplace.

PDEx is also responsible for calculating the Philippine Dealing System Treasury Reference Rates (PDST Rates). This system may be used as the basis for valuing and marking-to-market interest rate-sensitive instruments.[7]

3. The Purpose of Securities

The purpose of securities is to serve as the instruments by which investment funds are raised and transferred from those who have the funds (supply) and those who need the funds (demand), providing the evidence for the contractual financial claims of the securities holder (supplier of funds) against the securities issuer (the user of funds).

Securities provide the convenience of tradability to allow the ready, efficient exchange of securities ownership and financial claims they represent, in a free market of multiple buyers and sellers. It is the tradability of securities or the facility to exchange these securities between buyers and sellers, which makes them of particular utility in the financial markets. The ease with which securities investors can acquire or disinvest their holdings provide the securities holders the advantage of liquidity, and is an incentive to invest in such securities and promote the raising of capital for business purposes.

[5] KNOWING THE PHILIPPINE STOCK EXCHANGE, A guide for Investors, *Investors Primer II: The Philippine Stock Exchange, Inc.*, https://fglinc.tripod.com/knowstockex.htm
[6] https://edge.pse.com.ph/companyInformation/form.do?cmpy_id=478
[7] https://www.pds.com.ph/index.html%3Fpage_id=204.html

a. **The Objectives of the Securities Issuer**

1) **Raising capital –** The primary objective of the Issuer of securities is to raise funds for its business by accessing the funds of others who become co-owners of the business (equity securities) or become creditors (bonds and other debt instruments). As more securities of the corporation are made available through additional issues, this provides wider accessibility to these securities, in turn facilitating active trading and creating liquidity for the securities, favoring the attractiveness of the issue.

2) **Asset transformation –** The Issuer may also convert the value of its retained earnings to additional common stocks through the issuance of stock dividends, thus providing a means to enlarge the number and amount of tradeable securities.

3) **Refinancing of outstanding debt –** Another objective of the Issuer in issuing new debt securities is to refinance an existing debt. Refinancing can be used to simply replace existing debt but there could be another motivation, which is to take advantage of current lower interest rates compared to the older interest rates applied to outstanding debt.

4) **Risk management** – To manage the company's exposure to risks, the Issuer may issue more common stocks or bonds or other debt securities to balance or re-balance its corporate capital structure, which enhanced or reduced leveraging in its capital mix. This re-balancing could also mean changing the tenors of the various debt securities outstanding of the Issuer, adjusting the mix of maturities of corporate debt. In this regard, the various types of equity and debt securities, with various tenors and features, which have become available, have given the Issuer more options and tools for risk management.

b. **The Objectives of the Securities Investor**

In theory, the main objective of investment management is purely wealth maximization. More formally, it is the selection of assets which have the maximum expected return at a given level of risk. However, it would be an oversimplification to assume that the objective of investment is purely and simply wealth maximization. Investors should note that there are constraints imposed by time, law, and the investor's physical and financial resources, as well as psychological and emotional predispositions. For example, an investor's appetite for risk is another constraint in wealth maximization. The usual purposes of investment are:

1) **Capital Preservation –** To earn a rate of return that is at least equal to the rate of inflation; concern is to maintain purchasing power.

2) **Capital Appreciation –** To earn a nominal rate of return that exceeds the rate of inflation over a period of time.

3) **Current Income –** To earn a return on an investment for the purpose of generating income to improve cash flow position.

4) **Total Return –** To grow the portfolio in value to meet a future need through both capital gains and reinvestment of income.

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5) **Other objectives**:

a) To obtain management control of a company or have a significant influence over the affairs of the company, by acquiring a majority or a significant number of voting shares.
b) To obtain convenient access to corporate information, particularly important for advocates for greater protection of minority shareholder interests.
c) To use the investment for cash or fund management purposes.
d) In the case of proprietary or non-proprietary shares in corporations, the investor may want to enjoy the benefits of the right to use and access the facilities and amenities provided by the membership, say, in golf clubs or sports clubs.

B. Types of Securities

Following are the common forms of securities:

1. Equity Securities

Equity securities represent an ownership interest in an entity which can be classified as follows:

a. Common Shares are evidence of a proportionate ownership in a stock corporation. The shares of stock are issued by the corporation. These shares earn dividends as the corporation may declare. It is a class of shares with complete voting rights.

b. Preferred Shares are shares issued by any corporation which may be given preference in the distribution of the assets of the corporation in case of liquidation and in the distribution of dividends, or such other preferences as may be stated in the articles of incorporation. It is a class of shares that may be deprived of voting rights.

c. Redeemable Shares are shares which may be purchased by the corporation from the holders of such shares upon the expiration of a fixed period, regardless of the existence of unrestricted retained earnings in the books of the corporation, and upon such other terms and conditions stated in the articles of incorporation and the certificate of stock representing the shares, subject to rules and regulations issued by the Commission.[8]

The initial and increased/decreased authorized capital are required to be registered and approved by the SEC based on Sections 13 and 37 of the Revised Corporation Code (RCC).

2. Debt Securities

A debt security is any security that represents a creditor relationship with an entity. It has a maturity date and a maturity value. It includes any evidence of indebtedness such as bonds, notes, debentures, commercial papers, treasury bills, treasury bonds and other similar instruments as may be determined by the Commission.[9]

[8] Section 8 of Rules Governing Redeemable and Treasury Shares (the 1982 Rules).
[9] Rule 3.1.20, SRC.

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a. Bonds are evidence of indebtedness of an issuer with maturity dates and/or stated rates of interest payable periodically.

   Government bonds are issued by the National Treasury or a local government unit (LGU) and represent borrowings by the National Government or LGU.

   Corporate bonds are issued by corporations.

b. Notes represent another form of corporate borrowing with long-term maturities with "customized" features to meet the specific needs of the issuing corporations.

c. Commercial paper represents an evidence of indebtedness of any person with a maturity of 365 days or less.[10] Commercial papers are usually issued by corporations.

d. Certificate of deposit is evidence of ownership of a certain or specified amount of deposit in a bank, issued by the bank, which by agreement, represents a claim to the deposit that can be transferred from one holder to another. As an example, let's look at LTNCDs or Long Term Negotiable Certificate of Deposit. An LTNCD is a bank product offered to investors looking for a relatively safe investment, but with higher interest rates than a regular savings account or short-term time deposit.

3. Derivatives

A Derivative is a financial instrument which value changes in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or similar variable or underlying factor. It is settled at a future date (SRC Rule 3.1.9). A derivative is a financial contract whose value is linked to the value of any underlying asset.

Here are some common examples of derivatives:

a. Options or contracts that give the buyer the right but not the obligation, to buy or sell an underlying security at a predetermined price called the exercise or strike price, on or before a predetermined date, called the expiry date.[11]

b. Warrants or rights to subscribe or purchase new or existing shares in a company on or before a predetermined date.[12]

c. Futures are contracts similar to forwards but with the following differences: futures are generic exchange-traded, whereas forwards are individually tailored. Futures are generally settled through an offsetting (reversing) trade, whereas forwards are generally settled by delivery of the underlying item or cash settlement.[13]

   Futures are highly standardized contracts that are written by a clearing house that operates an exchange where the contract can be bought or sold.

   The seller of the contract, also called the holder of the short position, is the party that is obliged to deliver the stated asset.

[10] Rule 3.1.6, SRC.
[11] Rule 3.1.9.1, SRC.
[12] Rule 3.1.9.2, SRC.
[13] Philippine Accounting Standards (PAS) 39.

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The buyer of the contract, also called the holder of the position, is the party that is obliged to pay for the asset upon delivery.

The underlying asset, also called the deliverable items, is the asset that is to be traded under the terms of the contract. Settlement, maturity or expiration is the time at which the contract is to be fulfilled. The invoice amount or the forward contract price is the amount that must be paid for the contract size of the underlying asset by the holder of the long position at the time of settlement of the agreement. Contract size is the quantity of the underlying asset that is to be traded at the time the contract settles."[14]

d. Forwards are contracts to purchase or sell a specific quantity of a financial instrument, a commodity, or a foreign currency at a specified price determined at the outset, with delivery or settlement at a specified future date. Settlement is at maturity by actual delivery of the item specified in the contract, or by a net cash settlement.[15]

Two common types of forward contracts are: currency forwards (FX forward) and Interest Rate forwards or forward rate agreements (FRA).

e. Swaps. Swaps are customized derivative instruments. They are contractual agreements between two parties (called counterparties), in which the counter parties agree to exchange future cash flows for a stipulated period of time (called the term or tenor of the swap), based on certain agreed upon parameters and the price fluctuations in some underlying specified commodity or market index. Since at least one of the two streams of cash that are to be exchanged depends upon the market price of a commodity or index such as London Interbank Offered Rate (LIBOR), the exchange rate, the exchange rate between two currencies or the level of a stock market index at dates in the future can bring uncertainty regarding the future size of at least one of the two cash streams.

Derivatives are innovative products that aim to enhance returns, reduce risk, and provide diversification. They are used for hedging, speculation and arbitrage. While swaps, like futures and forwards, can be used for speculation, hedging or to take advantage of arbitrage opportunities, the primary motivation for using swaps is to manage business risk.[16]

4. Proprietary or Nonproprietary Share/Certificate

A proprietary share or certificate is defined as an evidence of interest, participation or privilege in a corporation which gives the holder of the share or certificate the right to use the facilities covered by such certificate and to receive dividends or earnings from the corporation. Upon the liquidation of the corporation, the holder shall have proportionate ownership rights over its assets[17].

On the other hand, a non-proprietary share or certificate is defined as an evidence of interest, participation or privilege over a specific property of a corporation that allows the holder of the share or certificate to use such property under certain terms and

[14] Santos (Ed), 2018, pp. 601-602.
[15] PAS 39.
[16] Santos, 2018, p. 617.
[17] Rule 3.1.15, SRC.

conditions. The holder, however, shall not be entitled to dividends from the corporation or to its assets upon its liquidation.[18]

5. Securities issued by Investment Companies

Under Sec. 4 of Investment Company Act (ICA) or Republic Act No. 2629, an investment company is engaged in the business of investing, reinvesting, or trading in securities. It is classified into two, namely: open-end and closed-end investment companies.

An open-end investment company[19] offers for sale any redeemable security of which it is the issuer whereas a closed-end company[20] offers for sale a fixed number of non-redeemable securities.

A mutual fund is one of the most popular collective investment schemes in the Philippines. A Mutual Fund Company (MFC) is a registered open-end investment company that holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting and trading in securities. It pools the funds of individuals and institutional investors to form a massive asset base which is entrusted to a full time professional Fund Manager who develops and maintains a diversified portfolio of security investments.[21]

An investment company can issue or offer for sale its shares or units of participation. An MFC that issues units of participation, each of which represents an undivided interest in the pool of investment assets of the scheme, is called a Unitized Mutual Fund (UMF).[22]

Therefore, a shareholder can subscribe or buy the shares at the prevailing Net Asset Value per Share (NAVPS) while a unitholder will purchase the units based on the prevailing Net Asset Value per Unit (NAVPU).

An open-end mutual fund can redeem its outstanding redeemable shares/units at the net asset value per share/unit (NAVPS/NAVPU) at any time upon redemption of its investors.

6. Real Estate Investment Trust (REIT) Securities

"Real Estate Investment Trust" or "REIT" is a stock corporation established in accordance with the Revised Corporation Code of the Philippines and the rules and regulations promulgated by the Commission principally for the purpose of owning income-generating real estate assets. For purposes of clarity, a REIT, although designated as a "trust", does not have the same technical meaning as "trust" under existing laws and regulations but is used herein for the sole purpose of adopting the internationally accepted description of the company in accordance with global best practices.[23]

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[18] Rule 3.1.13, SRC.
[19] ICA Section 5a.1.
[20] ICA IRR Rule 1 par. 6.
[21] ICA-IRR, Rule 1 par. 27.
[22] ICA-IRR, Rule 1 par. 41.
[23] SEC Memorandum Circular No. 1, Series of 2020, Revised Implementing Rules and Regulations of Republic Act No. 9856, otherwise known as the Real Estate Investment Trust (REIT) Act of 2009.

REIT securities are a type of security issued by REIT companies that allows the general public to invest in income-generating real estate. It is a type of investment instrument that provides a return to investors derived from the rental income of the underlying assets.

Investments in REITs are subscriptions to or purchases of shares of stock of the REITs which are in compliance with a REIT plan and other requirements and restrictions prescribed by the Commission.[24] REIT shares are easily convertible to cash, allow investors to invest in a diverse portfolio of properties, locations, and property types for a fraction of the cost, and may pay higher dividends.

7. Sustainable Finance Securities

Sustainable finance securities refer to financial instruments or investments designed to promote sustainable and responsible business practices, addressing various environmental and social challenges.

Some common types of sustainable finance securities include:

a. Green Bonds - These refer to bonds where proceeds will be exclusively applied to finance or refinance new and/or existing eligible Green Projects. Some eligible green projects include Renewable Energy, Energy Efficiency, Pollution Prevention and Control, Clean Transportation, and Climate Change Adaptation.[25]

b. Social Bonds - These refer to bonds where the proceeds will be exclusively applied to finance or refinance, in part or in full, new and/or existing eligible Social Projects such as affordable basic infrastructure, access to essential services, affordable housing, employment generation, food security, socioeconomic advancement, and empowerment.[26]

c. Sustainability Bonds - These refer to bonds where the proceeds will be exclusively applied to finance or refinance a combination of both Green and Social Projects that respectively offer environmental and social benefits.[27]

d. Sustainable and Responsible Investment (SRI) - These are investments offered by Investment Companies, that adopt one or more sustainability principles or considerations or environmental, social, and governance (ESG) factors as their key investment focus.[28] SRI is an investment approach that adheres to the considerations of existing internationally accepted sustainability standards.

e. Sustainability-Linked Bonds - These bonds are defined as any type of bond instrument for which financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/environmental, social, and governance (ESG) objectives which are: (1) measured through predefined Key Performance Indicators (KPIs) and (2) assessed against predefined Sustainability Performance Targets (SPTs).[29]

[24] Section 4 of R.A. No. 9856 (Real Estate Investment Trust Act of 2009).
[25] SEC MC No. 12 s. of 2018
[26] SEC MC No. 9 s. of 2019
[27] SEC MC No. 8 s. of 2019
[28] SEC MC No. 11 s. of 2022
[29] SEC MC No. 3 s. of 2023

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f. Blue Bonds - Blue Bonds are a subset of Green Bonds where proceeds will be exclusively applied to finance or refinance, in part or in full, new and existing Blue-eligible projects and/or activities. Blue Projects directly aim to address sustainable water management and ocean protection and/or seek to contribute to the development of the blue economy.[30]

C. Some Basic Comparisons between/among Securities Holders as regards entitlements

1. **Debt holders** have a fixed return in the interest rate established in the bond or other debt agreements, hence, these are called fixed income securities. Being creditors, they have preference over the assets of the corporations in case of liquidation.

   On the other hand, **Equity holders** are owners and bear the risks and benefits of ownership. Their potential return is in a way unlimited by the price at which the market values the worth of the company at any given time. It is a gain (or loss) in market price that is realized when the holder sells the shares.

2. **Derivative holders** have specific rights to the underlying assets as these rights are defined by the nature of the derivative contract, because there are varying derivative contract specimens. Essentially these rights are financial claims to be enforced, e.g. to buy or sell at a given price at a given time; or to deliver a commodity at a given price at a given time. There are accompanying conditions.

3. **Rights of holders of proprietary vis a vis nonproprietary shares**. Below are some of the examples of the rights of holders of proprietary shares and non-proprietary shares under the Implementing Rules and Regulations of the Securities Regulation Code (SRC-IRR):

DESCRIPTION OF RIGHTS	PROPRIETARY SHAREHOLDERS	NON-PROPRIETARY SHAREHOLDERS
Right To Use Facilities	Yes	Yes
Right to Receive Dividends or Earnings	Yes	No
Right to Share in Assets upon Liquidation	Yes	No

4. **Rights of Investment Company Shareholders vis a vis Unitholders**. Below are some of the examples of the rights of shareholders and unitholders of an Investment Company under the Implementing Rules and Regulations of the Investment Company Act (ICA-IRR):

DESCRIPTION	SHAREHOLDERS	UNITHOLDERS
Voting Rights	Yes	No
Right to notification on extension or new agreements entered into by the Fund	Yes	Yes
Change in the investment objective, policy, and strategy	Prior approval of shareholders representing a majority	Prior approval is not required but entitled to be notified of the following:

[30] SEC MC No. 15 s. of 2023

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	of the outstanding capital stock is required[31]	a. any change in the investment objective, policy, and strategy at least thirty (30) days before the change will be implemented[32]; and b. any material change to the Registration Statement and the subscription agreement[33].
Voluntary Revocation of Registration of Securities	Approval is required[34]	Approval is not required

D. Risks Associated with Securities

Risks are inevitable in investing. The risk is that the expected return or gain from the investment will not materialize, for various reasons. The underlying risks in securities are those attributable to the Issuer of those securities, *i.e.* the corporate issuer itself. For example: Is the company able to fulfill its debt obligation? Or is it in a healthy condition to keep its market value increasing? The desired answer to these questions is YES, but there are risks that can derail favorable expectations. And these risks are what is addressed by enterprise-wide risk management.

Acknowledging the unavoidability of risks, it is therefore instructive to the evaluation of investments, to have an appreciation of enterprise-wide risk management and practice to give a broad context to the more focused understanding of investment risks. This subject is examined in more detail in Topic 3: Risk Management.

Following are the commonly identified investment risks:

1. Liquidity Risk

Liquidity risk arises from the lack of marketability of an investment because it cannot be sold quickly enough when needed to prevent or minimize a loss or to take advantage of price movements.

Liquidity risk is more associated with stock investments when there are not enough buyers for sellers who wish to liquefy their investments and turn them into cash, for whatever their immediate needs are. In view of this, one of the considerations in stock investments is the size of a company's shares available in the market and the number of shareholders or investors. The government as a matter of policy encourages broad ownership of shares to encourage and support liquidity in the capital market. Relatedly, stock exchange rules require a minimum (but adequate) number of shares to be listed in an Initial Public Offering (IPO), to assure available number of tradeable shares, and support their liquidity.

[31] ICA-IRR Rule 14.2.
[32] *Id.*
[33] ICA-IRR Rule 3.4.g.
[34] ICA-IRR Rule 13.1.6.a.ii.

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2. Market Risk

Market risks, also known as systematic risks, are risks that affect the performance of the overall market due to general factors, such as political risk and macroeconomic risk.

In contrast, unsystematic risk is a company or industry-specific.

In more specific terms, market risk is the unexpected condition when the price or value of a security investment drops or moves in a volatile fashion, which causes a loss of value of the stock. (Market risk is attached more to equities investments than debt securities.)

There is such a thing as "market sentiment", a disposition to buy or to sell that is shared across a wide range of investors and investments.

How volatile market sentiment plays out, suddenly or unexpectedly, is a market risk. One may be unable to readily unload his shareholdings when he wants to without incurring a loss of value. As a measure of control when share prices uncharacteristically move too fast up or down, stock exchanges have adopted "circuit breaker" rules. Trading is automatically stopped when price movements breach certain thresholds. Trading may halt for a few minutes or for the rest of the trading day, depending on the degree of price volatility.

3. Inflation Risk

Inflation risk is the risk that the future return on investment will be of less value in terms of purchasing power due to inflation. Inflation risk is not the risk that there will be inflation, it is the risk that inflation will be higher than expected.

Compared to stock investments, bonds are more subject to inflation risk because bond coupon rates are fixed percentages or fixed income payments that do not change in absolute amounts over the lifetime of the bonds outstanding, even as the rate of inflation reduces the purchasing power of the fixed income payments. Stock prices would generally adjust value to inflation rates.

4. Interest Rate Risk

Interest rate risk is the potential for investment losses that result from a change in interest rates. If interest rates rise, for instance, the value or price of a bond or other fixed-income investment will decline to adjust to the current interest rates.

Bonds and fixed-income securities are more affected by interest rate risk.

Central banks, like the Bangko Sentral ng Pilipinas (BSP), exercise direct influence in changing interest rates by their policies of setting benchmark interest rates.

5. Credit Risk

This risk attaches to bond investments and similar debt instruments. It is the risk that the Issuer of the bonds will not be able to pay interest or principal when payments fall due. It is the risk of default on the obligation.

There are several factors that determine the likelihood or risk of default, and credit rating agencies are the specialized service providers for credit opinions.

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6. Risks in Derivatives

The very definition of a derivative indicates the risks that characterize it. The price of the underlying asset is subject to change in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or some other variables. Hence, there is volatility in the whole scheme that can produce losses. These derivatives are used for hedging and speculations relative to investing.

Part II. Securities Markets

A. What is a Market?

A market is a place where buyers and sellers trade goods or services or commodities for an agreed price. In our electronic age, the market is not necessarily a physical place but more inclusively, a "space" for conducting trading, i.e., the exchange of economic values. The market does not need to have a physical location. Also, the market does not necessarily own the goods and services involved and it can deal in any variety of goods and services.[35]

Characteristics of a "Good" Market
Like any market, we must have an adequate supply of securities available for trading which offer potential good returns or otherwise can be said to have "investment quality." Consequently, there should be an adequate number of Issuers to produce that supply of securities, and thereafter, an adequate number of sellers of securities who are matched by an adequate number of buyers or investors.

One characteristic of a good market is timely and accurate information on past transactions and prevailing buy and sell orders[36]. As a lubricant to trading transactions, there must always be available adequate investment information for all participants, timely made, to allow informed investment decisions characterized by transparency and fair-dealing.

Another important characteristic is liquidity. It means that an asset can be bought or sold quickly at a price close to the prices for previous transactions, assuming no new information has been received. In addition, low transaction costs contribute to a good market. It includes the cost of reaching the market, the actual brokerage costs and the cost of transferring the asset. Finally, market participants want prices to adjust quickly to new information regarding supply and demand. Therefore, there must be an external or informational efficiency, where prevailing market prices reflect all available information about the asset.[37]

Above all, there must be an effective regulatory environment that assures that the market and the transactions therein are conducted in accordance with law, in observance of good practices collectively called good governance principles: transparency, accountability, responsibility and fairness.

1. Financial Markets

Financial markets perform the important economic function of transferring funds from households, firms, and governments who have saved surplus funds by spending less

[35] Reilly F. and Brown K. l, 2012. p.58.
[36] *Ibid.*
[37] *Ibid.*

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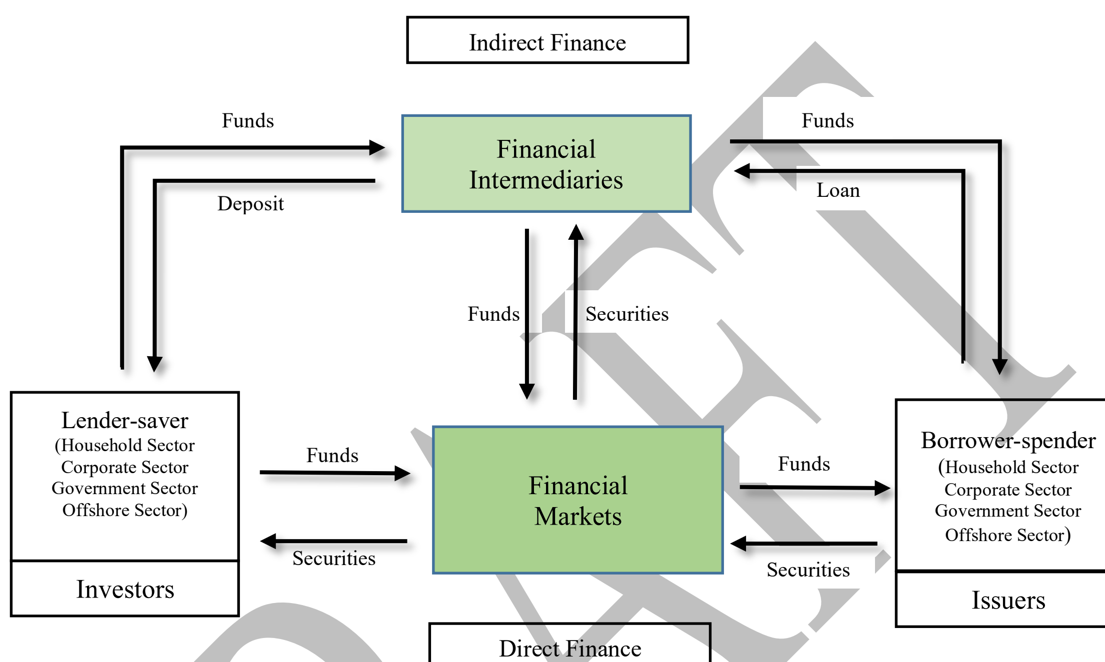
than their income to those who have a shortage of funds because they wish to spend more than they earn.

As shown in the figure below, in direct finance, borrowers borrow funds directly from lenders in financial markets by selling them securities (also called financial instruments), which are claims on the borrower's future income or assets.[38]

Flows of Funds Through the Financial System[39]



It shows the important function of the financial markets in the economy wherein they allow funds to move from people who lack productive investment opportunities to people who have such opportunities. Financial markets are critical for producing an efficient allocation of capital, which contributes to higher production and efficiency for the overall economy.[40]

Financial markets that function efficiently benefit all investors by keeping transaction costs low and allowing investors to trade financial instruments easily.

Financial market facilitates:

- The raising of funds and capital (in the money and capital market)
- The transfer of risk (in derivatives market)
- International trade (in currency market, i.e. foreign exchange market)

[38] Mishkin, F. S. (2018). *Economics of money, banking and financial markets* (12th ed.). Pearson.
[39] *Id.*
[40] *Id.*

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The financial market can be divided into different categories:

Money Market	• dealings in short-term maturities of financial contracts • financial instruments with maturities of less than one year • examples are Treasury bills (T-bills) issued by the Bureau of Treasury (BTr) with maturities of less than 360 days and short-term commercial papers (STCPs) issued by private companies (such as San Miguel Corporation STCPs) are included in the money market category • most money market instruments are fixed-income debt instruments[41]
Capital Market	• dealings in long-term debt instruments, such as bonds; or equities which represent proportionate interests in the ownership of a corporation, such as common shares or stocks • debt instruments are repaid upon their maturity dates and bear interest • equities, however, do not have to be repaid and exist for so long as the corporation exists • in case of liquidation, the equities holders are entitled to a proportionate share of the residual corporate assets after all debts are preferentially paid
Derivatives Market	• includes all financial contracts deriving their value from any underlying assets • includes options, futures, forwards, and swaps
Foreign Exchange Market	• refers to the market dealing in foreign currencies like the Philippine peso, U.S. dollar, and other major currencies • the Bankers Association of the Philippines (BAP) presides over this secondary market • admittedly, though, there is a "grey market" conducted through the many money changers in the country

2. Securities Market

In securities markets, what are traded are securities. In a broad picture, a securities market has a demand side where corporate issuers issue securities which they sell to raise funds they need and demand. On the opposite side is a supply side consisting of investors who have the funds to supply and buy the securities.

Between the demand and supply sides are the intermediaries, a collective term we use to identify all those institutions and individuals who enable and facilitate the securities trades to happen in various specialized roles and capacities.

In addition, there is the regulatory side which arches over the securities market to assure its orderly functioning.

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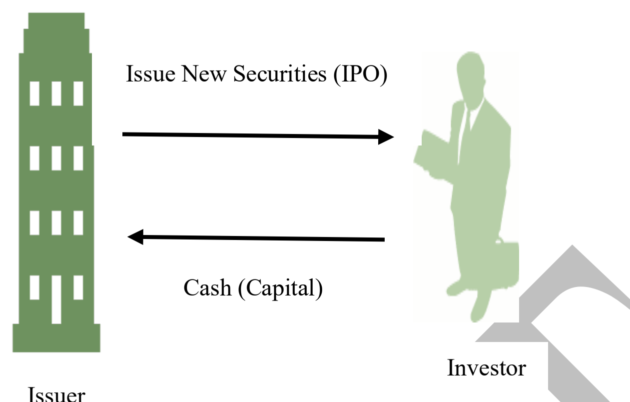
[41] Santos (Ed), 2018, pp.61-62.

B. The Primary Market[42]



The primary market includes both government securities and corporate (private) bonds. The importance of this primary market comes from the fact that it is an effective arrangement to raise large amounts of funds for much needed government and corporate operations. This manner of raising funds provides an alternative source of financing aside from bank financing which has its inherent limits. The Asian Financial Crisis of 1997 had vividly demonstrated that an over-reliance on bank borrowings exposes corporations, and even governments, to currency and interest rate volatility risk. Capital market sources of financing could have mitigated those risk exposures.

The inherent benefits and function of the primary capital market is of course to get the savings of the private sector channeled to the productive sectors of the economy, to fuel economic growth, and for the investors to participate in the benefits of their investment return and in the growth of the economy.

When the corporate Issuer of securities, also called the Originator, issues its securities to be sold to the public, this action is called an Initial Public Offering or an IPO, more commonly associated with public offering of shares of stock. These new securities are primary securities or shares, hence are identified as the component of the primary market. The purpose is to raise funds for the corporation which is the Issuer.

1. IPO: Stocks

An Initial Public Offering (IPO) is a company's first offering of shares to the general public. It usually involves new primary common shares (unissued shares) and sometimes secondary shares (shares owned by present stockholders). IPOs are required to list on the PSE. IPOs are the domain of Investment Bankers whose primary function is to assist companies raise capital and provide the financial advice that go with that effort. Investment banking includes raising capital of fairly large amounts through loan syndications, bond issues, IPO of common stocks, issues of hybrid instruments and other variations which innovative thinking can produce.

These are the two types of underwriting agreements. The appointment of an Underwriter or Underwriters for an IPO is crucial. Early in the planning process, the Underwriter is the overall adviser to the Issuer on the many aspects of preparing for and

[42] Harris, Larry. The Functioning of the Financial Markets. CFA Institute Investment Foundations, Third Edition Chapter 15.

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executing a successful IPO. The issuing company must be "in good order" for being introduced into the market. The financial condition must be seen to be healthy, the business plan worthy, the management competent, the organization well-prepared. The financial reports must be recently validated by external auditors.

At the same time, the principal risks faced by the Issuer must be pointed out and how these are manageable. Lawyers must be consulted to verify compliance with laws, and give opinions on potential liabilities. In other words, there are several aspects that the Underwriter must give advice to and coordinate, to present an IPO as a good investment. It requires a special kind of expertise. In the Philippines, the Underwriters are the universal banks and investment houses. Many of these investment houses are affiliates of these universal banks. Some are locals, others are foreign.

In an IPO, the **Prospectus** is the document made by or on behalf of an issuer, underwriter or dealer to sell or offer securities for sale to the public through registration statement filed with the SEC. It is the primary disclosure document and the selling tool to persuade investors to buy the securities. It goes with the Registration Statement required to be filed for the registration of securities with the SEC.

A prospectus (printed statement containing all material facts about the applicant's operations, e.g., risk factors, use of proceeds, terms of offering, financial statements and projections) is a major output of an IPO undertaking. After getting clearance from the SEC and PSE to sell shares to the public, the underwriter now markets the company via public presentations and sales calls (road shows) and monitors commitment from investors (book building). Shares are likewise offered to sales agents (trading participants) and the general public. Typically, ten percent of the total offering is allocated to small investors, while the public and investment banks are allocated 60% and 30%, respectively.

When there's an IPO, the desired outcome, aside from selling the whole issue, is to see the price of the stock rise slightly above the offering price, to signal that the IPO pricing was right, and the IPO investors are immediately rewarded. It's a measure of a successful IPO.

Then there's also the IPO Lock-Up period that can come with the public offering. This is a contractual obligation imposed on existing shareholders not to sell their shares for a certain period after the IPO, say, 90 or 180 days. The purpose of this lock-up period is to prevent large existing shareholders from flooding the market with their shares, thereby unduly depressing the price of the shares with the oversupply. It avoids price volatility.

In any case, "Delayed and Continuous Offering and Sale of Securities" is allowed. This is called Shelf Registration. Securities, which are intended to be issued in tranches at more than one instance after the registration statement has been rendered effective by the Commission, may be registered for an offering to be made on a continuous or delayed basis is the future, for a period not exceeding three (3) years from the effective date of the registration statement under which they are being offered and sold[43].

The reason for this is to facilitate the IPO process by avoiding repeating the tedious detailed procedures, so long as there are no material changes in the registration statement information which, if any, should be disclosed for the informed decision of the investing public. Shelf registration also give flexibility to the Issuer who can

[43] Rule 8.1.2, SRC.

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conveniently decide the time its best to offer additional shares, by getting them "off the shelf".

We shall now focus on some segments of the primary market and get more acquainted with how the primary issues are made and brought to market.

2. IPO: Bonds

The issue of bonded indebtedness is first of all authorized by the majority of the company's board of directors and must be approved by at least 2/3 vote of all outstanding shares entitled to vote.

Then they appoint an Underwriter who forms an Underwriting syndicate that consists of a head Manager with chosen Syndicate Members who in turn have Selling Agents who sell to individual investors.

The terms of the bond issue are approved by the board and presented to the shareholders for their approval. The Underwriter and possibly other advisors help design the bond issue and its terms.

The bond issue, to be allowed for sale or distribution in the Philippines, must be approved by the SEC through a registration statement filed with it, which shall be made available to each prospective purchaser. The application for increase of bonded indebtedness must be made within six (6) months from the date of approval of the board of directors and stockholders.

For a public offering, a credit rating of the bond issue is required. Thereafter, the bond issue is listed with the Philippine Dealing & Exchange Corp. (PDEX) which is the platform for dealing in fixed income securities. There are of course certain requirements for listing.

3. Government Securities

Government Securities are issued by the Bureau of Treasury (BTr) and is done by auction. Only Government Securities Dealers duly accredited (GS Dealers) participate in the auction which is conducted through auction tenders and auction awards all by electronic system. A BTr Auction Committee presides over the auctions: The Listing is automatic under the National Registry of Scripless Securities (NRoSS) managed by the Bureau of Treasury. Cash Settlement is done through the Bangko Sentral Ng Pilipinas BSP PhilPass system.

4. Local Government Bonds

Under the Local Government Code, Local Government Units (LGUs) are authorized to issue bonds as their respective Sanggunians may approve. LGU bonds would require a financial advisor to design these issues because LGU executives do not have the expertise to perform the preparatory task for this type of financing. The advisor would in these cases be the one also guiding in the marketing of these bonds and most probably are sold to a few institutional pre-selected investors.

LGU bond financing is a way of raising funds from the capital market that is relatively unknown, although with great potential.

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5. Private Placements

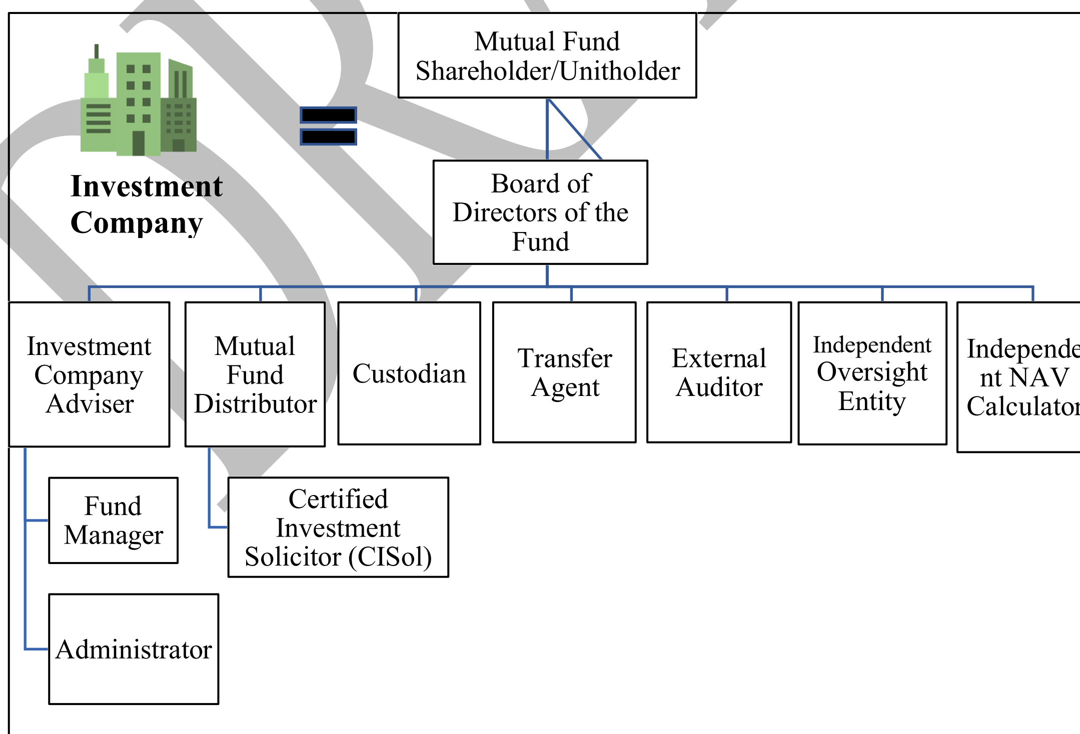
The sale of securities by an issuer to fewer than twenty (20) persons in the Philippines during any twelve-month period is an exempt transaction (Section 10, SRC) and does not need to be registered with the SEC. This is called a private placement, and is typically handled by an Underwriter.

6. Investment Company Securities

Generally, the securities of investment companies are traded over the counter through SEC-accredited mutual fund sales agents called Certified Investment Solicitor (CISol). The CISol is a natural person of legal age duly licensed by the SEC and appointed by the investment company or the Fund Manager or Mutual Fund Distributor to solicit, sell or offer to sell the shares or units of an investment company to the public.[44] However, there are some investment companies or mutual funds whose securities are listed and traded through the Philippine Stock Exchange (PSE).

Prior to its sale to the investing public, an Investment Company is required to register its shares or units. For such purpose, it is required to file a Registration Statement with the SEC and prospective investors shall be provided the Relevant Product Highlight Sheet and Prospectus, indicating, among others, whether it is an open-end or closed-end investment company; description of the terms, features, rights, and privileges of the shares or units to be registered, investment objective, policy and strategy of the Investment Company, use of proceed, profile of the prospective investors and investment suitability, risk factors and other information on the investments.[45]

Below is a graphical presentation of an Investment Company and the parties involved in its operation:



[44] ICA-IRR Rule 1 par. 4.
[45] ICA-IRR Rule 4, 4.2.

An investment company enters into a contract with the Fund Manager, Fund Adviser, Fund Distributor, Custodian, Transfer Agent, External Auditor, Independent Oversight Entity, and Independent NAV Calculator.

Hence, as shown above, the following are the parties involved in the operation of an investment company:

a. **Fund Manager (FM)** – a registered entity with an Investment Company Adviser license that is engaged in the business of managing the daily operations of an Investment Company in the investment, administration and accounting of fund assets.

   It must have sufficient technical and human resources; an efficient fund management operation system; adequate internal control system; a risk monitoring and management process, including a risk management framework for the assets that they manage, based on the size, complexity and risk of the assets under management; and adequate processes for handling customers' complaints.

   The Fund Manager may serve as Fund Adviser, Administrator, Distributor and Transfer Agent.

b. **Investment Company Adviser –** an Investment Company Adviser licensee who regularly advises or recommends investment decisions with regard to the securities or other portfolio of the Investment Company.

c. **Mutual Fund Distributor (MFD) –** a juridical person duly licensed or authorized by the SEC to distribute shares or units of an Investment Company as either principal distributor or sub-distributor.

   a) **Fund Manager as Fund Distributor.** The Fund Manager that intends to distribute the shares or units of the funds it is managing may no longer be required to secure a separate license as a MFD. Such fund participant shall be referred to as FM/MFD. However, if the FM/MFD intends to distribute the securities of another fund managed by a different Fund Manager or CIS Operator, it shall be required to secure a separate license as a Mutual Fund Distributor.

   b) **Certified Investment Solicitor (CISol)** – a natural person of legal age duly licensed by the SEC and appointed by the Fund or the FM/FD to solicit, sell or offer to sell the shares or units of an Investment Company to the public.

d. **Custodian** – an independent third party entity duly authorized or accredited by the Bangko Sentral ng Pilipinas or the SEC to engage in the business of custodial and safekeeping of investment assets.

e. **Transfer Agent** – a juridical person duly licensed by the SEC as a transfer agent to maintain an accurate registry for recording the initial and subsequent transfer of securities.

f. **Independent Oversight Entity (IOE) –** refers to an impartial committee or entity tasked to monitor the transactions and functions carried out by the Fund Manager. An Investment Company may constitute its Audit Committee as its IOE or may

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engage the services of a custodian bank, trust entity or an external auditor to serve as such.

g. **Independent Net Asset Value Calculator-** an independent entity that will calculate or cross-check its Net Asset Value (NAV) every dealing day which may be the custodian bank, trust entity, external auditor, audit committee or other service providers capable of calculating the NAV.

h. **External Auditor** –refers to Independent Accountants or Auditors appointed to audit the financial statements of an Investment Company, its appointed Fund Manager and Fund Distributor.

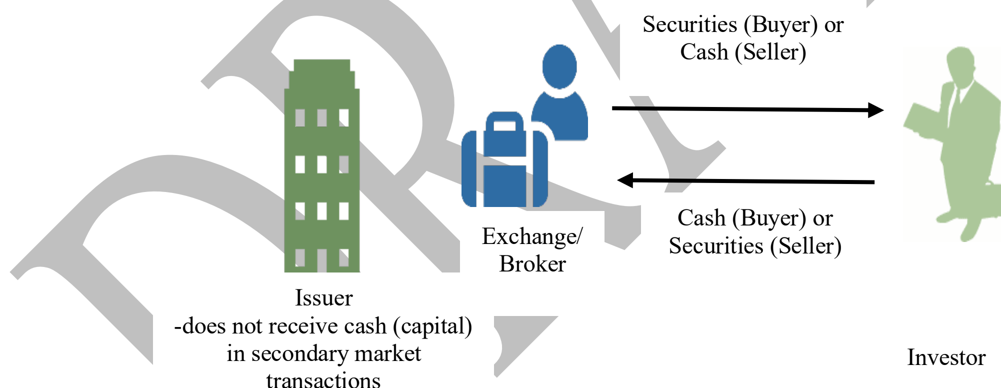
7. Issuances of Proprietary and Non-Proprietary Shares

Typically, the issuers of proprietary securities consist of sports and country Clubs while issuers of non-proprietary securities are those that sell membership in beach clubs and vacation and leisure clubs.

Prior to the sale of registered issuers of proprietary and non-proprietary shares/certificates to the investing public, the Registration Statement must be approved by the SEC.

Also, the Prospectus must contain , among others, the description of the nature and type of the shares or certificates, rights and privileges of their holders, in particular, their right over the use of the facilities of the Issuer.[46]

C. Secondary Market[47]



The Secondary Market refers to the venue where purchases and sales of fixed income securities are executed. It is called a secondary market because the transactions occur after the original or "primary" issuance of the securities. Participants in the secondary market are SEC-licensed Dealers, SEC-licensed Brokers, Qualified Investors and Public Investors, who buy and/ or sell fixed income securities in the secondary market. Public investors participate in the secondary market through the SEC-licensed Brokers tasked to act in the best interest of their Client Investor as "public representatives."[48]

[46] Rule 12.1.4.1.1, SRC.
[47] Harris, Larry. The Functioning of the Financial Markets. CFA Institute Investment Foundations, Third Edition Chapter 15.
[48] https://www.pds.com.ph/wp-content/uploads/2013/08/Buying-and-Selling-FI-Securities-in-PDEx.pdf

In the secondary market, what is traded are already-issued securities, and the cash proceeds from the sale of secondary shares go to the selling investor. In the primary market, the proceeds go to the issuer of the securities.

Trading in the secondary market can be done through an Exchange or "Over-the-Counter" (OTC).

1. Exchanges

Exchanges are more than physical locations. They set the institutional rules that govern trading and information flows about that trading. An exchange centralizes the communication of bid and offer prices to all direct market participants, who can respond by selling or buying at one of the quotes or by replying with a different quote. When two parties reach agreement, the price at which the transaction is executed is communicated throughout the market. The result is a level playing field that allows any market participant to buy as low or sell as high as anyone else as long as the trader follows exchange rules.[49]

a. **The Philippine Stock Exchange (PSE)**

The PSE is the sole stock exchange operating in the Philippines. It makes sure that trading transactions are done in an efficient, orderly, fair and transparent manner. With its SRO status, it enforces rules and regulations that its publicly listed companies and trading participants must strictly abide by. This way, the PSE lives up to its role as the 'manager' of the Philippine Stock Market.[50]

"Listed Companies, also known as 'issuers', are those whose shares of stock are traded on the PSE. These companies have satisfied the stringent listing and reportorial requirements of the PSE, and have gone through (IPO) or listing by way of introduction."[51]

b. **The Philippine Dealing & Exchange Corp. (PDEX)**

The PDEX is the organized exchange for fixed income securities in the Philippines. Like its counterpart in equities, PSE, it is also an SRO or self-regulatory organization licensed by the SEC.

The securities traded at PDEX are government securities and corporate bonds which have gone through a prescribed listing procedure.

Trading through PDEX facilities is conducted through Trading Participants who are Brokers or Dealers, all SEC-licensed and duly accredited by PDEX. The Broker executes all client orders in the trading system. The Dealer makes prices and executes all trades on the Trading System.

There are Retail Investors who are individuals or small/medium scale corporations and can transact only through a Broker. There are Qualified Investors which are the

[49] International Monetary Fund. Markets: Exchange or Over the Counter. Retrieved at https://www.imf.org/external/pubs/ft/fandd/basics/markets.htm

[50] Santos. (Ed), 2018, p.147.

[51] PSE Academy. Who are the Market Participants? Retrieved at https://www.pseacademy.com.ph/LM/investors~details/id-1316273868284/Who_are_the_Market_Participants.html

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trusts, insurance companies, pension funds and large corporations that can transact with a Broker or a Dealer.

2. Over-the-Counter Market

The over-the-counter market is the market created by the buying and selling of a security on a bilateral basis between parties that takes place outside of an exchange or Alternative Trading System (ATS).[52]

Compared to an Exchange wherein there is followed standardized pricing and execution procedures, the OTC market, stocks can come in non-standardized variations, trade can be done in flexible quantities or volume, and so price and executions quality varies. Strict disclosure requirements are not necessarily or usually made in the OTC market. Exchanges are more strictly and closely subject to regulatory oversight compared to the OTC market. There is relatively lack of reliable information in the OTC market than in Exchanges, which makes OTC trading comparatively riskier. In the OTC market there is heavy price competition in the nature of its "flexibility" which allows custom-fitted transactions.

D. The Transition from Primary to Secondary Markets

Once the primary issues are brought out in public offerings to the primary market by the Issuer, the issues become owned by the investors and become secondary issues to be traded in the secondary market where the counter parties are shareholders, not Issuer-to-investors.

In the secondary market, trading may be done through formal Exchanges or through the OTC market.

The secondary market is essential for a "good market" of securities, as we had earlier mentioned, because it provides the facility to enable sellers to sell when they need or want to, and to enable buyers to buy when they need or want to, in continuous manner. This ensures "liquidity" when the investor can "liquefy" his investment conveniently.

This liquidity makes the investment more attractive to the holder. In the secondary market, the Bond or Stock Exchanges, also provide an orderly procedure for price discovery, that is, a way to determine an appropriate and fair price for the transaction in the organized bid-and-ask sales process.

E. Secondary Markets and the Role of Market Makers

Market makers are dealers in securities who undertake to buy or sell at specified prices at all times, holding specified securities inventories, expecting to make a profit on the bid-ask spread. They guarantee to buy and sell at the prices they announce. Thus, an investor knows what securities are worth at any given time. They also assured that there is a place to sell current securities holdings or to purchase additional securities.

In addition, market maker refer to those Dealing Participants qualified by PDEX (1) to maintain firm two-way quotes for specified securities during the open trading sessions, provided, however, that until a securities borrowing/lending facility is in place for those

[52] SEC MC No.14. s. 2006.

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specified securities, the Market Maker commits to maintain a firm bid for specified securities and (2) to honor those quotes for amounts up to their posted volumes.[53]

F. The Participants in the Securities Market

Below are the participants in the Securities Market. We can first classify the participants broadly as:

- **Demand Side** - Participants who have a demand or need for funds: the ISSUERS or ORIGINATORS of Securities.
- **Supply Side** - Participants who have the supply of funds for the issuers: the INVESTORS.
- **Intermediation Side** - Participants who bridge the demand side and supply side by acting to enable and/or facilitate the market transaction process, collectively the FINANCIAL INTERMEDIARIES.
- **Regulatory Side** - Participants who perform the regulatory oversight of the market and participants.

1. In a primary issue, working with the demand side/issuer, the **Underwriter** plays a central role as enabler and facilitator to give birth to the IPO. The Underwriter advises on the design of the issue, including the terms of the issue, the marketing strategy, the contents of the prospectus and all aspects to assure the whole issue is subscribed and sold. An underwriter is a universal bank, investment house or any other financial institution duly licensed under the Investment Houses Law[54] who, in a public offering of securities, undertakes to sell all securities offered in the public offering (full underwriting) or to sell on a "best effort basis."

   Aside from the Underwriter, there may be other professionals onboarded to give financial and related advice with no underwriting obligations. To better assure a successful IPO, the Underwriter forms an underwriting syndicate of co-underwriters, assisted by a selling syndicate with sales agents appointed.

2. For a debt primary issue offered to the public, the **Credit Rating Agency** plays a role, not as an intermediary which effects the executions of a sale of securities, but as a provider of an independent credit opinion that helps issuers sell the issue, and which helps investors make informed decisions.

   The SRC IRR defines Credit Rating Agency as any corporation principally and regularly engaged in the business of performing credit evaluation of corporation and business projects or of debt issues with the intentions of assessing the overall creditworthiness or of ascertaining the willingness and ability of the issuer to pay its financial obligations as they fall due, and which assessment is translated by credit ratings periodically and publicly announced[55].

3. The **investors**, representing the funds supply side, are of course the necessary matching component of the market. Investors have access to the securities issues through their

[53] PDEX Rules for Fixed Income Securities Market, As Amended Rule 1.12
[54] Rule 12.1.1, SRC.
[55] Rule 39.1.5.1, SRC.

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brokers and salesmen. Institutional investors most probably would be dealers themselves or would work through broker dealers.

4. Conducting a securities market requires a venue for the buy and sell transactions. This is not necessarily a physical location but a facility or space for the operation of an electronic system of transactions. Still, we would still need an operator of that system for which reason we have the PSE for equities and the PDEX for fixed income securities. These two institutions are indeed participants in the securities market by providing the trading infrastructure which both enables and facilitates the executions of buy and sell transactions. Using these infrastructure facilities, trading participants perform their functions.

5. **Broker** is a person engaged in the business of buying and selling securities for the account of others while Dealer means any person who buys and sells securities for his/her own accounts.[56] A broker can operate electronically (electronic broker) or by telephone (voice broker).[57] In addition, Broker Dealer is any entity that buys or sells securities for its own and customers' account.

6. **Salesmen** employed by Broker Dealers in the meantime perform their own functions of selling securities. Salesman shall refer to a natural person hired to buy and sell securities on a salary or commission basis properly endorsed to the SEC by the employing Broker Dealer. It shall also include any employee of an issuer company whose compensation is determined directly or indirectly on sales of issuer's securities. [58]

7. **Associated Person** shall mean any person employed full time by the Broker Dealer whose responsibilities include internal control and supervision of other employers, agents, salesmen, officers, directors, clerks and stakeholders of such Broker Dealer for compliance with the Code (SRC) and rules and regulations adopted thereunder.[59]

   Pursuant to Section 28 of the SRC, Brokers, Dealers, Salesman and Associated Persons shall be registered with the SEC.

8. **Trading participant**, on the other hand, is any broker dealer who has the right, pursuant to the rules of the Exchange or organized market, to trade in that Exchange or organized market.[60]

9. After the trading transaction, there is the matter of payment and Settlement. PSE and PDEX have their own system of settlement. It is the **Clearing Agency** that makes deliveries of securities and/or payments in connection with transaction in securities. A Clearing Agency is any entity that provides a facility for the performance of the following activities:

   a. Make deliveries of securities and/or payments in conventions with transactions in securities;
   b. Reduce the number of settlements of securities transactions or allocate settlement responsibilities in accordance with the rules issued by the SEC or the Exchange; and/or

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[56] Section 3.3 and 3.4, SRC.
[57] BIS Quarterly Review, 2016 December.
[58] Rule 28.1.5.2.1, SRC.
[59] Rule.28.1.5.2.2, SRC.
[60] Rule 3.1.24, SRC.

c. Provide the means for the central handling of securities so that transfers, loans, pledges and similar transactions can be made by bookkeeping entry; or otherwise facilitate the settlement of securities transactions without physical delivery of securities.

10. Because securities transactions are now electronic-driven, dispensing with a lot of paper work and paper certificates, securities bought are kept by an authorized Securities Depository for central safekeeping and asset services. Securities Depository holds securities accounts, provides central safe keeping and asset services, which may include the administration of corporate actions and redemptions, and plays an important role in helping to ensure the integrity of securities issues (that is, securities are not accidentally or fraudulently created or destroyed their details changed).[61]

11. Alongside the depository is the Transfer Agent which registers the transfer of traded securities and records the ownership of securities by bookkeeping entry. Transfer Agent is any person who performs on behalf of an Issuer or by itself as Issuer any of the following activities:

    a. Countersigns, when applicable, certificates of securities upon their issuance;
    b. Monitors the issuance of securities to prevent unauthorized issuances;
    c. Registers the transfer of such securities;
    d. Exchanges or converts such Securities;
    e. Records the ownership of securities by bookkeeping entry without physical issuance of securities certificate.[62]

12. Lastly, an Issuer is any entity authorized by the SEC to offer to sell, sell or promote the sale to the public of its equity, bonds, instruments of indebtedness and other forms of securities.[63] In the primary market, the Issuer is the creator of the securities and the principal seller, in this capacity also known as the Originator.

To recap:

The securities market, like all other markets has major participants: the Sellers (Issuers) on the one side, the Buyers (Investors) on the opposite side, and the Intermediaries in between, with the regulatory authorities watching over the participants and the market.

The Intermediaries facilitate the implementation of the buy-and-sell transactions. These Facilitators assist in getting the transaction done (Brokers Dealers, Trading Participants, Salesmen) and getting the transaction completed (Clearing Agency/Settlement). The trading facilitators/institutional infrastructures are the PSE and PDEX. The Facilitators which provide the essential services of keeping the investors/securities holders "at the ready" for continuing further transactions are the Transfer Agent and the Depository.

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[61] Rule 3.1.21, SRC.
[62] Rule 3.1.25, SRC.
[63] Rule 3.1.11, SRC.

Part III. The Mechanics of Transacting in Equities Securities

A. Important Concepts in Transacting Securities

1. The Long and Short Position

An investor has a long position, if he bought and owns shares of stocks. By contrast, an investor has a short position, if he sold shares of stocks he does not own with the hope of buying back the same shares later at a lower price, to cover his previous sale.

2. Types of Orders

a. **Market Order** is an order to buy or sell securities without a specified price, executed at the best bid-offer-price or last traded price, whichever is better.

b. **Limit Order** is an order to buy or sell securities at a specified volume and price with an unexecuted portion added to the Central Order Book at the entered limit price.

c. **Market on Opening/ Closing Order** is an order to buy or sell securities at the indicative opening/closing price. This order has no specific price (to be determined at the pre-opening/ closing phase).

d. **Market-to-Limit Order** is an order to immediately buy or sell securities at the best possible price between the best-bid- offer and the last traded price with the unexecuted portion automatically transformed into a limit order at the executed price.

e. **Stop Order (Stop Loss/Stop Limit)** is an order that stays inactive until a trade occurs at a predetermined trigger price or better and is immediately treated as a market order. With a stop order, you tell your broker, "When the price hits PhpX, buy (or sell) the stock."

3. Cash and Margin Accounts

Cash accounts are trades settled in cash. On the other hand, Margin trading is the purchase of stocks partly financed by the brokers, with the purchased stocks as collateral. The agreement enables the client to purchase an extra amount of shares on credit while at the same time exploiting bargain prices.

4. Determining the Percentage Return on Margin Purchase, Including Commissions, Interest Paid, and Dividends Received

Brokers charge interest on the debit balances with spread above the bank's lending rates. Thus, investors must include this in the computation of ROI.

5. Maintenance Margin

A decline in the market value of stocks purchased requires depositing additional margin (cash or stocks), to "maintain" the credit arrangement.

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6. Delivery of Securities

Settlement of trades is done under the T+ 3 concept, which means "Transaction date plus 3 days", i.e. settle by the third day following the day of the transaction. This means that if you buy on Monday, you will have to pay by Thursday. Conversely, if you Sell on Monday, the proceeds will come by Thursday.

7. The Cost of Investing

If an investor buys a stock whose market price is PhP10.00, based on the Board Lot Table, the number of shares he or she can buy as a regular transaction should be in multiples of 100 shares. So, if an investor wants to buy 1,000 shares, which conforms with the board lot table being a multiple of 100 shares, his or her required cash outflow shall be as follows:

Buying transaction costs

Market price/share	PhP	10.00
Number of shares to be bought	x	1,000
	PhP	10,000.00
Broker's Commission* (0.25% + 12% VAT)	+	28.00
SEC Fee (Transaction Value x 0.005%)	+	0.50
PSE Transaction Fee (Transaction Value x 0.005%)	+	0.50
SCCP Fee (Transaction Value x 0.01%)	+	1.00
Total Cash Outlay	PhP	10,030.00

**If a buying investor opts to be issued and keep a physical certificate in his/her name, an upliftment or withdrawal fee of PhP50.00 per certificate issuance request and transfer fee of PhP100.00 + 12% VAT will be charged. In the example above, the combined upliftment/withdrawal fee and transfer fee payable by the buying investor will amount to PhP 162.00 (= PhP50.00 + PhP112.00).*

If an investor wishes to sell a stock that is trading at PhP 10.00, based on the Board Lot Table, the number of shares that he or she can sell as a regular transaction should be in multiples of 100 shares. So, if the investor wants to sell 1,000 shares, which conforms with the board lot table being a multiple of 100 shares, his or her cash inflow shall be as follows:

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Selling transaction costs

Market price/share	PhP	10.00
Number of shares to be sold	x	1,000
	PhP	10,000.00
Broker's Commission* (0.25% + 12% VAT)	-	28.00
Stock Transaction Tax** (Transaction Value x 0.6%)	-	60.00
SEC Fee (Transaction Value x 0.005%)	-	0.50
PSE Transaction Fee (Transaction Value x 0.005%)	-	0.50
SCCP Fee (Transaction Value x 0.01%)	-	1.00
Net Cash Receivable	*PhP*	*9,910.00*

**Broker's commission may vary depending on value of transaction, with a maximum allowable commission rate of 1.5%.*
***The Stock Transaction Tax is imposed only on selling transactions*
****If a selling investor has certificates, he/she needs to have this converted into book-entry form in the PDTC system. A cancellation fee of PhP 20.00 + 12% VAT and transfer fee of PhP100.00 + 12% VAT will be charged. In the example above, the combined cancellation fee and transfer fee to be paid by the selling investor will amount to PhP134.40 (= PhP22.40 + PhP112.00).*

On the other hand, the following are the fees involved in case of an investment company:

a. **Management Fee** - refers to the fee paid to the Fund Manager for managing the daily operations of the Fund in the investment, administration and accounting of fund assets and monitoring of the activities of third party service providers such as custodian, transfer agent and distributors.

b. **Distribution Fee** - refers to the fee paid to the Mutual Fund Distributor for marketing, distributing and selling the shares or units of an investment company.

c. **Transfer Agent Fee** - refers to the fee paid to the transfer agent that is appointed to maintain an accurate registry for recording the initial and subsequent transfer of securities.

d. **Custodian Fee** - refers to the fee paid to the custodian for the safekeeping of the investment assets of the investment company.

e. **Independent Net Asset Value Calculation (INAVC) agent fee** - refers to fee paid to an independent entity engaged by the Fund to calculate or cross-check its Net Asset Value (NAV) every dealing day.

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f. **Sales Load** - refers to the charge or commission on the cost of acquiring the shares or units of an investment company.

g. **Early Redemption Fee** - imposed on redemptions made by shareholders/unitholders during the minimum holding period or such brief period of time after the purchase of shares or units.

It is worthy to note that under Rule 6.11.1 of the ICA-IRR, the total operating expenses of an investment company shall not exceed ten percent (10%) of its average investment fund or net worth as shown in its previous Audited Financial Statements covering the immediately preceding fiscal year.

B. The Short Sale

A short sale is the sale of securities not owned by the seller with the hope of buying back the same security at a lower price to lock in profits. Short sellers deliver borrowed certificates first and later on, the purchased security to "cover" the borrowed certificate.

Short selling is not limited to individual investors; market makers may also sell short. If there is an influx of orders to buy, the market makers may satisfy this demand by selling short.

The SEC approved the Revised PSE Rules on short selling in October 2007. The guidelines state that only securities included in the list of qualified securities, as determined by the PSE, will be eligible for short selling in accordance with the following criteria: 1) market capitalization of at least Php 10 billion; and, 2) tradability – traded 100%, excluding block sales, during the last six months prior to the date of approval of the list. Securities automatically considered qualified are listed securities where derivative products are issued, as well as all constituent stocks of the PSE Composite Index (PSEi). Although approved in principle, this remained largely untapped ever since the 2007- 2009 Global Financial Crisis. It was only in June 2018 when SEC approved the implementing guidelines for short selling.[64]

C. Foreign Securities

There are Dollar Denominated Securities (DDS) which are listed in the PSE which are traded and settled in US dollars. They provide issuers with the ability to raise dollar – denominated capital without incurring foreign exchange risks. It also benefits investors through greater diversification by having dollar – denominated stocks in their portfolios.

DDS may also reduce the currency risk exposure of foreign investors who trade PSE-listed securities. Furthermore, DDS provides local investors with alternative investment avenues for their US Dollar currency positions.

This DDS is not to be confused with the Dollar Denominated Trading Facility (DDT) which was launched by the PSE in 2003. DDT allowed Philippine listed Companies with common shares listed abroad and denominated in US Dollars to be traded locally. Under DDT, the subject shares that were quoted and traded in US Dollars are the same shares that are listed and quoted in Philippine Pesos.[65]

[64] Santos 2018, pp.158-159.
[65] Santos. (Ed) 2018, pp.144-145.

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D. Regulations

Our regulatory authorities, in fact all market participants, are concerned about maintaining the integrity of the securities market, and at center stage is the Investor/ Customer who participates in that market. Because the securities market has seen the occurrence of fraudulent and illegal schemes perpetuated by investor participants, there are prevention-driven regulations imposed by law and implemented through the SEC and the exchange like PSE.

These regulations come under the category of Know Your Customer requirements, in short, KYC. These requirements have been heightened by the need to prevent "money laundering" activities.

At the minimum, the bona fide identity of new customers must be established. There is such a thing as conducting customer identification and customer due diligence (CDD). The objective is to gain a holistic understanding of a client, including his risk profile.

The following information from individual clients are required:
1. Complete name/names used
2. Present address
3. Permanent address
4. Mailing address
5. Date/Place of birth
6. Nationality
7. Contact details
8. Nature of work/ Name of employer or nature of self-employment
9. Tax identification number, SSS No. or GSIS No.
10. Source of Funds
11. Specimen Signature
12. Names of beneficial owner or beneficiaries, if applicable

There is also conducted a so-called client suitability assessment (CSA), to establish a risk profile.

Part of the KYC protocol is for the broker or dealer or investment solicitor to do an assessment of the investor's financial and other personal circumstances so that there can be a better matching of the investment instruments to the investor's intentions and capabilities. In other words, the investment to be made is suitable to the client.

There usually would be a CSA form for the investor to fill up and answer to determine such information as:
1. return or investment objective;
2. funds available for investment;
3. willingness to take risks;
4. ability to take risks;
5. investment knowledge;
6. investment experience;
7. liquidity requirements; and
8. time horizon for investing.

The answers would then be translated to numerical scores that would in turn be translated to a client profile that describes him/her as a Conservative, Defensive, Moderate, Balanced

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or Aggressive Investor. From this profile, the broker or dealer or investment adviser develops a suggested suitable investment portfolio.

Each broker or dealer or investment adviser would conceivably have a slightly different but essentially the same or similar approach.

E. Securities Investor Protection Initiatives

The Securities and Exchange Commission (SEC) and the PSE have jointly put in place a number of initiatives designed to build market confidence and integrity through transparency, fairness, and efficient trading of stocks wherein every individual or institutional investor is protected from fraud, trade manipulation, and malpractices by PSE trading participants.

Below are these investor protection initiatives:

1. Self-Regulatory Organization (SRO) Status

In June 1998, the SEC granted the PSE the SRO status. This empowers the PSE to formulate marketplace rules and impose penalties or sanctions to PSE trading participants who will not comply with these rules.

2. Capital Markets Integrity Corporation (CMIC)

With the primary objective of reinforcing the confidence of the investing public, the PSE Board of Directors passed Resolution No. 91, series of 2010, on May 26, 2010, which approved the spin-off of its Market Regulation Division into a separate and independent corporation.

The CMIC was incorporated subsequently, in March 2011. Then on February 3, 2012, the SEC granted the CMIC its SRO status and it started operating on March 12, 2012 as the primary regulator of PSE Trading Participants by performing independent audit, surveillance and compliance enforcement.

3. Risk Based Capital Adequacy (RBCA)

SEC Memorandum Circular No. 16, s. 2004, mandates PSE trading participants to comply with the RBCA Rules. Essentially a risk management measure enforced by the CMIC, RBCA ensures that stockbrokers have enough capital to cover its exposure to risks. It also ensures that stockbrokers are financially sound or liquid enough to promptly settle claims and other obligations to clients.

4. Customer First Policy

The CMIC regularly monitors and audits the operations of stockbrokers. It ensures that business and trading practices of stockbrokers conform with the laws stipulated in the Securities Regulation Code of the Philippines, including the Customer First Policy, whereby stockbrokers' orders must always surrender priority to their clients.

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5. PSE Disclosure Rules

Since timely and reliable company disclosures are essential components of a fair and efficient market, the PSE makes it compulsory for listed companies to promptly disclose factual and truthful information.

a. **10-Minute Rule**. The PSE requires that material information, that may affect a listed company's share price positively or negatively, be disclosed within ten minutes after its occurrence.

b. **Selective Disclosure Rule**. Disclosures must also be done first to the PSE so that it may cascade information to every investor and general public through its communication channels and not to a selected group of individuals only.

6. PSE Electronic Disclosure Generation Technology (PSE EDGE)

The PSE EDGE is a fully automated system that allows the efficient processing, validation, submission, distribution, and analysis of time-sensitive disclosure reports submitted to the PSE. This new disclosure system, which was acquired from the Korea Exchange, takes the place of the PSE Online Disclosure System (ODiSy).

It is equipped with a variety of features, which standardize the disclosure reporting process of PSE's listed companies, improve investors' disclosure searching and viewing experience, and promotes greater transparency in the market.

7. Total Market Surveillance (TMS)

The CMIC monitors the market closely through a state-of-the-art surveillance system called TMS, which was developed by the Korea Exchange. TMS is equipped with the essential elements of the surveillance process and provides an active monitoring and warning mechanism. It is designed to protect the integrity of the stock market from fraud, manipulation, and breaches of marketplace rules. The CMIC investigates unusual price and volume movements to identify and sanction trading participants, and issuers or investors who might have committed unfair market practices.

8. Securities Investor Protection Fund (SIPF)

Another initiative undertaken for the protection of investors is the SIPF. Similar to what the Philippine Deposit Insurance Corp. does, SIPF seeks to build and enhance investors' confidence in the market and is intended to protect the investing public from extraordinary losses, other than the ordinary market fluctuations, arising from fraud, failure of business, or judicial insolvency of PSE Trading Participants.

All of these protective initiatives collectively serve to ensure the health and integrity of the equities market. They make investing in the Philippine stock market secure.

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Part IV. Stocks and Stockholders

Stocks or shares issued by corporations are among the most familiar securities traded in the capital market and so it is instructive to know who issues them (the corporation), how these issuers are formed, how they "create" stocks or shares, how these shares of stock are classified, and what are the benefits attached to ownership of these shares.

A. Corporations

A corporation is an artificial being created by operation of law, having the right of succession and the powers, attributes, and properties expressly authorized by law or incident to its existence.[66]

A corporation is invested by law with a personality separate and distinct from that of the persons composing it as well as from that of any other legal entity to which it may be related. A corporation is a juridical entity with legal personality separate and distinct from those acting for and in its behalf and, in general, from the people comprising it. Following this, the general rule applied is that obligations incurred by the corporation, acting through its directors, officers and employees, are its sole liabilities. [67]

A corporation can act only through natural persons duly authorized for the purpose or by a specific act of its board of directors. The governance and management of corporate affairs in a corporation lies with its board of directors.[68]

However, there are instances when the distinction between personalities of directors, officers, and representatives, and of the corporation, are disregarded. We call this piercing the veil of corporate fiction.

Piercing the corporate veil is warranted when the separate personality of a corporation] is used as a means to perpetrate fraud or an illegal act, or as a vehicle for the evasion of an existing obligation, the circumvention of statutes, or to confuse legitimate issues.[69]

The doctrine of piercing the corporate veil applies only in three (3) basic areas, namely:

1. defeat of public convenience as when the corporate fiction is used as a vehicle for the evasion of an existing obligation;
2. fraud cases or when the corporate entity is used to justify a wrong, protect fraud, or defend a crime; or
3. alter ego cases, where a corporation is merely a farce since it is a mere alter ego or business conduit of a person, or where the corporation is so organized and controlled and its affairs are so conducted as to make it merely an instrumentality, agency, conduit or adjunct of another corporation.[70]

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[66] Section 3, RCC.
[67] Garcia v. Social Security Commission Legal and Collection, G.R. No. 170735, December 17, 2007.
[68] Lim v. Moldex Land, Inc., G.R. No. 206038, January 25, 2017.
[69] Lanuza, Jr. v. BF Corp., G.R. No. 174938, October 1, 2014.
[70] Zambrano v. Philippine Carpet Manufacturing Corp., G.R. No. 224099, June 21, 2017.

B. Organizing Corporations

Typically, private corporations are created under the RCC by filing Articles of Incorporation; although some corporations are created by special laws or charters and are governed by such Special laws or individual charters, usually government-owned or controlled corporations.[71]

The organization starts with incorporators filing Articles of Incorporation in prescribed form with the Securities and Exchange Commission (SEC). Any person, partnership, association or corporation, singly or jointly with others but not more than 15 in number may organize a corporation although there is now recognized a One Person Corporation.[72]

The Articles shall contain substantially the following:

1. The name of corporation;
2. The specific purpose or purposes for which the corporation is being formed. Where a corporation has more than one stated purpose, the articles of incorporation shall indicate the primary purpose and the secondary purpose or purposes: *Provided,* That a nonstock corporation may not include a purpose which would change or contradict its nature as such;
3. The place where the principal office of the corporation is to be located, which must be within the Philippines;
4. The term for which the corporation is to exist, if the corporation has not elected perpetual existence;
5. The names, nationalities, and residence addresses of the incorporators;
6. The number of directors, which shall not be more than fifteen (15) or the number of trustees which may be more than fifteen (15);
7. The names, nationalities, and residence addresses of persons who shall act as directors or trustees until the first regular directors or trustees are duly elected and qualified in accordance with this Code;
8. If it be a stock corporation, the amount of its authorized capital stock, number of shares into which it is divided, the par value of each, names, nationalities, and subscribers, amount subscribed and paid by each on the subscription, and a statement that some or all of the shares are without par value, if applicable;
9. If it be a nonstock corporation, the amount of its capital, the names, nationalities, and residence addresses of the contributors, and amount contributed by each; and
10. Such other matters consistent with law and which the incorporators may deem necessary and convenient.

An arbitration agreement may be provided in the articles of incorporation pursuant to Section 181 of the Revised Corporation Code.

C. Evidence of Ownership of Shares of Stock

The Certificate of Stock is the evidence of ownership of shares of stock but securities or shares of stock in uncertificated or scripless form may be allowed by the SEC. The pertinent provisions of the RCC are in Sections 62 and Section 63.

A certificate of stock must be issued in accordance with the bylaws of a corporation and signed by the president or vice president, countersigned by the secretary or assistant secretary, and sealed with its seal.

[71] Section 4, RCC.
[72] Section 10, RCC.

It will be issued only upon full payment of the amount of subscription together with interest and expenses (in case of delinquent shares), if any is due.

The shares of stock are considered personal property and may be transferred by delivery of the certificate or certificates indorsed by the owner, his attorney-in-fact, or any other person legally authorized to make the transfer.

For the transfer to be valid, it must be recorded in the books of the corporation showing the names of the parties to the transaction, the date of the transfer, the number of the certificate or certificates, and the number of shares transferred.

The Commission may require corporations whose securities are traded in trading markets and which can reasonably demonstrate their capability to do so to issue their securities or shares of stocks in uncertificated or scripless form in accordance with the rules of the Commission.

It is worthy to note that no shares of stock against which the corporation holds any unpaid claim shall be transferable in the books of the corporation.

The stockholder on record is the one whose name is duly recorded in the Stock and Transfer Book (STB) of the corporation.

D. Classification of Shares

Under the Revised Corporation Code, the classification of shares, their corresponding rights, privileges, or restrictions, and their stated par value, if any, must be indicated in the articles of incorporation (AOI). Hence, the shares in stock corporations may be divided into classes or series of shares, or both.

1. **Common Shares** issued by any stock corporation, whose holders have voting rights, hence, they can exercise control over the company through their right to vote.

2. **Preferred shares** issued by any stock corporation may be given preference in the distribution of the assets of the corporation in case of liquidation and in the distribution of dividends, or such other preferences. [73]

   Hence, although holders of preferred shares do not possess voting rights, they have a priority over holders of common shares in terms of dividend payment and liquidation.

3. **Founder's Shares** may be given certain rights and privileges not enjoyed by the owners of other stocks such as the exclusive right to vote and be voted for in the election of directors for a limited period not to exceed five (5) years from the date of incorporation. However, such exclusive right shall not be allowed if its exercise will violate the Anti-Dummy Law, Foreign Investments Act of 199 and other pertinent laws[74].

4. **Redeemable shares** may be issued by a stock corporation when expressly so provided in the articles of incorporation. They may be purchased or taken up by the corporation upon the expiration of a fixed period, regardless of the existence of unrestricted retained earnings in the books of the corporation, and upon such other terms and conditions as

[73] Section 6, RCC.
[74] Section 7, RCC.

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may be stated in the articles of incorporation, which terms and conditions must also be stated in the certificate of stock representing said shares. [75]

5. **Treasury Shares** are shares of stock which have been issued and fully paid for, but subsequently reacquired by the issuing corporation by purchase, redemption, donation or through some other lawful means. Such shares may again be disposed of for a reasonable price fixed by the board of directors.[76]

Par and No Par Value Shares

The Revised Corporation Code provides that the shares or series of shares may or may not have a par value. No par value shares are those issued without par value and they are deemed fully paid and non-assessable. Hence, the holder of such shares shall not be liable to the corporation or to its creditors in respect thereto. However, no-par value shares must be issued for a consideration of at least Five Pesos (P5.00) per share. The entire consideration received by the corporation for its no-par value shares shall be treated as capital and shall not be available for distribution as dividends. On the other hand, par value shares are those with stated par value. The par value is provided in the AOI of a corporation.

E. Rights of Stockholders

1. Right to dividends

The holders of common shares are entitled to **dividends** or allotments of surplus profits on the basis of proportionate number of shares held. The declaration of dividends must be authorized by the board of directors, which has the discretion to do so.

Under the law, the board of directors of a stock corporation may declare dividends out of the unrestricted retained earnings which shall be **payable in cash, property, or in stock** to all stockholders on the basis of outstanding stock held by them.

However, any cash dividends due on delinquent stock shall first be applied to the unpaid balance on the subscription plus costs and expenses, while stock dividends shall be withheld from the delinquent stockholders until their unpaid subscription is fully paid.

The approval of stockholders representing at least two-thirds (2/3) of the outstanding capital stock shall be required for the issuance of stock dividends.[77]

In relation to the right to dividends, the law expressly prohibits stock corporations from retaining surplus profits in excess of one hundred percent (100%) of their paid-in capital stock. But there are exceptions to this such as when justified by definite corporate expansion projects or programs approved by the board of directors or when the corporation is prohibited under any loan agreement with financial institutions or creditors, whether local or foreign, from declaring dividends without their consent, and such consent has not yet been secured.

If it can be clearly shown that such retention is necessary under special circumstances obtaining in the corporation, such as when there is need for special reserve for probable contingencies, the prohibition will not likewise apply.[78]

[75] Section 8, RCC.
[76] Section 9, RCC.
[77] Section 42, RCC.
[78] Section 42, RCC.

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2. Right to attend and vote in stockholders' meetings

a. Attendance and Voting Rights at Stockholder Meetings

Stockholders are entitled to attend stockholders' meetings, the annual and special meetings, and to vote on matters presented for voting. They can vote in person or by proxy in all meetings. When so authorized in the bylaws or by a majority of the board of directors, the stockholders of corporations may also vote through remote communication or in absentia.

On 12 March 2020, the Commission has issued SEC Memorandum Circular No. 6, s. 2020 prescribing the Guidelines on the Attendance and Participation of Directors, Trustees, Stockholders, Members, and Other Persons of Corporations in Regular and Special Meetings through Teleconferencing, Video Conferencing and Other Remote or Electronic Means of Communication. Hence, the company may conduct its meeting using teleconferencing, videoconferencing, computer conferencing or audio conferencing that allow stockholders' reasonable opportunities to participate where they can vote, speak, read or hear the discussions. This would include the right to vote of stockholders.

On the other hand, for proxies to be valid it is required to be in in writing, signed and filed, by the stockholder, in any form authorized in the bylaws and received by the corporate secretary within a reasonable time before the scheduled meeting. Unless otherwise provided in the proxy form, it shall be valid only for the meeting for which it is intended. Under the law, no proxy shall be valid and effective for a period longer than five (5) years at any one time.[79]

Voting trusts are also allowed by law. A voting trust agreement is defined as an agreement in writing whereby one or more stockholders of a corporation consent to transfer his or their shares to a trustee in order to vest in the latter voting or other rights pertaining to said shares for a period not exceeding five years upon the fulfillment of statutory conditions and such other terms and conditions specified in the agreement. The five year-period may be extended in cases where the voting trust is executed pursuant to a loan agreement whereby the period is made contingent upon full payment of the loan[80].

Hence, a stockholder of a stock corporation may create a voting trust for the purpose of conferring upon a trustee or trustees the right to vote and other rights pertaining to the shares for a period not exceeding five (5) years at any time.

There is also a special provision on the Right to Vote of Secured Creditors and Administrators in case a stockholder grants security interest in his or her shares in stock corporations. The secured creditor shall have the right to attend and vote at meetings of stockholder if such right is expressly given by the stockholder-grantor in writing which is recorded in the appropriate corporate books.[81]

Following the prescribed procedures, a stockholder may also be nominated and be voted upon for a seat or membership in the board of directors and also propose a special meeting of stockholders. [82]

[79] Section 57, RCC.
[80] Lee v. Court of Appeals, G.R. No. 93695, February 4, 1992.
[81] Section 54, RCC.
[82] Section 49, RCC.

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b. **Pre-emptive Rights**

All stockholders of a stock corporation have a right to enjoy pre-emptive rights to subscribe to all issues or disposition of shares of any class, in proportion to their respective shareholdings, unless such right is denied by the articles of incorporation or an amendment thereto.

However, such pre-emptive right shall not extend to shares issued in compliance with laws requiring stock offerings or minimum stock ownership by the public; or to shares issued in good faith with the approval of the stockholders representing two-thirds (2/3) of the capital stock, in exchange for property needed for corporate purposes or in payment of a previously contracted debt.[83]

c. **Right of Appraisal**

Under the law, any stockholder of a corporation shall have the right to dissent and demand payments of the fair value of the shares. It applies in the following instances:

1) In case an amendment to the articles of incorporation has the effect of changing or restricting the rights of any stockholders or class of shares, or of authorizing preferences in any respect superior to those of outstanding shares of any class, or of extending or shortening the term of corporate existence;

2) In case of sale, lease, exchange, transfer, mortgage, pledge or other disposition of all or substantially all of the corporate property and assets as provided in this Code;

3) In case of merger or consolidation; and

4) In case of investment of corporate funds for any purpose other than the primary purpose of the corporation.[84]

d. **Right of Inspection of Corporate Records**

Under the law, corporate records, regardless of the form in which they are stored, shall be open to inspection by any director or stockholder of the corporation, in person or by a representative, at reasonable hours on business days. To exercise such right, a demand in writing may be made by such director or stockholder at their expense for copies of such records or excerpts from said records. [85]

e. **Right to residual assets**

In case of liquidation, the shareholders, as owners, have a proportionate claim to the residual assets of the corporation after all debts and other liabilities are paid.

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[83] Section 38, RCC.
[84] Section 80, RCC.
[85] Section 73, RCC.

Part V. Valuation and Analysis of Securities

The investment process is a never-ending story of analyzing, evaluating, implementing, and monitoring. Macroeconomic and microeconomic factors such as inflation, unemployment, interest rates, foreign exchange rates, GNP, cost of wages, sales, etc. influence the investment landscape. Political and socio-cultural aspects likewise affect the investment environment. Trends in the global capital markets are also of crucial importance to the investor.

Against the backdrop of such investment environment, the investor seeks out his objectives of investment. The investor will be affected by his age, religion, tax bracket, among others. Risk plays an important role in coming up with investment objectives.

The next element in the investment process is portfolio (a basket of securities) screening and selection consistent with the constraints and objectives set forth by the investor. This process can be approached with the use of different valuation tools. In order to achieve the investment objectives and to determine the value of a portfolio, an investor must utilize valuation principles, and analyze the stocks, bonds, and derivative securities that make up the portfolio.

A. Valuation Principles and Practices

1. Analysis of Financial Statements

Financial statements are a structured representation of the financial position and financial performance of an enterprise. These financial reports aim to provide information about an enterprise's financial position, financial performance (or results of operations), and cash flows that is useful to a wide range of users in making economic as well as public policy (in the case of the government and its agencies) decisions. While enterprises can prepare interim financial information, financial statements are usually prepared and presented on an annual basis.

Financial statements are important in analyzing a company's financial performance, growth, and value. The following sub-sections discuss in detail the various financial tools and processes used in analyzing financial statements; the uses of the basic ratios of financial analysis which would assist a company and parties at interest to determine its financial strengths and weaknesses; the differences between a forecast and projection; how such forecasted or projected financial statements are prepared and used, and their limitations.

An efficient capital market would have already incorporated information from financial statements into security prices. If so, it may seem that analysis of the enterprise's financial statements and ratios is a waste of time. In fact, the contrary is true. Analysis of financial statements allows the would-be investor to gain knowledge of the enterprise's operating and financial structure. Combining knowledge of the enterprise's strategy, operating and financial leverage, and possible macroeconomic and microeconomic scenarios are necessary to determine an appropriate market price for the firm's stock. The final outcome of the process, is the market determination of the firm's current security price.

a. **Major Financial Statements**

A complete set of general purpose financial statements includes:

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- a statement of financial position as at the end of the period;
- a statement of profit or loss and other comprehensive income for the period;
- a statement of changes in equity for the period;
- a statement of cash flows for the period; and,
- notes to financial statements, comprising the significant accounting policies and other explanatory information.

An enterprise is required to disclose comparative information in respect of the previous period for all amounts reported in the current period's financial statements, except when Philippine Financial Reporting Standards (PFRS) specifically permits otherwise. It should also include comparative data for any narrative and descriptive information disclosed when such data is relevant to the understanding of the current period's financial statements.

1) Statement of Financial Position

A Statement of Financial Position presents an entity's assets, liabilities, and residual equity interest in the net assets as of a given point in time. This report shows the entity's financial position and condition, hence, also called Balance Sheet. A proper classification of the current and non-current portion of assets and liabilities should be presented separately in the statement of financial position except when a presentation based on liquidity (unclassified) provides information that is reliable and more relevant.

Asset or liability should be classified as current when:

a) it expects to realize the asset (or intends to sell or consume it) or settle the liability in its normal operating cycle;
b) it holds the asset or liability primarily for the purpose of trading;
c) it expects to realize the asset or settle the liability within twelve months after the reporting period; or
d) the asset is cash or a cash equivalent (as defined in PAS 7) unless the asset is restricted from being exchanged (or used to settle a liability) or the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

All other assets or liabilities should be classified as non-current. Whichever method of presentation (either classified or unclassified) is adopted, an enterprise should disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines amounts expected to be recovered or settled: a) no more than twelve months after the reporting period; and, b) more than twelve months after the reporting period.

2) Statement of Comprehensive Income/ Statement of Profit or Loss

The Statement of Profit or Loss shows the results of operations of an entity over a particular period of time. It presents the period's income and expenses and the resulting net income or loss.

Many large companies today prepare a Statement of Comprehensive Income. The Statement of Comprehensive Income presents a company's results of operations (net income or loss) and its other comprehensive income (OCI). If the company has no other comprehensive income, then the contents of the Income Statement and Statement of Comprehensive Income would be the same.

Other comprehensive income includes gains and losses that cannot be reported in the Income Statement such as revaluation surplus, translation adjustments, and unrealized gains, for a given period.

All items of income and expense recognized in a period should be presented: a) in a single statement of comprehensive income; or, b) in two statements: a statement displaying components of profit or loss (separate income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income).

3) Statement of Changes in Equity

The Statement of Changes in Equity shows the balances of the equity accounts at the beginning of the period, the changes that occurred during the period, and the ending balances as a result of such changes. Equity is commonly affected by additional subscriptions and issuance of shares, declaration of dividends to the shareholders and changes in the accumulated retained earnings as a result of the entity's operations over a particular period of time.

4) Statement of Cash Flows

The Statement of Cash Flows, or Cash Flow Statement, presents the beginning balance of cash, the changes that occurred during the period, and the cash balance at the end of the period as a result of the changes.

These changes represent the entity's cash inflows and outflows from three activities: operating, investing, and financing, during the reporting period.

a) The operating cash flows show the sources and uses of cash in the normal course of the company's operations. These may include Cash Sales, Collections of Accounts Receivable, Cash Purchases, Payments of Accounts Payable, Rent Payments, Wages and Salaries, Interest and Tax Payments.

b) The financing cash flows show the company's ability to service its debt, declare and pay dividends, or obtain funding for its operations from investors or creditors. Examples of financing cash flows are Loan Principal Payments, Payment of Cash Dividends, Proceeds from Loans, and Repurchases of Stocks.

c) The investing cash flows show the cash inflows and outflows associated with the purchase and sale of both productive assets and business interests. Capital expenditures for acquisitions of Property and Equipment, Proceeds from Disposal of Machinery, Acquisition of Investment in Stock of a Subsidiary are some of the items that may be included in investing cash flows.

5) Measures of Cash Flows

Traditional Cash Flow equals net income plus depreciation expense and the change in deferred taxes. But it is also necessary to adjust for changes in operating (current) assets and liabilities that either use or provide cash. These changes can add to or subtract from the cash flow estimated from the traditional measure of cash flow: net income plus noncash expenses.[86]

Free Cash Flow modifies cash flow from operations to recognize that some investing and financing activities are critical to the firm. It is assumed that these expenditures must be made before a firm can use its cash flow for other purposes such as reducing debt outstanding or repurchasing common stock. Two additional items are considered: (1) capital expenditures (an investing expenditure), and (2) the disposition of property and equipment (a divestment sources of cash).[87]

Earnings Before Interest, Taxes, Depreciation and Amortization (**EBITDA**) is extremely liberal. This very generous measure of operating earnings does not consider any of the adjustments noted previously. Specifically, it adds back depreciation and amortization (as in traditional measure) along with both interest expense and taxes, but does not consider the effect of changes in working capital items (such as additions to receivables and inventory) or the significant impact of capital expenditures. The result is basically operating earnings plus depreciation expense. However, this measure is not recommended to be used.[88]

b. **Purpose of Financial Statement Analysis**

Financial statement analysis seeks to evaluate management performance in several areas, including profitability, efficiency and risk. Although it involves analyzing historical data, the ultimate goal of this analysis is to provide insights that will help an investor or analyst to project future management performance, including pro forma balance sheets, income statements, cash flows, and alternative risk measures. It is the firm's expected future performance that determines whether an investor should lend money to a firm and invest in it.[89]

c. **Common Size Financial Statement Analysis**

The items in a financial statement (balance sheet, income statement or cash flow statement) may be shown as a percentage of a common base figure. Financial statements that indicate items as a percentage of selected based figures, instead of currency amounts, are called **common size financial statements**. These normalize financial statement items to allow easier comparison of different sized firms.[90]

Investors convert financial statements to common size financial statements, and evaluate these common size financial statements in order compare a company's performance from its competitors, and identify notable changes in its financial

[86] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 263.
[87] *Id.*, pg. 264.
[88] *Id.*, pg. 265.
[89] *Ibid.*
[90] *Id.*, pg. 267.

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position and cash flows. This method is called **common size financial statement analysis**.

In converting to common size financial statements, the usual base figure to which other line items in the balance sheet are expressed is **total assets**. For the income statement, the common base figure is the **total revenues**, while the **total cash inflow** is the base figure for cash flow statement items.

d. **Analysis of Financial Ratios**

Financial ratios are valuable analytical tools when used as part of a thorough financial analysis. Ratio analysis involves applying the methods for calculating and interpreting their results to assess a company's performance and condition. They may also be used as bases for financial forecast or projection. Ratio analysis makes use of financial data taken from the company's balance sheet and income statement for the periods to be examined.

The results of a ratio analysis are of interest to a company's shareholders, creditors, as well as its own management and other stakeholders. The company's current and future level of risk and return are the concern of the stakeholders. Having the overall financial performance of the company as their concern, the company's management use financial ratios to identify, isolate and address problems that are currently being experienced and to identify those that may arise in the future.

Creditors, on the other hand, are concerned with the company's short-term liquidity and its ability to repay debt. Creditors and investors would like to be certain that the company is profitable and would continue being financially sound in the future.

e. **Limitations of Financial Ratios**

Financial ratios are useful tools in analyzing a company's financial position and performance. However, in using these ratios, the following limitations should be considered:

1) The information used in computing for the financial ratios are based on historical data. Hence, financial ratios do not guarantee that the company's previous performance and position will carry forward into the future.

2) The usefulness of financial ratios is affected by inflation. In analyzing financial statements that involve two different time periods, inflation may distort the financial ratios due to the occurrence of inflation between the time periods. Moreover, assets are usually acquired at different dates, and the figures in the financial statements are not adjusted to reflect the influence of inflation. Therefore, unless these figures are adjusted for inflation, there is a possibility that the resulting financial ratios will be distorted.

3) The accounting policies adopted by a company may affect the financial ratios. A company may change its accounting policies during a reporting period, thus, making the figures recorded after the change not comparable to the figures recorded prior the change. Moreover, in analyzing the financial ratios of different companies, it is possible that these companies are not using the same accounting policies and methods (*e.g.* one company might be using a straight-

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line depreciation method, while the other might be using units-of-production method).

4) Not all companies are created equal. Not only do companies differ in accounting policies and methods, they also differ in size, in the industry they belong to, and in the type of business strategies they implement. Hence, these factors should be considered in analyzing financial ratios.

5) Other Limitations. Financial analysts should also be able to discern and consider other limitations, as follows:

   a) Rules of thumb for comparative analysis

      i. While some rules of thumb on desired ratios have been set, acceptable ratios may differ from one industry to another.

      ii. Using ratio analysis to compare companies within the industry with different accounting policies may yield misleading results.

   b) Data source of ratios

      i. Ratios are based on financial statements of a company as of a given period. An analyst must bear in mind that the figures therein are based mostly on historical costs.

      ii. Most ratios disregard off-balance sheet items which may have a significant impact on a company's operation.

   c) Use of single ratios

   Although single ratios serve as measures by themselves, such measures should not be regarded as conclusive. As a check, the analyst may compare the results with industry developments or current market conditions, the company's historical financial performance, as well as future plans.

   d) Use of multiple ratios

   While no one ratio can tell a story, more ratios do not necessarily make a better analysis. Multiple ratios should be used in relation to related accounts and an overall analysis of the company's financial condition, results of operations and cash flows.

f. **Computation of Financial Ratios**

The financial ratios are subdivided into four specific areas of analysis: liquidity, activity, leverage, and profitability.

1) **Liquidity ratios**

A company's liquidity refers to its ability to fulfill its obligations when they become due. In determining the liquidity of a company, the following basic indicators are used: a) Current Ratio, and b) Quick or Acid-Test Ratio.

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a) Current ratio

The Current Ratio is an indicator of the company's ability to pay its short-term obligations. This is computed by dividing Current Assets by Current Liabilities. Current Assets normally include Cash, Marketable Securities, Accounts Receivable, and Inventories while Current Liabilities consist of Accounts Payable, Short-term Notes Payable, Current Maturities of Long-Term Debt, Accrued Income Taxes, and Other Accrued Expenses.

$$Current\ Ratio = \frac{Current\ Assets}{Current\ Liabilities}$$

b) Quick or Acid test ratio

The Quick or Acid Test Ratio shows the extent to which a firm can meet its short-term obligations without relying on the sale of its inventories. It is calculated by subtracting Inventories from Current Assets, then dividing it by Current Liabilities. Basically, this ratio is a measure of how "quick" the company's assets could be turned into cash. Inventories are deducted since these are the least liquid among the Current Asset accounts.

$$Quick\ or\ Acid\ Test\ Ratio = \frac{(Current\ Assets - Inventories)}{(Current\ Liabilities)}$$

2) **Activity ratios**

Activity ratios measure how effectively the enterprise is using its assets for its operations. It indicates a company's ability to convert different accounts within their balance sheets into cash or sales. Companies seek to turn their productions or services into cash or sales as fast as possible because this will generally lead to generation of higher revenues.

a) Inventory turnover

This ratio shows how many times the inventory of a company is sold and replaced over a specific period of time. Inventory Turnover is computed by dividing Cost of Sales by average inventory.

$$Inventory\ Turnover = \frac{Cost\ of\ Sales}{(Beginning\ Inventory + Ending\ Inventory) \div 2}$$

b) Average collection period

The Average Collection Period is used to determine the average number of days that Accounts Receivables get to be collected. This can be computed in two steps:

- Annual Sales is divided by 360 to obtain the Average Daily Sales, and
- Average Accounts Receivable is divided by Average Daily Sales to find the number of days sales is tied up in receivables

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$$Average\ Collection\ Period = \frac{(Beginning\ Accounts\ Receivable + Ending\ Accounts) \div 2}{Annual\ Sales\ \div 360}$$

c) Average payment period

The Average Payment Period determines the average number of days that a company settles its Accounts Payable with its suppliers. This is computed by dividing Accounts Payable by Average Purchases per Day. Average Purchases per Day is arrived at by dividing Annual Purchases by 360.

$$Average\ Payment\ Period = \frac{(Beginning\ Accounts\ Payable + Ending\ Accounts) \div 2}{Annual\ Purchases\ \div 360}$$

d) Fixed asset turnover

The Fixed Asset Turnover measures how efficiently a company has been using its fixed assets to generate sales. Fixed Assets, in this context, refers to Property, Plant, and Equipment which are used in the conduct of business and are not intended for sale.

They are also referred to as "earning assets" because they generally provide the basis for the firm's earning power and value. The Fixed Asset Turnover is computed by dividing the company's Net Sales by its Average Net Fixed Assets. Net sales pertains to sales less returns, and allowances and discounts. On the other hand, Net Fixed Assets refers to Fixed Assets less Accumulated Depreciation and any impairments.

$$Fixed\ Asset\ Turnover = \frac{Net\ Sales}{Average\ Net\ Fixed\ Assets}$$

e) Total asset turnover

Total Asset Turnover measures the company's efficiency at using its assets to generate earnings and is determined by dividing Net Sales by Average Total Assets.

$$Total\ Asset\ Turnover = \frac{Net\ Sales}{Average\ Total\ Assets}$$

3) **Leverage ratios**

Leverage ratios measure the funds supplied by a company's owners against the financing provided by its creditors. In essence, it is a creditor's measure of the financial risk it is taking on the Company.

a) Debt ratio

Debt Ratio is calculated by dividing Total Liabilities by Total Assets. This ratio measures the percentage of total funds provided by creditors. The higher the debt ratio, the more financial leverage a company has.

$$Debt\ Ratio\ = \frac{Total\ Liabilities}{Total\ Assets}$$

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4) **Profitability ratios**

The analysis of a company's profitability ratios tells how well management is using the company's resources to generate earnings. Profitability ratios measure the extent by which an enterprise generates revenues to cover its cost of operation and provides a return to its owners or investors. Gross Profit Margin, Operating Profit Margin, Net Profit Margin, Return on Assets, Return on Equity, Earnings Per Share, and Price or Earnings Ratios are useful for internal financial performance evaluation and external comparisons.

a) Gross Profit Margin

The Gross Profit Margin is an indication of management's efficiency in turning over the company's products at a profit after allowing for the Cost of Goods Sold. It shows the margin available to cover operating costs and the remaining yield out of the company's operations.

$$Gross\ Profit\ Margin\ =\ \frac{Net\ Sales - Cost\ of\ Sales}{Net\ Sales} \times 100$$

b) Operating Profit Margin

Operating Profit Margin is a more stringent measure of the company's ability to manage its resources as it takes into account the Selling, General and Administrative Expenses incurred in producing its Revenues. It does not cover Interests and Taxes. This is calculated by dividing Operating Profits by Net Sales.

$$Operating\ Profit\ Margin\ =\ \frac{Operating\ Profits}{Net\ Sales} \times 100$$

c) Net Profit Margin

Net Profit Margin is an important indicator that shows how efficiently the company is managed after taking into account all Costs, Expenses, Interests and Taxes. This ratio is the end result of the company's operations for the period. It effectively sums up in a single figure management's ability to run the business.

$$Net\ Profit\ Margin\ =\ \frac{Net\ Income}{Net\ Sales} \times 100$$

d) Return on Assets (ROA)

The Return on Assets seeks to measure the effectiveness with which the firm has employed its total resources. This profitability ratio is sometimes associated with Return on Investments (ROI). This is computed by taking Net Income and dividing it by the company's Average Total Assets.

$$ROA = \frac{Net\ Income}{Average\ Total\ Assets} \times 100$$

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The higher the ROA of a company, the more effective a company is in generating profits with its available assets.

e) Return on Equity (ROE)

Return on Equity measures the rate of return on the stockholders' investment in the company. The higher the ROE of the company, the better off the stockholders are. The computation of ROE is shown below.

$$ROE = \frac{Net\ Income}{Average\ Stockholders'Equity} \times 100$$

f) Earnings Per Share (EPS)

Earnings Per Share is the amount earned during the period from each outstanding share of common stock. EPS is computed by dividing the period's Net Income by the Weighted Average Number of Shares Outstanding.

$$EPS = \frac{Net\ Income}{Weighted\ Average\ Number\ of\ Shares\ Outstanding}$$

g) Price/Earnings (P/E) Ratio

The Price/Earnings Ratio measures the amount an investor would be willing to pay for each peso of a company's earnings. In computing for the P/E ratio, it is necessary to initially calculate for the company's EPS since this would be used as the denominator.

$$P/E\ Ratio = \frac{Market\ Price\ per\ Share\ of\ Common\ Stock}{Earnings\ Per\ Share}$$

g. **Risk Analysis**

Risk analysis examines the uncertainty of income flows for the total firm and for the individual sources of capital (that is, debt, preferred stock, and common stock). The typical approach examines the major factors that cause a firm's income flows to vary. More volatile income flows mean greater risk (uncertainty) facing the investor.[91]

The total risk of the firm has three important components/factors: two internal and one external. Business risk and financial risk are the internal components, while external liquidity risk is an important external risk factor.

Business risk is the uncertainty of operating income caused by the firm's industry. This uncertainty is due to the firm's variability of operating earnings caused by its products, customers, and the way it produces its products. Specifically, a firm's business risk is measured by the volatility of the firm's operating income over time. In turn, this volatility of operating earnings is due to two factors: (1) the volatility of

[91] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 281.

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the firm's sales over time, and (2) how the firm produces its products in terms of its mix of fixed and variable costs – that is, its operating leverage.[92]

Financial risk is the additional uncertainty of returns to equity holders due to a firm's use of fixed financial obligation securities. This financial uncertainty is in addition to the firm's business risk. When a firm sells bonds to raise capital, the interest payments on this capital will precede the computation of common stock earnings, and these interest payments are fixed contractual obligations. As with operating leverage, during an economic expansion, the net earnings available for common stock after the fixed interest payments will experience a larger percentage increase than operating earnings. In contrast, during business decline, the earnings available to stockholders will decline by a larger percentage than operating earnings because of these fixed financial costs (*i.e*. interest payments). Notably, as a firm increases its relative debt financing with fixed contractual obligations, it increases its financial risk and the possibility of default and bankruptcy.[93]

Relationship between Business risk and Financial Risk. A very important point to remember is that the acceptable level of financial risk for a firm depends on its business risk. If the firm has low business risk (*i.e*., stable operating earnings), investors are willing to accept higher financial risk. In contrast, if a firm is in an industry that is subject to high business risk, an investor would not want these firms to also have high financial risk.[94]

External Market Liquidity is the ability to buy or sell an asset quickly with little price change from a prior transaction assuming no new information. Investors might be able to sell an illiquid stock quickly, but the price would be significantly different from the prior price. Alternatively, the broker might be able to get a specified price, but it could take several days to do it. The most important determinant of external market liquidity is the number of shares or the dollar value of shares traded (the dollar value adjusts for different price levels). More trading activity indicates a greater probability that one can find someone to take the other side of a desired transaction. A very good measure that is usually available is **trading turnover** (the percentage of outstanding shares traded during a period of time), which indicates relative trading activity. It is computed by dividing the number of shares traded during the year with the average number of shares outstanding during the year.[95]

h. **Analysis of Growth Potential**

The analysis of sustainable growth potential examines ratios that indicate how fast a firm should grow. Analysis of a firm's growth potential is important for both lenders and owners. Owners know that the value of the firm depends on its future growth in earnings, cash flows, and dividends.[96]

Creditors are also interested in a firm's growth potential because the firm's future success is the major determinant of its ability to pay obligations, and the firm's future success is influenced by its growth. Currently, it is widely recognized that the

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[92] *Id.*, pg. 282.
[93] *Id.*, pg. 283-284.
[94] *Id.*, pg. 284.
[95] *Id.*, pg. 291-292.
[96] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 292-293.

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more relevant analysis is the ability of the firm to pay off its obligations as an ongoing enterprise, which is impacted by its growth potential.[97]

The growth of the business, like the growth of any economic entity, including the aggregate economy, depends on:

1) The amount of resources retained and reinvested in the entity; and
2) The rate of return earned on the reinvested funds.

The more a firm reinvests, the greater its potential for growth. Alternatively, for a given level of reinvestment, a firm will grow faster if it earns a higher rate of return on the funds reinvested. Therefore, the growth rate of equity earnings and cash flows is a function of two variables: (1) the percentage of net earnings retained (the firm's retention rate), and (2) the rate of return earned on the firm's equity capital (the firm's ROE), because when earnings are retained they become part of the firm's equity.[98]

i. **The Value of Financial Statement Analysis**

While the analysis of financial statements seems like a waste of time because it uses historical data, it allows an investor or analyst to gain knowledge of a firm's operating and financial strategy and structure. This, in turn, assists the analyst in determining the effects of future events on the firm's cash flows. Combining knowledge of the firm's operating and financial leverage, its strategy, and possible macro- and microeconomic scenarios is necessary to determine an appropriate market value for the firm's stock. Combining the analysis of historical data with potential future scenarios allows analysts to evaluate the risks facing the firm and then to develop an expected return and cash flow forecast based on these risks. The detailed analysis of the historical results ensures a better estimation of the expected cash flows and an appropriate discount rate, which in turn leads to a superior estimate of the intrinsic value of the firm.[99]

j. **Specific Uses of Financial Ratios**

In addition to measuring firm performance and risk, financial ratios have been used in three major areas in investments: (1) stock valuation, (2) assigning credit quality ratings on bonds, and (3) predicting insolvency (bankruptcy) of firms.[100]

1) **Stock Valuation Models**

Most valuation models attempt to derive a value based on one of several present value of cash flow models or appropriate relative valuation ratios for a stock. All the valuation models require an estimate of the expected growth rate of earnings, cash flows, or dividends and the required rate of return on the stock. Clearly, financial ratios can help in estimating these critical inputs.[101]

[97] *Id.*, pg. 293.
[98] *Ibid.*
[99] Reilly and Brown, *supra* note 86, pg. 299.
[100] *Ibid.*
[101] *Ibid.*

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When estimating the required rate of return on an investment, these estimates depend on the risk premium for the security, which is a function of its business risk, financial risk, and liquidity risk. Business risk is typically measured in terms of earnings variability; financial risk is identified by either the debt proportion ratios or the earnings or cash flow ratios.[102]

Financial Ratios:
a) Average debt-equity
b) Average interest coverage
c) Average dividend payout
d) Average return on equity
e) Average retention rate
f) Average market price to book value
g) Average market price to cash flow
h) Average market price to sales

Variability Measures:
a) Coefficient of variation of operating earnings (adjusted for growth)
b) Coefficient of variation of sales (adjusted for growth)
c) Coefficient of variation of net income (adjusted for growth)
d) Systematic risk (beta)

Non-ratio Variable:
a) Average growth rate of earnings and cash flows

These ratios can also be used as a filter to derive a subset of stocks to analyze from some total universe of stocks.[103]

2) **Estimating the Ratings on Bonds**

In the Philippines, a Credit Rating Agency ("CRA") means any corporation principally and regularly engaged in the business of performing credit evaluation of corporations and business projects or of debt issues with the intention of assessing the overall creditworthiness or of ascertaining the willingness and ability of the issuer to pay its financial obligations as they fall due, and which assessment is translated by credit ratings periodically and publicly announced[104].

An issuer of commercial papers shall be rated by a CRA accredited by the Commission, except:

a) For an issuance that amounts to not more than twenty-five percent (25%) of the issuer's net worth both on the basis of its stand-alone Audited Financial Statements and Consolidated Audited Financial Statements, if applicable; or

b) Where there is an irrevocable committed credit line with a bank covering one hundred percent (100%) of the proposed issuance. [105]

[102] *Ibid.*
[103] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 300.
[104] Rule 39.1.5.1 of the 2015 Implementing Rules and Regulations of the Securities Regulation Code.
[105] Rule 12.1.2.1.3, *id.*

A CRA is required to have a well-defined and updated credit rating criteria, which are uniformly applicable across companies.[106] The rating definitions, policy for use, and rating criteria shall be explained to the rated entity before the rating services are engaged.[107] Moreover, a CRA is required to disclose whether its ratings indicate the probability of default on the rated instrument, issuer, or expected loss (which factors in recoveries post-default)[108].

Numerous studies have used financial ratios to predict the rating to be assigned to a bond. The major financial variables considered in these studies were as follows[109]:

Financial Ratios:
a) Long-term debt-total assets
b) Total debt-total capital
c) Net income plus depreciation (cash flow)-long-term senior debt
d) Cash flow-total debt
e) Earnings before interest and taxes (EBIT)-interest expense (fixed charge coverage)
    i. Cash flow from operations plus interest-interest expense (cash flow coverage)
    ii. Market value of stock-par value of bonds
    iii. Net operating profit-sales
    iv. Net income-owners' equity (ROE)
    v. Net income plus interest expense-total assets (ROA)
    vi. Working capital-sales
    vii. Sales-net worth (equity turnover)

Variability Measures:
a) Coefficient of variation of sales (adjusted for growth)
b) Coefficient of variation of operating earnings (adjusted for growth)
c) Coefficient of variation of net earnings (adjusted for growth)
d) Coefficient of variation of return on assets

Non-ratio Variable:
a) Subordination of the issue
b) Size of the firm (total assets)
c) Size of the firm (market value of stock)
d) Issue size for alternative bond issues
e) Par value of all publicly traded bonds of the firm

3) **Predicting Insolvency (Bankruptcy)**

Analysts have always been interested in using financial ratios to identify firms that might default on a loan or declare bankruptcy. The analysis involves examining a number of financial ratios expected to reflect declining liquidity for several years prior to the declaration of bankruptcy. Some of the financial ratios included in successful models for predicting bankruptcy were as follows[110]:

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[106] Rule 39.1.5.4.2.3.2, *id.*
[107] Rule 39.1.5.4.1.3, *id.*
[108] Rule 39.1.5.4.2.1, *id.*
[109] Reilly and Brown, *supra* note 93.
[110] *Id.*, pg. 301.

Financial Ratios:
a) Cash flow-total debt
b) Cash flow-long-term debt
c) Sales-total assets
d) Net income-total assets
e) EBIT/total assets
f) Total debt/total assets
g) Market value of stock-book value of debt
h) Working capital-total assets
i) Retained earnings-total assets
j) Current ratio
k) Working capital-sales

2. Security Valuation Principles

Analysts and investors use several valuation models which are based from different assumptions. According to Prof. Aswath Damodaran, there are four approaches to valuation. The first, **discounted cash flow valuation**, relates the value of an asset to the present value of expected future cash flows on that asset. The second, **liquidation and accounting valuation**, is built around valuing the existing assets of a firm, with accounting estimates of value or book value often used as a starting point. The third, **-relative valuation**, estimates the value of an asset by looking at the pricing of 'comparable' assets relative to a common variable like earnings, cash flows, book value or sales. The final approach, **contingent claim valuation,** uses option price models to measure the value of assets that share option characteristics.[111]

On the other hand, Reilly and Brown submit that there are two general approaches to the valuation process: (1) the top-down, three-step approach, or (2) the bottom-up, stock valuation, stock picking approach.[112]

The difference between the two-approaches is the perceived importance of the economy and a firm's industry on the valuation of a firm and its stock. Advocates of the top-down, three-step approach believe that both the economy/market and the industry effect have a significant impact on the total returns for individual stocks. In contrast, those who employ the bottom-up, stockpiling approach contend that it is possible to find stocks that are undervalued relative to their market price, and these stocks will provide superior returns regardless of the market and industry outlook.[113]

a. An Overview of the Valuation Process

Reilly and Brown posit that, regardless of the qualities and capabilities of a firm and its management, the economic and industry environment will have a major influence on the success of a firm and the realized rate of return on its stock. They recommend a three-step, top-down valuation process in which you first examine the influence of the general economy on all firms and the security markets, then analyze the prospects for alternative global industries in this economic environment, and finally turn to the analysis of individual firms in the alternative industries and to the common stock of these firms.[114]

[111] Aswath Damodaran, *Valuation Approaches and Metrics: A Survey of the Theory and Evidence* (2006).
[112] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 310.
[113] *Ibid*.
[114] Reilly and Brown, *supra* note 102, pg. 311.

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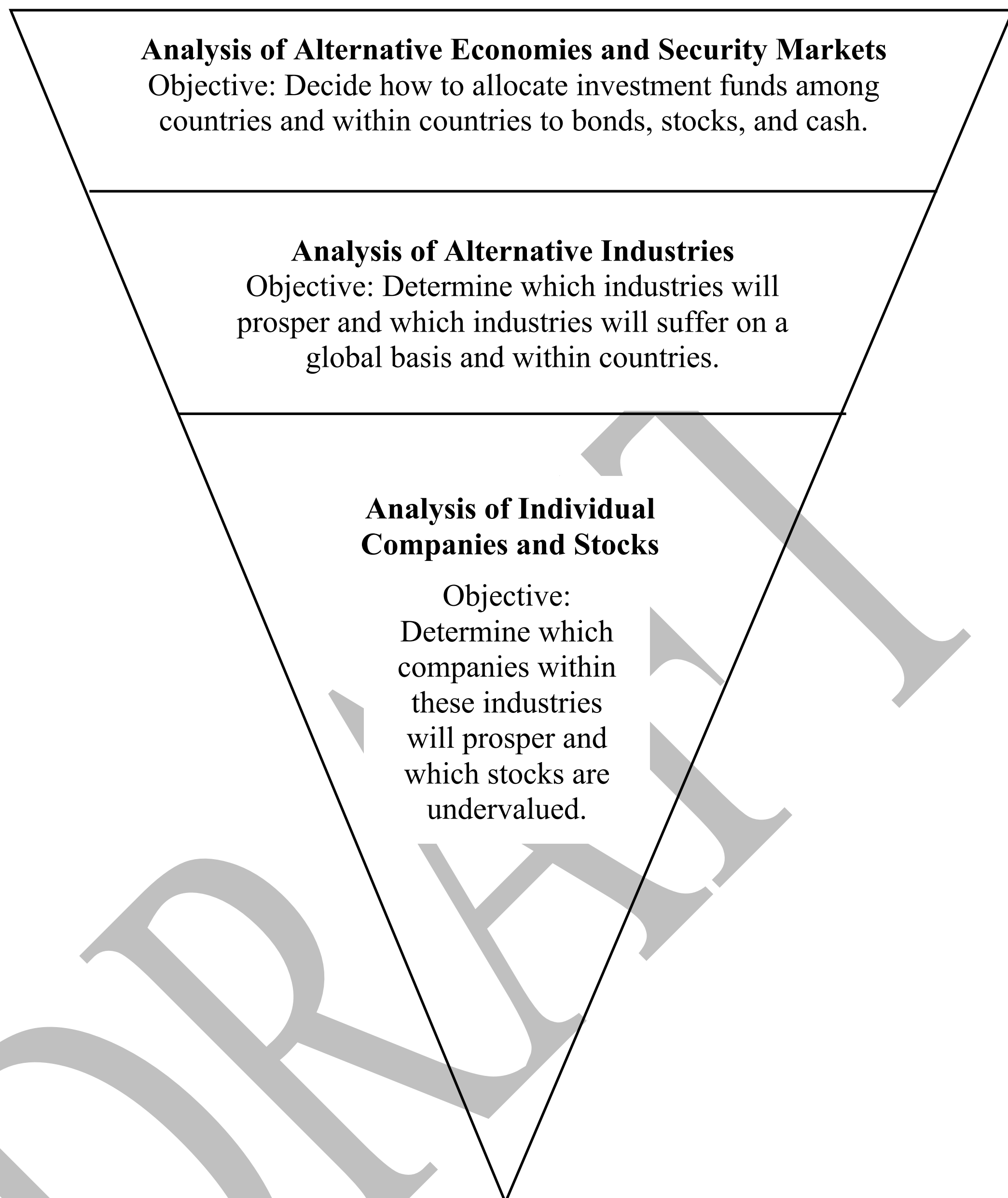

b. **Why a Three-Step Valuation Process?**

This valuation process is a big-picture to smaller-picture way of examining things, providing a comprehensive framework of analysis. The first step is to look at the macro-economic factors affecting the global economy (*e.g.* oil prices, geopolitical risks, and the local economy (*e.g.* GDP, interest rates, foreign exchange) which have an impact on the key inputs to valuation particularly on cash flows, risk and timing. The second step is to look at the industry factors that influence business performance, for generally each industry presents its own characteristic risks and opportunities. The third step is to look at the individual business itself by doing a company analysis which focuses on the securities issuer itself.

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1) General Economic Influences/Considerations

a) Macroeconomic Factors

The rise and fall of the security markets is inextricably linked to the changes in the aggregate economy. The price of a firm's stock reflects investor's expectations about the firm's performance in terms of earnings as well as the investor's required rate of return. Such stock price performance is likewise affected by the overall performance of the economy. For bonds, the price is determined by interest rates, which are also influenced by the overall economic activity and the monetary policy of the Bangko Sentral ng Pilipinas (BSP).

In monitoring business cycles, the National Statistical Coordination Board (NCSB) and the National Economic and Development Authority (NEDA) have jointly developed the Leading Economic Indicators (LEIs) system to serve as basis for short-term forecasting of the macroeconomic activity in the country (with said system now a maintained database by the Philippine Statistic Authority or PSA). The LEIs include eleven identified indicators generated on a quarterly basis. One of these indicators is the Philippine stock price index. Analysis of the relationship between the economy and the stock market has been consistent, making stock prices one of the better leading indicator series.

Understanding the economy and economic policies

A macroeconomy can be viewed as an aggregate of interlinked sectors that produce goods and services and respond to market forces of demand and supply, among others. The macroeconomy is described by the aggregation of total expenditure of the sectors and the national income Y:

$$Y = C + I + G + (X - M)$$

In this equation, Y or output refers to the aggregate earnings of the factors of production (national) plus indirect taxes (net) and capital consumption allowance. National output is measured by the gross domestic product (GDP), which refers to the value of all goods and services produced domestically by all resident sectors engaged in production, given a specified time period. Another measure of output is the gross national product (GNP), which is the sum of all goods and services produced by the Filipino-owned factors of production in the country and elsewhere in the rest of the world. The GNP figure for the Philippines is usually higher than GDP as the former includes net factor income from the rest of the world.

Economic sectors that constitute total national expenditure comprise the household consumption (C), investment or capital formation by the business sector (I), expenditures by the government (G), and net exports (X-M), that is, total export earnings (X) less total import bill (M). All these are major components of the macroeconomy that influence valuation.

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b) Political Social and Environmental Status

Aside from the economic indicators mentioned above, the analyst also has to consider the performance of other regional stock markets. The globalization of financial markets increased the correlation among the indices of the major markets. For example, the fall in equity markets was a global phenomenon because the subprime crisis led to either an economic slowdown or a full-blown recession in some major economics. The fall in Wall Street was followed by substantial declines in Asian bourses for the year 2008: Shanghai composite declined by 68.4%; India's SENSEX by 52.4%; Jakarta Composite Index by 50.6%; Singapore's Strait Times by 49.4%; and the Philippine Stock Exchange Index (PSEi) by 48.3%. For the first half of 2009, the recovery of the local bourse mirrored developments in several exchanges in Asia. This shows the connectedness of global markets.

Moreover, political risks tend to affect the growth of the Philippine economy. Woes in the political arena may also pull down the PSEI. This risk is seriously taken into consideration by investors and independent rating agencies as it impacts on domestic consumer and business confidence. It affects spending patterns, investment decisions and planning. Likewise, foreign investors tend to shy away from markets whose locals are not confident of even their own government's ability to steer the economy.

Finally, sentiments regarding the economy affect market psychology. Consumers' and producers' optimism or pessimism concerning the economy are equally important in determining economic performance. If consumers have confidence about future income levels, they will be more than willing to spend on big-ticket items. Similarly, business will increase production and inventory levels if they anticipate higher demand for their products. Given such, beliefs influence how much consumption and investment will be pursued and thus affect the aggregate demand for goods and services. In the Philippines, there are a number of consumers and firm surveys that attempt to capture sentiments and outlook regarding the economy in general, as well as snapshots of issues of particular concern to the polled respondents. For example, there is the executive outlook survey of the Makati Business Club (MBC), and the quarterly business expectations survey of the BSP.

2) Industry Analysis/ Industry Influences

Industry analysis is the second step in the Three-Step Valuation Process. From the macroeconomic analysis, we move down to examining the industries in the general economy. The fact is, every industry has its own characteristics and influence on the companies within its classification, because they're a part of that business sector.

Cross-Sectional Industry Performance

To find out if the rates of return among different industries varied during a given period, researchers compared the performance of alternative industries during a specific time period. Studies of the annual performance by numerous

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industries found that different industries have consistently shown wide dispersion in their rates of return. These results imply that industry analysis is important and necessary to uncover these substantial performance differences – that is, industry analysis helps identify both unprofitable and profitable opportunities.[115]

Industry Performance over Time

Another set of studies questioned whether industries that perform well in one time period would perform well in subsequent time periods, or outperform the aggregate market in the later time period. These time-series studies imply that past performance alone does not project future industry performance. The results do not, however, negate the usefulness of industry analysis. They simply confirm that variables that affect industry performance change over time, and each year it is necessary to estimate the current intrinsic value for each industry based on future estimates of relevant variables and compare this to its current market price.[116]

Performance of the Companies within an Industry

Other studies examined whether there is consistency in the performance of companies within an industry. These studies typically have found wide dispersion in the performance among companies in that industry that would do well. The fact that there is not a strong industry influence across firms in most industries means that a thorough company analysis is necessary. Still, industry analysis is valuable because it is much easier to select a superior company from a good industry than to find a good company in a poor industry. By selecting the best stocks within a strong industry, an investor avoids the risk that his analysis and selection of the best company in the industry will be offset by poor industry performance.[117]

Differences in Industry Risk

The studies of risk dispersion found a wide range of risk among different industries and the differences in industry risk typically widened during rising and falling markets. Although risk measures for different industries showed substantial dispersion during a period of time, individual industries' risk measures are stable over time. Hence, the dispersion means that the analysis of industry risk is necessary, but this analysis of risk is useful when estimating the future risk for an industry.[118]

Summary of Research on Industry Analysis

The conclusions of the studies dealing with industry analysis are:

- During any time period, the returns for different industries vary within a wide range, which means that industry analysis is an important part of the investment process;

[115] *Id.*, pg. 397-398.
[116] *Id.*, pg. 398.
[117] *Ibid*.
[118] *Ibid*.

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- The rates of return for individual industries vary over time, so we cannot simply extrapolate past industry performance into the future;

- The rates of return of firms within industries also vary, so analysis of individual companies in an industry is a necessary follow-up to industry analysis;

- During any time period, different industries' risk levels vary within wide ranges, so we must examine and estimate the risk factors for alternative industries; and

- Risk measures for different industries remain fairly constant overtime, so the historical risk analysis is useful when estimating future risk.[119]

Industry Analysis Process

Industry analysis process is similar to the analysis of the economy and the aggregate equity market. It involves a macroanalysis of the industry to determine how this industry relates to the business cycle and what economic variables drive this industry. Macroanalysis of the industry will make the estimation of the major valuation inputs (a discount rate and the expected growth for earnings and cash flows) easier and more accurate.[120]

3) Company Analysis

Company Analysis is the third step in our valuation process. This analysis focuses on the status and prospects of the business itself, with specificity. The company after all is the Issuer of those securities traded in the market and its specific business condition is at the core that determines the value of the securities as investment.

Firm Competitive Strategies

A company's competitive strategy can either be defensive (involves positioning the firm to deflect the effect of the competitive forces in the industry) or offensive (the firm attempts to use its strengths to affect the competitive forces in the industry).[121]

Low-cost strategy – consists of business approaches and initiatives undertaken by a company to become the low-cost producer and, hence, the cost leader in its industry.[122]

Differentiation strategy - consists of business approaches and initiatives undertaken by a company to identify itself as unique in its industry in an area that is important to buyers.[123]

[119] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 399.
[120] *Ibid*.
[121] Keith C. Brown, Herbert B. Mayo and Krishna G. Palepu, Security Analysis, compiled by Dr. Anthony DC Altarejos (2015).
[122] *Id.*
[123] *Id.*

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Whichever strategy it selects, a firm must determine where it will focus this strategy, specifically, a firm must select segments in the industry and tailor its strategy to serve these specific groups.[124]

SWOT Analysis

As we might understand, there can be, and there are, so many approaches to analyzing a company's condition and prospects. Here, however, we choose to focus on a familiar, tested analytical framework called SWOT, for STRENGTH-WEAKNESSES-OPPORTUNITIES-THREATS.

The analytical exercise usually is conducted visually by drawing four quadrants, each of which is labelled as S, W, O and T, and every quadrant space filled in with the identified elements/characteristics. As an example:

STRENGTHS	WEAKNESSES
• Multiple products • Established brands • Strong supply chain	• Product prices relatively high • Salesforce stretches • Finances limited
OPPORTUNITIES	THREATS
• An expanding market • Unused manufacturing capacity • A new major investor	• A big competitor coming • Liberalized imports • Competing substitute Products

This, of course, is a very limited example, but drives the point of the analysis. This framework invites the analyst to seek and identify the central elements that go to the development of a coherent business strategy.

Strengths are all the positive components of the business as represented by all kinds of resources – management, workforce, finances, products, raw materials availability, marketing strength, market share, etc.

Weaknesses are those factors that limit the company's ability to be more competitive - weaknesses in people, products, capital, customer loyalty. Operational inefficiencies would be part of these. The weakness may be lack of, or deficiency in, resources.

Opportunities are those factors which can make the company more profitable, more competitive, more established in the marketplace. These include all those developments in the marketplace which present an expansion of prospective customers.

Threats are all those external factors which could prove to be obstacles or hindrances to the achievement of the company's business plans, such as those which threaten share of market, customer loyalty, and ability to comply with more stringent government regulations. The deterioration of the general economy and conditions in the industry are constant threats.

[124] *Id.*

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To many business managers, the product-market strategy is the central issue, and those who do company analysis often check the relevance of this company strategy to evaluate continued competitiveness in an evolving market and economic environment. Where resources are always limited, there is a premium to a concentrated application of resources where the advantages are clear. In other words, a sharp, focused competitive strategy rather than a dispersed one is the objective. Ultimately, company analysis must be directed to zero in on the competence and experience of a tested management in command of the company.

c. **Theory of Valuation**

The theory of company valuation that is presented as a logical one by proponents is that the value of a company is the equivalent of all the accumulated streams of expected returns or cash flows to be generated by the company in the future. But since future cash flows are not as valuable as present cash flows or, stated a bit differently, since present cash held now is of greater value than future cash still to be received, the future cash flows should be restated and translated to their value equivalent today, i.e. their present value, in computing the consolidated value of the company today.

To translate future cash flows to their present value, Present Value Tables are used which are pre-computed figures or amounts.

Translating future cash flows to their present value requires the choice of a discount rate or a "required rate of return" to apply to the future cash flows to bring them to their equivalent present value today. This exercise of translating is called **discounting** and the result of adding all these discounted future cash flows will give us the estimated "true" intrinsic value of the company, from which the value per share can be derived and computed.

This resulting value should be compared to the market price. If the market price is higher, we may conclude there is an overprice by the market. If the market price is lower, we may conclude there is an underprice by the market.

This theory is a popular model for assessing the value of a firm as a going concern. It is based on the observation that a stock investor expects a return consisting of cash dividends and capital gains (or losses) when he finally sells the stock.

Approaches to the Valuation of Common Stock

Let's put common stock valuation in a broad framework.

Valuation techniques of common stock have been generally classified into two approaches:

1) The **discounted cash flow valuation technique**, which measures the present value of future cash flows, including dividends, operating cash flow and free cash flow; and

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2) The **relative valuation technique** which estimates the value of the stock based on its current price relative to variables considered relevant to valuation, such as earnings, cash flow, book value, or sales.

The ***Discounted Cash Flow (DCF) Valuation*** approach identifies three techniques but all three are based on the basic valuation model which asserts that the value of an asset is the present value of its expected cash flow.

The first DCF technique is the **Dividend Discount Model** or **DDM** for short. This model assumes that the value of a share of common stock is the present value of all future dividends. This requires making estimates of the future dividends and of the rate of return. Assumptions have to be made.

One starting assumption is that there is a dividend during a Period, and the stock is held for an infinite period. But what if there are no dividends paid? or if the stock is not held for an indefinite period? There are formulas to make reasonable estimates in these cases, which are based on some additional assumptions.

Also, a required rate of return must be determined to apply to the future dividends, to compute their present value. By consensus, this rate of return is the nominal risk-free rate and the expected rate of inflation. For this real risk-free rate, a proxy is often used in a government bond, and in the U.S. it's the 10-year government bond's promised yield.

A second DCF technique is to compute the **Present Value of Operating Cash Flows or OCF**. Here, what is discounted are "the operating free cash flows prior to the payment of interest to the debt holders but after deducting funds needed to maintain the firm's asset base (capital expenditures). Also, because you are discounting the total firm's operating free cash flows, you would use the firm's weighted average cost of capital (WACC) as your discount rate."[125]

A third DCF technique is the **Free Cash Flows to Equity** or **FCFE.** The free cash flows to equity are "derived after operating free cash flows have been adjusted for debt payments (interest and principal). Also, these cash flows precede dividend payments to the common stockholder. Such cash flows are referred to as free because they are what is left after providing the funds needed to maintain the firm's asset base (similar to operating free cash flow). They are specified as free cash flows to equity because they also adjust for payments to debt holders and to preferred stockholders. Notably, because there are cash flows available to equity owners, the discount rate used is the firm's cost of equity (k) rather than the firm's WACC."[126]

d. **Valuation Using Discounting and Present Value**

In this section, we discuss how the Theory generally described above is computed and applied.

The discounted cash flow (DCF) models use the cash flow statement as basis for valuation. Under this method, the present value of the company's cash flow forecast or projection is computed using a reasonable discount rate. An analyst can either use dividends or the Free Cash Flow to determine the valuation of the firm.

[125] Reilly F. and Brown K. l, 2012. p.346.
[126] *Id.*, p. 347.

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Rationale for using the DCF method

This approach adopts the viewpoint of a potential investor who considers anticipated cash flow as the fundamental source of common equity value. In the DCF approach, the value of a business is the present value of the expected cash flow derived from the business over a certain period discounted at a rate that reflects the risks that accompany its operations. In contrast to the capitalized earnings method, the DCF approach accounts for the difference in value by factoring in the capital expenditures and other cash flows required in generating such earnings over a period of time. This approach is widely used by companies in evaluating investment proposals, using investments of similar risk as benchmarks.

Limitations of the DCF method

The DCF method suffers the same susceptibility to errors and inaccuracies or pitfall as the capitalized earnings method (discussed in the following section). Moreover, the use of an appropriate discount rate (for example, weighted average cost of capital, T-bills plus a risk premium, *etc.*) is crucial as this rate dramatically changes the valuation estimates.

There are two major considerations to be aware of when using the DCF method. The valuation is as good only as the estimates of the cash flows are good. And, the choice of an appropriate discount rate is critical. Often, companies use the weighted average cost of capital which reflects the rate of return used by the shareholders.

e. **Estimating the Inputs to a DCF Analysis: The Cash Flows**

What future cash flows are going to be used for doing a DCF analysis?

Operating Cash Flow would be the major cash flow item which is the cash generated from normal business operations or activities. A more refined or "granular" item would be Free Cash Flow which is the cash a company generates from its normal business operations after deducting any amounts spent for capital expenditures.

In addition, there is the cash flow generated from the sale of the investment at some assumed terminal date, the terminal value.

In addition, still, the cash flows from expected, assumed cash dividends would have to be included in the computation to complete the total cash flows needed to be discounted.

The total present value of these cash flows would represent the "intrinsic value" of the company to the investor, following the DCF way. This can be compared to the market capitalization to see if the values match or if the market is overpricing or underpricing the stock.

In another way of looking at it, the present value of the free cash flows can be compared with the reported net worth or equity of the company, checking if there are material disparities.

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f. **Estimating the Inputs to a DCF Analysis: The Discount Rate**

The discount rate is the interest rate applied to determine the present value of future cash flows in a DCF analysis.

The appropriate discount rate is suggested by many financial literature as the **Weighted Average Cost of Capital (WACC)**. It is the weighted average of the average cost of debt plus the average cost of equity.

To compute for the average cost of debt, one simple way is to divide the total interest payments over total outstanding debt averaged over, say, a two-year period. If there are company bonds outstanding, the coupon rate can be conveniently used as cost of debt.

To compute for the average cost of equity, this is what investors expect to earn on their investment in the stock. There is a formula for this (which we shall not discuss here), but it takes into consideration the "risk free rate of return", the "market rate of return"; and the "Beta" or the sensitivity to change of the stock return to the market return.

Sometimes, market practitioners engaged in DCF analysis, simply have assumptions about the cost of equity, differentiating between "stable" companies that have lower cost of capital than "venture" companies that have higher cost of capital because they're riskier. It's a matter of "situational judgment".

g. **Relative Valuation Techniques**

A relative valuation model is a business valuation method that compares a company's value to that of its competitors or industry peers to assess the firm's financial worth using some common applicable metrics. Relative valuation models are different from absolute value models, which try to determine a company's standalone intrinsic worth based on its estimated future free cash flows discounted to their present value.

Relative valuation is a comparison approach that uses multiples, averages, ratios, and benchmarks to determine a firm's value.

Here are some commonly used metrics.

1) Net Asset Value (NAV) Method

This method uses the company's balance sheet as basis for valuation. Under this approach, the value of a company is the fair market or net realizable value of its assets less its liabilities and preferred stockholdings, if any. The net amount is divided by the number of shares outstanding to determine the stock price per share. The NAV method is easy to use since the information needed is in the balance sheet. Usually, the NAV is used in valuing real estate companies. However, the problem of this method is that it uses past data and does not recognize the time value of money. Therefore, analysts will need to estimate the fair market value of its land holdings using available zonal values and/or published prices in the property market.

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Mutual fund securities follow a unique valuation method based on the daily Net Asset Value Per Share (NAVPS) or Net Asset Value Per Unit (NAVPU), which are regularly published.

The shares or units in the Investment Company is issued or redeemed at a price arrived at by dividing the fund's NAV by the number of shares or units outstanding. (Rule 8.5 of ICA-IRR) The price of securities subscribed or redeemed within the cut-off time of the day the subscription or request for redemption is received, respectively, shall be based on the net asset value per share/unit computed as of the closing day. The Net Asset Value per Share or NAVps refers to the computed NAV on a per share basis at the close of the day. It is calculated by dividing the Investment Company's total net assets from the shares outstanding. (Rule 1.30 of ICA-IRR) On the other hand, the Net Asset Value per Unit or NAVpu refers to the computed NAV on a per unit basis at the close of the day. It is calculated by dividing an MFC's total net assets by the number of its outstanding units.[127]

Rationale for using NAV

When considering the liquidation of the assets of a business, the NAV approach is most suitable. Since the real value of a company's assets also lies in their ability to generate earnings, this method is useful in valuing a company through periods of low or negligible earnings or losses. This valuation approach is preferred over other valuation methods in circumstances when the entity being valued is a holding company rather than an operating company and when a significant portion of the company's asset portfolio can easily be liquidated such as marketable securities, notes, or contracts receivable, for which there is a ready market. The virtue of the NAV method is its simplicity relative to other valuation methods as it makes use of readily available information.

2) Earnings Multiplier Model

Many investors prefer to estimate the value of common stock using an earnings multiplier model. The reasoning for this approach recalls the basic concept that the value of any investment is the present value of future returns. In the case of common stocks, the returns that investors are entitled to receive are the net earnings of the firm. Therefore, one way investors can estimate value is by determining how much they are willing to pay for an expected earnings (typically represented by the estimated earnings during the following 12-month period or an estimate of "normalized earnings"). For example, if investors are willing to pay 10 times expected or "normal" earnings, they would value a stock they expect to earn P2 a share during the following year at P20. You can compute the prevailing earnings multiplier, also referred to as the price/earnings (P/E) ratio, as follows:

Earnings Multiplier = Price/Earnings Ratio

$$= \frac{\text{Current Market Price}}{\text{Expected 12-Month Earnings}}$$

[127] Rule 1.31 of ICA-IRR.

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The computation of the current earnings multiplier (P/E ratio) indicates the prevailing attitude of investors toward a stock's value. Investors must decide if they agree with the prevailing P/E ratio (that is, is the earnings multiplier too high or too low?) based upon how it compares to the P/E ratio for the aggregate market, for the firm's industry, and for similar firms and stocks.[128]

3) The Price-to-Cash Flow (P/CF) ratio

This is a stock valuation indicator or multiple that measures the value of a stock's price relative to its operating cash flow per share. The ratio uses operating cash flow which adds back non-cash expenses such as depreciation and amortization to net income. A high P/CF ratio indicates that the high price is not generating enough cash flows to support the multiple. This metric measures the current price of the company's stock relative to the amount of cash generated by the company.

4) The Price-to-Book Value (P/BV) ratio

This compares a company's market value to its book value. Book value is the net assets of the company. This is a widely used measure. A value of under 1.0 is considered a potentially undervalued stock.

5) The Price to Sales (P/S) ratio

This measures the value placed on each peso of a company's sales. This is calculated by dividing the company's market capitalization by its total sales over a designated period, say, one year; or by dividing the stock price by the sales per share, i.e. on a per-share basis.

The relative valuation method does not give an exact result as it is based on a comparison and assumes that the market has valued the companies accurately. This is one limitation of the metric.

Relative valuation techniques however are easy to use for quick valuations and at least indicate whether further study needs to be done.

h. **Estimating the Inputs: The Required Rate of Return and the Expected Growth Rate of Valuation Variables**

1) **Required Rate of Return (k)**

The nominal required rate of return on an investment will be the discount rate for most cash flow models and affects all the relative valuation techniques. There is a difference in the discount rate when employing the present value of operating free cash flow technique because it uses the weighted average cost of capital (WACC). Notably, the cost of equity is a critical input to estimating the firm's WACC.

Three factors influence an equity investor's required rate of return (k):

[128] Reilly & Brown, Investment Analysis and Portfolio Management 10th Edition, Chapter 11: An Introduction to Security Valuation, Page 347-349

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a) *The economy's real risk-free rate* (RRFR) – the absolute minimum rate that an investor should require, which depends on the real growth rate of the investor's home economy because capital invested should grow at least as fast as the economy.

b) *The expected rate of inflation*; and

c) *The risk premium* – causes the differences in the required rates of return among alternative investments that range from government bonds to corporate bonds to common stocks.

2) **Expected Growth Rates**

After arriving at a required rate of return, the investor must estimate the growth rate of sale, cash flows, earnings, and dividends because the alternative valuation models for common stock depend heavily on good estimates of growth (g) for those variables. The growth rate of dividends is determined by the growth rate of earnings and the proportion of earnings paid out in dividends (the payout ratio). Over the short run, dividends can grow faster or slower than earnings if the firm changes its payout ratio.[129]

B. Analysis of Common Stocks

1. Macroanalysis and Microvaluation of the Stock Market

a. Components of Market Analysis

Here we address the analysis of **the capital market itself**, as distinguished from the individual securities traded in that market. Market analysis has two components: 1) the macroanalysis of the relationship between the aggregate securities markets and the aggregate economy; and 2) the specific microvaluation of the stock market.

Market analysis is based on the proposition that "security markets reflect what is expected to go on in the economy." The objective therefore is to try to determine future market movements as these are influenced by the aggregate economic environment.

Microanalysis layers over this macroanalysis, to draw conclusions about putting a specific value to the market, developing an estimated intrinsic value for the market as indicated in a chosen "market indicator series."

If this sounds theoretical, it is because it is. But let us introduce ourselves to the ideas anyway for they contribute deeper insights for our acquaintance with the stock market. All these ideas or conclusions are the results of serious research and studies by various authors and deserve our intellectual attention.

b. Macromarket Analysis

The basic premise in macromarket analysis is that security markets move according to changes in expectations for the aggregate economy. In the case of debt securities,

[129] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 338.

they are affected in their prices by the level of interest rates which are in turn driven by the general economic activity. In the case of aggregate stock prices, they move according to investors' expectations about earnings, cash flows and rates of return attributed to corporation which are directly influenced by the general economic conditions.

The approach of researcher-economists to macromarket analysis has been to study and record the relationship between stock prices and the economy by choosing some set of economic indicators tracked continuously. Of these economic indicators, the more prominent ones are inflation rates and interest rates.

c. **Microvaluation Analysis**

Microvaluation analysis makes an estimate of specific values for an aggregate stock market series, for example the PSEi, using the valuation models and techniques applied to the valuation of securities. These techniques are: (1) the dividend discount model or DDM; (2) the free cash flow to equity model or FCFE; (3) the earnings multiplier and (4) the other relative valuation ratios.[130]

The DDM Valuation Model Applied to the Market

If we might recall, the Dividend Discount Model (DDM) has been used to determine the intrinsic value of a stock in fundamental analysis. This DDM approach can also be applied to determining the valuation of the market itself. As we might also recall, the DDM approach has been reduced and simplified in this equation.

$$Vj = Pj = \frac{D_1}{k - g}$$

where:

Vj = current fair value of stock
Pj = the price of stock
D_1 = dividend in Period 1, which is equal to D_0 (1 + g)
k = the required rate of return for stock j
g = the constant growth rate of dividend

This model suggests that the parameters to be estimated are (1) the required rate of return *(k)* and (2) the expected growth rate of dividends *(g)*. After estimating g, it is simple to estimate D_1 because it is equal to the current dividend (D_0) times (1 + g).

Applied, say, to the valuation of the market index PSEi, the estimate of D_1 is the current D_0 for the latest 52- week period times (1+g).

The estimate of *k* is a function of the nominal risk-free rate (NRFR) plus a market risk premium.[131]

Another microanalysis market valuation technique is the Free Cash Flow to Equity (FCFE) Model. In this model, the free cash flow is computed as follows, starting with Net Income:

[130] Reilly, 2012.
[131] Reilly, 2012. pp.377-378.

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Net Income
+ Depreciation Expense
- Capital expenditures
+/- Changes in Working capital
- Principal debt repayments
+ New debt issues

This approach determines the free cash flow that is available to the shareholders after payments to all other capital suppliers and after providing for the continued growth of the company.

The point of this discussion is to show that the valuation approaches to individual stocks can also be applied to the valuation of the aggregate market itself. We shall leave details of these two techniques – on dividends, and on free cash flows – to some other advanced modules, but the idea is to introduce the reader to the fact that there are indeed studies which have examined and tried to measure what at first blush appears difficult to do but can be "scientifically" estimated.

A third technique of microvaluation analysis of the stock market is to compute for a Stock Market Earnings Multiplier.

Market Valuation Using the Earnings Multiplier Approach

The ultimate objective of this microanalysis is to estimate the intrinsic market value for a stock market series, such as the S & P Industrial Index, or the PSEi. This estimation process has two equally important steps.

1) Estimating the future earnings per share for the stock market series.

2) Estimating the appropriate earnings multiplier for the stock market series based on long-run estimates of required rate of return for stock and constant growth rate of dividends.

Estimating aggregate earnings would involve an exercise of – in the prescribed procedure – estimating GDP; estimating Sales per Share for the Market Series; estimating corporate net profits; aggregate operating profit margin; interest expense; the tax rate; then finally calculating Earnings per share. (Doing this detailed exercise is beyond the scope of this basic course.)

The next step is estimating an earnings multiplier. The major variables that affect the aggregate stock market earnings multiplier in a country are:

- The composite dividend payout ratio for common stocks in a country
- The required rate of return on common stock in the country being analyzed.
- The expected growth rate of dividends in the country being analyzed.[132]

2. Industry Analysis

[132] Reilly F. and Brown K., 2012. p. 400.

To guide our study of industries, it has been helpful to classify industries in a way which is comparable among all countries, not just for economists and stock analysts but for policymakers and corporate managers as well.

Framework for industry analysis

The Philippine Standard Industrial Classification (PSIC) is a statistical classification of economic activities in the country. For purposes of international comparability, this industrial classification system is patterned after the United Nations International Standard Industrial Classification (ISIC) with some modifications to suit the national situation and its requirements. The PSIC serves as a guide in the classification of establishments according to their economic activity that will be useful for economic analysis. It serves as a framework for data collection, processing, and compilation. This is to ensure uniformity and comparability of industrial statistics produced by various entities in both government and private sectors, including those involved in statistics and research activities. It also provides an effective mechanism for the integration of large numbers of statistics being collected for decision-making and policy formulation, and furnishes a basis for anticipating the emergence of new industries.

A new PSIC listing was released in 2009 and to date, this is the currently-used PSIC in government statistics. According to the PSA,

> *The 2009 PSIC was patterned after the UN International Standard Industrial Classification (ISIC) Rev. 4, but with some modifications to reflect national situation and requirements. The PSIC was revised to 1) reflect changes in economic activities, emergence of new industries, and the structure of the economy, 2) to take into account the new technologies employed which affect the organization of production and shifting of economic activities, and 3) to realign with the ISIC revisions for purposes of international comparability.*

With the above industrial classification and definition, it is important to embark on industry analysis as a guide for choosing stock investments. Industry analysis is important because it is unusual for a firm in a troubled industry to perform well. Just as economic performance can vary widely across countries, performance can also vary widely across industries.

This framework using the PSIC is a most appropriate tool for any analyst doing industry analysis of the Philippine Stock Market. Our discussion here is an extension of our industry analysis in an earlier section. At this time, we focus on other aspects. Within the framework of a macroanalysis of an industry, the topics we examine are:

- The business cycle and industry sectors.
- Structural economic changes and alternative industries
- Evaluating an industry's life cycle
- Analysis of the competitive environment in an industry

We shall do a summarized examination.

a. Economic trends directly influence industry performance. These trends take two basic forms: **cyclical changes** and **structural changes**.

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While business cycles influence industry performance, different industries are differently affected in both degree and timing of effect, and this is the challenge to the analyst – to know when the effect hits the industry and by what magnitude. And knowing this, the investor may shift from one industry to another to anticipate favorable or unfavorable developments.

For example, during a recovery in a business cycle, because it increases disposable income and consumer confidence, consumer durable companies are in an expansive mood and become attractive investments. During a recession in the business cycle, however, the companies which thrive are those producing staple goods or necessities, e.g. food, beverage, medicines.

b. As we said, there are also structural changes, i.e. major changes in how the economy functions. We highlight some of the causes of these major changes:

There's **demographics**, which describe population growth, age distribution, their geographical dispersion, their income classifications and their general profile. Demographics change, and with it, industry performance can and does change.

Lifestyles – how people live, work, spend their time, their leisure, their money – all these are determinants of consumer behavior, and bear inevitably on industry performance.

Technology has obviously affected our worklife, what we manufacture or provide in service, and how. Because of technology, new businesses appear, old businesses disappear, things change, sometimes slowly, sometimes very fast. Some industries are born. And many industries are affected across the board by new technology.

Government regulations also impinge on industries, some more than others. Some industries are heavily regulated, e.g. utilities, and what they can do and charge for their services are very much under regulatory control. Taxes are a form of regulation which can be targeted to specific industries, e.g. "sin taxes" on alcohol and tobacco products.

c. In industry analysis, evaluating the industry life cycle is a favorite approach. The premise is, that an industry goes through a "stage of life" like a man's life: birth, adolescence, adulthood, middle age, old age.

The industry life cycle in parallel comes in five (5) stages:

1) Pioneering development
2) Rapid accelerating growth
3) Mature growth
4) Stabilization and Market Maturity
5) Deceleration of Growth and decline

This framework gives the analyst the guide for determining what the sales and profit potentials for an industry are, depending on what stage the industry is. The challenge, of course, is in correctly putting the industry in the correct classification of development stage.

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d. A component of industry analysis is to determine the competitive structure of the industry, meaning, the intensity of the competition within the industry itself, because the nature of this competitive environment within the industry itself can tell us something about how an individual company in that industry can stay on and prosper. Prof. Michael E. Porter is the foremost resource on industry analysis and competitive strategy. He says that the Basic Competitive Forces to watch for are:

1) Rivalry among the existing competitors;
2) Threat of new entrants;
3) Threat of substitute products;
4) Bargaining power of buyers; and
5) Bargaining power of suppliers

After considering these aspects of industry, it is possible to compute an industry rate of return by applying the same concepts of valuation we have earlier introduced – the present value of cash flows and the relative valuation ratios.[133]

3. Company Analysis versus Stock Valuation

The company's valuation that describes its financial condition and earnings prospects, is quite different from the valuation of its stocks which describes the "correct" pricing of the stock by the market.

A company analysis may show that it is financially sound and its profitability is well established for the foreseeable future, but the market price should be examined if – applying the valuation techniques of discounted cash flows or relative ratios – the intrinsic value of the stock is lower or higher than the market price. If the intrinsic value is lower than the market price, then this shows that the market has probably overpriced the stock and is an expensive buy. If the intrinsic value is higher than the market price, then this shows that the market has probably underpriced the stock and suggests a good buy. If the intrinsic value is about the same as the market price, then there's a match of values, and it is what it is.

For the investor, the proper question really is, even if the company is a good one, am I buying its stock at a good price? At an overprice? or at a bargain?

Back to the basics, however, we must always keep in mind that fundamentally, the market price should follow and be based on the general good health of the company. This, in turn, is a reflection of the effects on the company of the economic and industry environment in which it operates, including such structural influences we had earlier discussed –demographics, lifestyles, technology, and government regulations.

Economic, Industry, and Structural Links to Company Analysis
The analysis of a company and its stock is the final step in the top-down approach to investing. Rather than selecting stocks only on the basis of company-specific factors, top-down analysts review the current status and future outlook for domestic and international sectors of the economy. Based on this macroeconomic analysis, they identify industries that offer attractive returns in the expected economic environment. The analysis concentrates on the two significant determinants of a stock's intrinsic value:

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[133] Reilly F. and Brown K., 2012.

(1) growth of the firms expected earnings and cash flows, and (2) its risk and the appropriate required return (discount rate).[134]

Economic and Industry Influences
Given a period of economic-industry growth, the most attractive firms in the industry will typically have high levels of operating leverage wherein a modest percentage increase in revenue results in a much larger percentage rise in earnings and cash flow. Firms in an industry will have varying sensitivities to economic variables, such as economic growth, interest rates, input costs, and exchange rates. Because each firm is different, an investor must determine the best candidate for purchase under expected economic conditions.[135]

Structural Influences
In addition to economic variables, other factors, such as social trends, technology, and political and regulatory influences, can have a major effect on some firms in an industry. Some firms are able to take advantage of demographic changes or shifts in consumer tastes and lifestyles, or they can invest in technology to lower costs and better serve their customers. Although the economy plays a major role in determining overall market trends and industry groups display sensitivity to economic variables, other structural changes may counterbalance the economic effects, or company management may be able to minimize the impact of economic or industry events on a company.[136]

4. Technical Analysis

Technical analysis (or technicals) is a method of securities analysis that makes use of historical price patterns to determine an optimal entry and exit value for a security. It involves the use of price charts and statistical oscillators to help determine the best entry and exit price for a security. It is now accepted as a complement to fundamental analysis. If fundamental analysis is into the known intrinsic value driving the price of the security, technical analysis is into the market perception driving the price of the security. If fundamental analysis employs mathematical tools to dissect the underlying financials of a security, technical analysis employs mathematical tools to measure the underlying market psychology driving price patterns. As commonly known, fundamental analysis is interested in the causes of a price movement, while technical analysis pertains to the effect on price movement as it is said to discount everything into it. Both have strengths and weaknesses. It is up to the investor to determine which method suits him or her best. Contrary to purist arguments, a balanced combination of both appears to be beneficial in certain situations and markets. It is finding this balance of both that is driving the developing academic study of behavioral finance.

a. **Premises of technical analysis**

Technical analysis is driven by three major premises:

1) Market action discounts everything – it is the major premise of technical analysis. Anything that can influence or affect the price of a security is reflected on its price, thus the need to understand price actions that essentially reflect the shift in supply-demand.

[134] Keith C. Brown, Herbert B. Mayo and Krishna G. Palepu, Security Analysis, compiled by Dr. Anthony DC Altarejos (2015), pg. 406.
[135] *Id.*, pg. 407.
[136] *Ibid*.

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2) Prices move in trends – prices over a period of time move in a particular direction until it is reversed. This is further expounded in each respective subtopic.
3) History repeats itself – as prices move in trends, recognizable patterns unfold along the way. Over the long run, these are repeated.

b. **Arguments for and against technical analysis**

Practitioners of technical analysis are normally individual equities investors, currency and derivatives traders. Hedge funds also rely on technical analysis up to a certain degree. While institutional investors will not admit it, they solicit the opinion of technical analysts in some way to help them in their entry and exit price decisions. In developed markets, technical analysis has evolved from merely identifying chart patterns and oscillators to sophisticated "surface maps" of the securities. These computer-generated maps driven by sophisticated algorithms are dynamic and are updated real time whenever there are movements in the securities it tracks.

Compared to fundamental analysts, technical analysts capitalize on price action. An investor using technical analysis buys a security when its market price is at an oversold level, and sells it when its market price is at an overbought level. They profit, and cut their losses, by trading with the trend. "Trading with the trend" means buying at lows or perceived lows and selling at significant highs or perceived highs.

One particular advantage that technical analysis seems to have over fundamental analysis is its universality. On the one hand, this explains its use by currency and commodities traders. Beyond the law of supply and demand and various macroeconomic indicators that vary for each country, there are no uniform bases for valuation for these assets.

On the other hand, technical analysis is considered to be the weak form of the efficient markets. Practitioners are ridiculed as practitioners of astrology as it is not an exact science but an art. An often-cited argument is whether historical price data and patterns can repeat themselves and be used to forecast future trend or estimate price targets. This has to do with the random nature of market prices. In extreme cases, for example, experience from market crashes show us that catastrophic fall in prices can occur independently of development in the fundamental factors and most technical analysts also fail to predict such fall in prices. Another valid argument with trading on price action is that over the long run, profits are not maximized as trading costs accumulate for every transaction. Moving in and out only enrich the brokers.[137]

Challenges to Technical Trading Rules

An obvious challenge to technical analysis is that the past price patterns or relationships between specific market variables and stock prices may not be repeated. Another problem with technical analysis is that the success of a particular trading rule will encourage many investors to adopt it, and will eventually neutralize the technique. Further, most of the trading rules require a great deal of subjective judgment. Finally, the standard values that signal investment decisions can change over time.[138]

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[137] Santos, R (Ed). 2018
[138] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 547.

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C. Analysis of Bonds

1. Determinants of Bond Safety

Bond- rating agencies base their quality ratings on an analysis of the level and trend of financial ratios of the issuer. A review of some of the ratios is given here.

Ratios used in bond ratings

Ratio	Formula	Comments
Times Interest Earned	Earnings Before Interest and Taxes / Interest Expense	This refers to the ratio of earnings before interest payments and taxes to interest obligations. It is generally considered safe if the interest earned occurs two or more times a year.
Leverage Ratio/ Debt to Equity Ratio (D/E ratio)	Total Liabilities / Total Owner's Equity	This illustrates the relationship between "what is owed and what is owned". The higher the D/E ratio, the higher the risk to the creditor or lender. A too-high leverage ratio indicates excessive indebtedness signaling the possibility that the company will be unable to earn enough to satisfy the obligations of the bonds. With a high D/E, it would be difficult to borrow additional funds.
Current Ratio	Current Assets / Current Liabilities	This is one of the most commonly used liquidity ratios and measures a company's ability to cover its short-term debts or current liabilities. The rule of thumb is that a current ratio of at least 2:1 is considered solvent. However, a ratio less than this is also possible as each company should determine what the most effective current ratio is. A desired current ratio is one that does not create short-term liquidity problems or sacrifices profitability for safety (too high a ratio)
Quick Ratio/ Acid Test Ratio	Cash + Marketable Securities + Receivables / Current Liabilities	This is a more stringent measure of solvency and includes only the company's more liquid current assets.
Return on Total Assets (ROTA)	EBIT / Average Total Assets X 100%	This is a broad measure of the company's ability to generate profits using all the resources of the company. Earnings Before Interest and Taxes (EBIT) is used in order to measure the income-generating capacity of the company regardless of how the business is financed and taxed. Firms with higher return on assets should be better able to raise money in security markets because they offer prospects for better returns on the firm's investment.

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Ratio	Formula	Comments
Return on Equity (ROE)	$\frac{\text{Net Income}}{\text{Average Stockholder's Equity}}$ X 100%	This measures the return on investment by the stockholders of the company.
Gross Profit Margin (GPM)	$\frac{\text{Gross Profit}}{\text{Net Sales}}$ X 100%	This indicates the basic cost structure of the company. An analysis over time of a company's GPM compared to industry standards will show its relative cost-price position.
Operating Profit Margin (OPM)	$\frac{\text{Operating Profit}}{\text{Net Sales}}$ X 100%	The variability of the OPM over time is a prime indicator of the business risk for a company because it reflects not only the cost structure of the company's products but also its ability to control other operating expenses (selling and administrative).
Net Profit Margin (NPM)	$\frac{\text{Net Income}}{\text{Net Sales}}$ X 100%	This basically uses the concept of OPM but also considers other income, interest expense and taxes.

2. Time Value of Money and Bond Pricing

a. **Time value of money**

Money to be received today is not of the same value as the money to be received after a year even if the amount is the same and the risk of non-payment is removed. The peso that will be received now can be invested and earn interest, which can then be withdrawn after a year. Therefore, the peso that is yet to be received is not worth as much as the peso on hand. In simple terms, a PhP 100 value in two years is only worth PhP 82.64 today at an interest of 10%. Present value tables show the value today of asset prices in the future dependent on time (or period) and interest rates.

a. **Bond pricing**

Because a bond's coupon and payment of its principal occur in the future, the price an investor would be willing to pay for the claim to those payments depends on the value in pesos to be received in the future compared to the pesos on hand today.

This "present value" calculation depends in turn on market interest rates.

To value a security, we discount its expected cash flows by the appropriate discount rate. The cash flow from a bond is the sum of its maturity (par) value, and the coupon payments until maturity date less any accrued interest. Therefore,

Price of a Fixed Rate Bond= Present Value of the Face, Maturity or Redemption Value + Present Value of the Coupons - Accrued Interest (if any)

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3. Computing Bond Yields

Bond yields
The current yield of a bond measures only the cash income provided by the bond as a percentage of bond price and ignores any prospective capital gain or losses. The yield to maturity is the standard measure of the total return of the bond (both the current income and the price increase or decrease) over its life.

Yield to maturity
An investor considering the purchase of a bond in the secondary market is not quoted a promised rate of return. Instead, the buyer must use the bond price, maturity date, and coupon payments to compute for the return offered by the bond over its life. The yield to maturity (YTM) is defined as the interest rate that makes the present value of a bond's payments equal to its price. This interest rate is often viewed as a measure of the average rate of return that will be earned on a bond if it is bought at present and held until maturity.

The bond's yield to maturity is the internal rate of return on an investment in the bond. The yield to maturity can be interpreted as the compounded rate of return over the life of the bond, assuming that all bond coupons can be reinvested at an interest rate equal to the bond's yield to maturity. Yield to maturity is widely accepted as average return.

Yield to maturity is different from the current yield of a bond, which is the bond's annual coupon payment divided by the bond price. For example, for the 10%, 20-year bond currently selling at PhP1,197.93, the current yield would be PhP100/ PhP1,197.93 = 0.0835 or 8.35% per annum. Compare this with the effective annual yield to maturity of 8.16%. For this bond, which is selling at a premium over par value (PhP1,197.93 rather than PhP1,000), the coupon rate (10%) exceeds the current yield (8.35%), and the current yield in turn exceeds the yield to maturity (8.16%). The coupon rate is higher than the current yield because the coupon rate divides the payments by par value (PhP 1,000) rather than by the bond price (PhP 1,197.93). In turn, the current yield exceeds yield to maturity because the yield to maturity accounts for the built-in capital loss on the bond; the bond bought today for PhP1,197.93 will eventually fall in value to PhP1,000 its par at maturity.

Nominal Yield
Nominal Yield is the coupon rate of a particular issue. A bond with an 8 percent coupon has an 8 percent nominal yield. This provides a convenient way of describing the coupon characteristics of an issue.[139]

The term structure of interest rates
In the real world, it is rare that the same constant interest rate is used to discount cash flows of any maturity. It is a common empirical pattern that longer-term securities have higher yields. The term structure of interest rates is the structure of interest rates for discounting cash flows for different maturities.

Forecasting Interest Rates
Interest rates are the price for loanable funds. Like any price, interest rates are determined by the supply and demand for these funds. Although lenders and borrowers have some fundamental factors that determine supply and demand curves, the prices for these funds (interest rates) also are affected for short periods by events that shift the

[139] *Id.*, pg. 605.

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curve. Hence, the goal of bond investors and bond portfolio managers is to continuously assess the major factors that affect interest rates but rely on others – such as economic consulting firms, banks, or investment banking firms – for detailed insights on the real risk-free rate of interest (real RFR) and the expected rate of inflation.[140]

Fundamental Determinants of Interest Rates

The real RFR is the economic cost of money, that is, the opportunity cost necessary to compensate individuals for foregoing consumption. Supply and demand are the fundamental economic determinants of interest rates (i). As the supply of loanable funds increases, the level of interest rates declines, other things being equal. Interest rates increase when the demand for loanable funds increases, all else the same.[141]

Moreover, the interest rate of a specific bond issue is also influenced by the unique characteristics of the bond that influences the bond's risk premium (RP). Bond investors separate risk premium into four components:

a. The quality of the issue as determined by its risk of default relative to other bonds;
b. The term to maturity of the issue, which can affect price volatility;
c. Indenture provisions, including collateral, call features, and sinking-fund provisions; and
d. Foreign bond risk, including exchange rate risk and country risk.[142]

The term structure under certainty

One conclusion reached as to why the longer-term bonds offer higher yields to maturity is that longer-term bonds are riskier and that higher yields are evidence of a risk premium that compensates for interest rate risk. Another possibility is that investors expect interest rates to rise and that the higher average yields on long-term bonds reflect the anticipation of high interest rates in the latter years of a bond's life. The easiest case to start the analysis of these possibilities is one with no uncertainty where investors already know future interest rates.

Bond pricing

The interest rate for a given time interval is called the short interest rate for that period. No one can really predict where interest rates are headed. However, with financial theory as a guide, the price you pay for a peso of earnings, should drop as the interest rate used to discount that earning rises. The conventional wisdom points to an inverse relationship between interest rates and prices of stocks.

Note that the yield is the single interest rate that equates the present value of the bond's payments to the bond's prices. Although interest rates may vary over time, the yield maturity is calculated as one "average" rate that is applied to discount all of the bond's payments.

The following Figure is a graph of the yield to maturity on a sample of bonds as a function of time to maturity. This is called the yield curve. While the graph in this Figure rises smoothly, a wide range of curves may be observed in practice.

[140] *Id.*, pg. 617-618.
[141] *Id.*, pg. 619.
[142] *Id.*, pg. 620.

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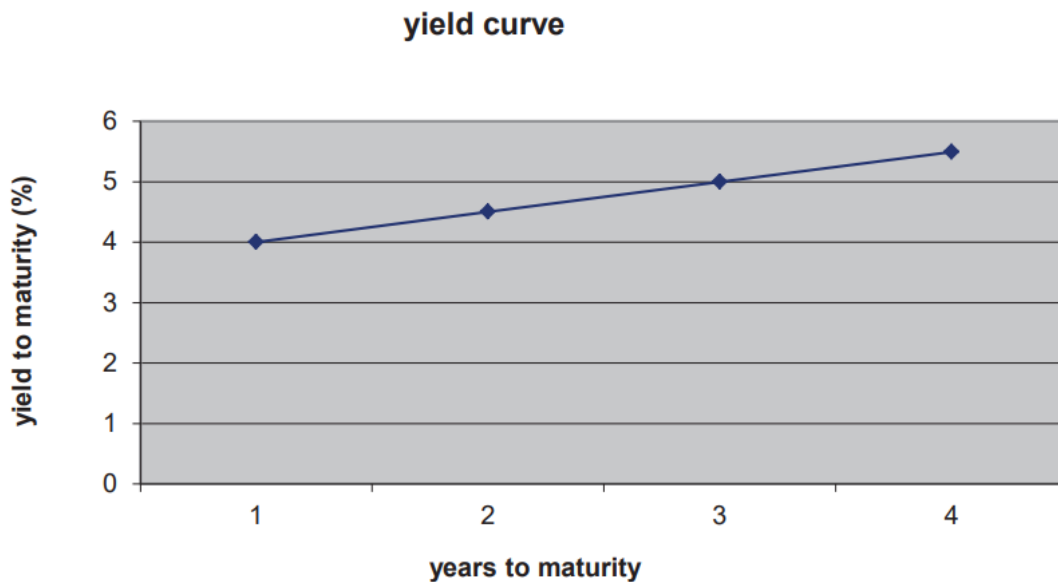
Figure B.1. Sample yield curve



The yield to maturity on zero-coupon bonds is sometimes called the spot rate that prevails today for a period corresponding to the maturity of the zero. The yield curve, (the last column of Table B.1.), thus presents the spot rates for four maturities. Observe that the spot rates or yields do not equal the one-year interest rates for each year.[143]

Technical Analysis of Bond Markets
The theory and rationale for technical analysis of bonds are the same as for stocks, and many of the same trading rules are used. A major difference is that it was generally not possible to consider the volume of trading bonds until information regarding volume began to be reported.[144]

D. Derivative Security Analysis

1. Definition. Uses. Types

Definition
Derivatives are financial instruments or securities or agreement whose value is "derived" from or depends upon the price of some other (underlying) commodity, security, or index. The derivative itself is a mere contract between two or more parties and the value is determined by the fluctuations in the underlying mentioned assets.

The International Accounting Standards (IAS) defines a derivative as a financial instrument or a contract with all three of the following characteristics:

a. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or some other variable (sometimes called the underlying);

[143] Santos, R (Ed). 2018.
[144] Frank Reilly and Keith Brown, *Analysis of Investments and Management of Portfolios* (10th Ed.), pg. 560.

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b. It requires no initial net investment or an initial net investment that is smaller than what would be required for other types of contracts that would be expected to have a similar response to change in market factors; and

c. It is settled at a future date.

Uses of derivatives
Derivatives are innovative products that aim to enhance returns, reduce risk, and provide diversification. The three main uses for derivatives are discussed below:

a. Hedging. Derivatives are used to mitigate the risk of economic loss arising from changes in the value of the underlying asset. It allows risk on the price of the underlying asset to be transferred from one party to another. The objective is to reduce the risk of having the future selling price deviating unexpectedly from the current market value of the asset.

b. Speculation. Derivatives are used to increase profit through a bet on future movements in the value of an underlying asset.

c. Arbitrage. Derivatives are used to exploit the discrepancy between prices of the same product across different markets. Arbitrage occurs when the current buying price of an asset falls below the price specified in a future contract, or when a simultaneous buy-and-sell transaction occurs in two different markets, resulting in a price difference between these markets.

Types of derivatives
There are several types of derivative instruments, as shown in Box 13.1. These vehicles are developed to meet the needs of corporations, financial institutions, or portfolio managers who want low-cost ways of managing the return or risk profiles of their assets or portfolios.

Types of derivatives instruments

Types of Derivatives

- Forwards - private contracts between 2 parties, traded Over-the-Counter (OTC)
- Futures - traded on an Exchange
- Swaps - equivalent to a series of forwards contracts (mostly traded Over-the-Counter)
- Options - contracts giving their holder the right to take a certain action (mostly traded on an Exchange)

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2. Forwards and Futures

Forward contracts
A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future at a price identified beforehand. Unlike the futures contracts, which are written by a clearing house and traded over an exchange, forward

contracts are written by the parties themselves. The different types of forward contracts are enumerated below:

a. Currency forwards – a contract that locks in the price at which an entity can buy or sell a currency on a future date. Also known as "outright forward currency transaction," "forward outright" or "FX forward."

b. Interest rate forwards or forward rate agreement (FRA) – an over-the-counter contract between parties that determines the rate of interest to be paid or received on an obligation beginning at a future start date. The contract determines the rates, termination date and notional value, FRAs are usually an exchange of a fixed rate for a variable rate, paying only the differential on the notional amount of the contract. The two parties are the borrower (paying the fixed rate) and the lender (receiving the fixed rate).

   Bank A enters into an FRA with Company B, in which Bank A will receive a fixed rate of 5% yearly on a principal of USD 1 million over three years. In return, Company B will receive the one-year London Interbank Offered Rate (LIBOR), determined in three years' time, on the principal amount. The agreement will be settled in cash in three years.

   If, after three years, the LIBOR is at 5.5%, Bank A is required to pay Company B because the LIBOR is higher than the fixed rate.

Bank A (Receive):	USD 1 million x 5%	=	USD 50,000
Company B (Receive):	USD 1 million x 5.5%	=	USD 55,000
Net Received by Company B (Bank A to Pay)		=	USD 5,000

Future contracts
A futures contract is an agreement between two parties that is initiated at one point in time but requires the parties to the agreement to perform some act (usually the trading of assets for cash), in accordance with the terms (or some clearly defined rule) of the agreement, at some future point in time.

Futures are highly standardized contracts that are written by a clearing house that operates an exchange where the contract can be bought and sold.

Basic types of futures contract
Future contracts are traded on a wide variety of assets including commodities, stock indices, fixed income financial instruments, and currencies. All of these contracts operate in the same way and share common features. However, these various types of contracts also have their own special provisions based on the characteristics of the underlying assets.

3. Options

The owner of an option has the right, but not the obligation, to do something. Most often, this right entitles the option holder to buy or sell some number of units of the underlying asset at a specified price for a defined period of time.

When one purchases an option, the buyer has the right but not the obligation to do something. The option buyer can always let the expiration date go by, at which point the

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option becomes worthless. If this happens, he loses 100% of the investment, which is the money used to pay for the option

There are two types of option contracts:

a. Calls, which give the holder the right, but not the obligation, to buy a specified number (contract size) of a specified asset (underlying asset) at a specified price (exercise or strike price) on, or at any time until, a specified expiration date (settlement or expiration date).

b. Puts, which give the holder the right, but not the obligation, to sell a specified number (contract size) of a specified asset (underlying asset) at a specified price (exercise or strike price) on, or at any time until, a specified expiration date (settlement or expiration date).

Call and put option contracts oblige the writer (also called the seller) of the contract to deliver (in case of calls) or purchase (in case of puts) the assets specified in the contract, if the holder of the option chooses to exercise it. However, the holder of an option is not under any obligation to exercise it. Therefore, from the option holder's viewpoint, options are assets because they embody a valuable right to buy or sell an asset at a set price for a stated time. From the option writer's viewpoint, options are contingent liabilities that impose the obligation to sell or purchase a stated number of a stated asset, at a stated price, for a stated time, contingent upon the choice made by the holder of the option.

Options also have characteristics of contracts because they are agreements between the option holder and writer to engage in a transaction involving a stated asset, at an agreed-upon price, in the future, if the option holder chooses to do so. Because options are agreement with asset-like characteristics (from the buyer's viewpoint), it costs something to enter into them. This is called the option premium. This premium is paid by the buyer (who receives something of value) to the seller of the option (who must be compensated for accepting the contingent liability).

There are two major factors to be considered in option prices: First, the strike price or exercise price is the price at which an underlying stock can be purchased or sold. This is the price a stock price must go above (for calls) or go below (for puts) before a position can be exercised for a profit. Second, the expiration date is the day on which an options or futures contract is no longer valid and, therefore ceases to exist.

Options premiums are the total cost (the price) of an option. This price is determined by factors that include the stock price, strike price, time remaining until expiration (time value) and volatility. A summary of action given in the box below:

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Option action summary

	Call Option	Put Option
In-the-Money	Strike Price < Market Price of the Underlying Asset	Strike Price > Market Price of the Underlying Asset
Out-of-the-Money	Strike Price > Market Price of the Underlying Asset	Strike Price < Market Price of the Underlying Asset
At-the-Money	Strike Price = Market Price	Strike Price = Market Price

Most options are American options, meaning they can be exercised at any time until they expire. European options can only be exercised on their expiration date. Generally, American options have more value than European option because they have greater flexibility. However, if the holder of an option has no need to exercise it early, this flexibility would have no value. In that case, an American option and a European option with the same terms would have the same value. In no case would an American option be worthless than a European option, all other factors being equal.

Standard option contracts have been established for trading on various organized exchanges in a number of underlying assets, including individual stocks, stock indexes, individual bonds (usually treasury bonds), foreign currencies, stock index futures, treasury bond futures, foreign currency futures, and individual commodity futures.[145]

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[145] Santos, R (Ed). 2018.

Topic 2: Economic Principles and Market Theories (EPMT)

When was the last time you bought some generic medicine or immune-boosting vaccine? Or do you go for branded instead? Would you be happy in a world where there was only one brand for anything you needed? Perhaps not. Competition among manufacturers, wholesalers, retailers is good for the consumers. Because of competition, we get reasonably good quality at a reasonably fair price. On the other hand, if we were a pharmaceutical company, would we pour a great deal of money into research to develop new cures if we thought we would not be able to get our money back selling our product because some government somewhere had decided to let every Tom, Dick, and Harry use our formula to manufacture their own medicines? The money for research would be a high cost.

Would we get enough benefits out of it to justify the cost? How do we create incentives for invention and innovation in the pharmaceutical industry while ensuring the incompatible existence of competition? Is the pharmaceutical industry unusual, or are most industries similarly paradoxical? Questions like these—well, more complicated versions of questions—that keep Economists up all night will be explored in this Part of the Module. Of course, economists also have an incentive for trying to answer such questions. But then again, it would cost them some sleepless nights (and their hairlines). Surely, Economists will only do it if the trade-off is positively worthwhile, the same thing with your diligence and eagerness to learn this topic. It has something to do with the incentives emanating from being a certified Securities professional.

Economics can be a pretty abstruse, intimidating field, but it doesn't have to be. We have your back. Economists at SEC are humans, too. We only use models, symbols, and numbers to simplify and qualify the process of understanding our complex world. We have put together the fundamentals of Economics in a way that sparks your curiosity as you make decisions and go about life. We are confident that you will do a great job as you discover the Economist in you.

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Part I. Fundamentals of Economics

LEARNING OUTCOMES

- Understand economics as field of study of production, distribution, and consumption;
- Differentiate microeconomics and macroeconomics;
- Identify elements of and factors that affect quantity demanded;
- Describe how demand for a product or service is affected by substitute and complementary products and services;
- Identify elements of and factors that affect quantity supplied;
- Understand market equilibrium;
- Interpret price elasticities and income elasticities of demand and describe their effects on quantity and revenue;
- Distinguish between accounting profit and economic profit;
- Describe production levels and costs, including fixed and variable costs, and describe the effect of various costs on profitability; and
- Compare types of market structures: perfect competition, monopoly, monopolistic competition, and oligopoly, among others.

A. Economics

One of the immediate—and the most important—tasks of the day is to define Economics. An easy way to start is to provide you with definitions from a few but world's renowned economists who succinctly characterized Economics in a single phrase.

Definition[146] of Economics	Economist-Author
"the art of household management"	Xenophon[147]
"the study of mankind in the ordinary business of life"	Alfred Marshall
"the study of economies, at both the level of individuals and of society as a whole"	Paul Krugman and Robin Wells
"the study of how society manages its scarce resources"	Gregory Mankiw
"the science which studies human behavior as a relationship between ends and scarce means which have alternative uses"	Lionel Robbins
"the study of the use of scarce resources which have alternative uses"	Thomas Sowell
"the science of how a particular society solves its economic problems"	Milton Friedman
"the study of how societies use scarce resources to produce valuable commodities and distribute them among different people"	Paul Samuelson and William Nordhaus
"social science that studies the choices that individuals, businesses, governments, and entire societies make as they cope with scarcity"	Robin Bade and Michael Parkin
"a social science concerned with the problem of using or administering scarce resources (the means of producing) to attain the greatest or maximum fulfillment of our unlimited wants (the goal of producing)"	Campbell McConnell, Stanley Brue, and Sean Flynn
"the study of the principles governing the allocation of scarce resources among competing ends when the objective of the allocation is to maximize the attainment of the ends"	George Stigler

You now have an idea that Economics endeavors to study how individuals, businesses, and governments conduct themselves in activities that involve production, distribution, and consumption of resources. Quite notably, you see how Economics situates itself within the realm of social science and straddles in a broad spectrum of disciplines—from anthropology to psychology to sociology, all of which conscientiously paying attention to human decision-making and human well-being.

As you went through from one definition to another, you noticed that most of our economists incessantly refer to the realities of dealing with the allocation and management of *scarce resources*. It appears that if only resources are abundant, you would not have to study Economics. Alternatively put, life wouldn't be difficult. But so long as every person, every business, and every country deal with scarce resources, Economics is everywhere. Economics is needed.

[146] See Marshall's *Principles of Economics (1890)*; Robbins' *An Essay on the Nature and Significance of Economic Science (1935)*; Mankiw's *Principles of Economics (2020)*; Samuelson & Nordhaus' *Economics (2009)*; Krugman & Wells' *Microeconomics (2017)*; Bade and Parkin's *Foundations of Economics (2017)*; McConnell, Brue, & Flynn's *Economics (2020)*; Friedman's *Essays in Positive Economics (1966)*; Stigler's *Production and Distribution Theories (2017)*; Sowell's *Basic Economics (2014)*

[147] A Greek writer in the fourth century BCE who is believed to have invented the word "economics" (*Handbook of the History of Economic Thought, 2012*).

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1. Scarcity

You might have probably experienced opening the door to your refrigerator and stared at the food selection. For a moment, you were annoyed and declared you have nothing to eat. You made your way to your closet, sifted through the clothes inside, and discriminated against each. You were displeased for not having the right clothes or, worse, declaring nothing to wear.

It is fascinating (and perplexing) that compared to other people who struggle to survive and make ends meet, you are caught in a situation where your available resources are not enough to fulfill your wants, including your needs and your desires, at a given time. Quite plainly (and frankly), we never get enough, and that there is always something else that we like to have. But this is not necessarily wrong. However, this situation gives rise to a fundamental economic problem of *scarcity,* from which all others arise.

In Economics, these resources, or more distinctly referred to as *factors of production*, are categorized into four types.

Table 1 The Four Factors of Production

	Land	Labor	Capital	Entrepreneurship
Type	Natural Resource Factor	Human Resource Factor	Man-Made Resource Factor	Enterprise Factor
Inclusion	Renewable and Non-Renewable resources as Raw Materials	Skilled and Economically Active Working Population	Machinery, Tools and other Capital Goods used in Production	The entrepreneur who organizes the three factors; Enterprise for risk-taking
Reward	Rent	Wage	Interest	Profit

The level of satisfaction of the economic agents, such as consumers, producers, and government, is determined by the quantity and quality of the factors of production used to create goods and services. Countries with sufficient high-quality resources are poised to satisfy the wants of their population. However, in reality, not all countries are endowed with the much-needed factors of production. Some have more than enough land and capital but lack skilled labor and experienced entrepreneurs. Even developed countries could struggle not having all at a time.

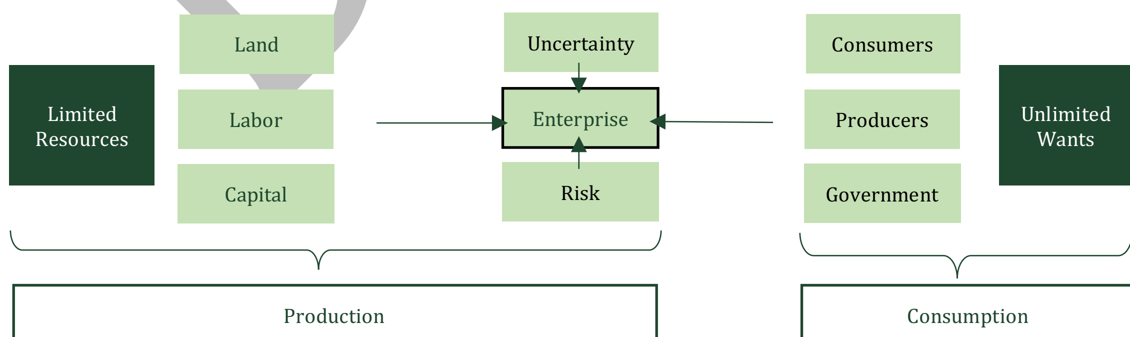

Figure 1 Interplay of the Fundamental Economic Problem and Factors of Production

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Apart from availability issues, economic agents could face market risks and economic shocks, which make it challenging to maximize the potential of the finite resources, find alternatives, and allocate these resources more efficiently and effectively.

2. Tradeoff

When unavoidable infinite wants are matched with finite resources, choices are required among competing options and uses for such resources. And in making decisions, we face our own dose of rationality, bounded rationality[148], or irrationality[149].

Have you systematically and purposefully made a choice based on available information? If you did, we would consider you as a rational person. But circumstances could tie us down, and we do not always make decisions by carefully weighing up the facts. Despite this, we often get favorable positive results. And we declare we make better decisions. Unknowingly, humans become irrational, especially when forced to deal with uncertainty or complexity. Our mental shortcuts and assumptions allow us to make swift, instantaneous decisions. On some occasions, to our detriment. At times to our advantage.

Whatever the circumstances are, every decision we make carries a certain cost to choose the preferred alternative and give up other potential choices. We aptly express this condition in Economics as a *trade-off.* In the process, perceived benefits or opportunities are foregone, hence the notion of *opportunity cost*—the economic cost of any decision made between choices and alternatives.

Let us talk about your *time*. We are confident that you would agree that time is a limited resource and there are many items on your to-do list. Clearly, you face your fair share of a fundamental economic problem—this time, a scarcity of time. You can spend all day reading this Module or binge-watching your favorite Netflix series or divide it between the two, equally or unevenly. Obviously, every single minute spent on reading is time not spent on watching. How about deciding on whether to go to work or take a vacation? How about driving your car, hopping on a bus, taking an MRT, or finding yourself in an airplane? The list could go on, and the idea is just the same: tradeoffs are inevitable. How about not deciding at all? Our inaction and inability to take a decision have corresponding opportunity costs as well. But no matter what, we continue to make choices and sacrifices. We face tradeoffs head-on.

3. Incentives

To the surprise of many, Economics is, in essence, a study of *incentives*[150]. Incentives encourage us to face trade-offs and their consequences. It motivates us to pursue satisfying our wants and needs, especially when others eye on the same things or when different things seem more exciting.

Our appetite in investing in the capital markets, for instance, is essentially dependent on the value of expected gains and the extent of perceived losses, given the level of risks and

[148] Given the limits to our thinking capacity, availability of information, and time, human rationality is bounded as proposed by Herbert Simon, *Models of Bounded Rationality: Empirically Grounded Economic Reason (1997)*.
[149] The landmark paper of Nobel Prize-winning psychologists Amos Tversky and Daniel Kahneman, *Judgement Under Uncertainty: Heuristics and Biases (1974),* will help you journey towards understanding human irrationality.
[150] As proposed by American economist Steven D. Levitt and journalist-author Stephen J. Dubner Authors of award-winning books: *Freakonomics (2009)*, *SuperFreakonomics (2011)*, *Think Like a Freak (2014)*, and *When to Rob a Bank (2015)*.

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uncertainties in the market. With certainty, gaining (or not losing) incentives induce us to place an investment willfully. However, the reality could eclipse expectations.

You have probably been in a situation where you get something in return for doing a favor or completing a task? But the incentive is not at all always positive. Aside from the prospect of being rewarded, you could be induced to act to avoid punishment or penalty. Further, incentives (or, more appropriately, disincentives) could discourage and dissuade us from doing something.

Departing from economic perspectives, incentives are not always monetary or financial. Aside from *economic incentives*, where material gains or losses are at stake, *social incentives* could significantly influence decision-making and consumer behavior. This type of incentive covers a range of interpersonal motivations that influence us to act socially and appropriately, upholding a positive reputation and avoiding negative image. Another flavor of incentive has something to do with our moral compass. Doing the right thing is undoubtedly within the bounds of *moral incentives*.

Which of these three flavors of incentives dominate your decision-making process? Whatever appeals and applies to you, our individual preferences—similarities and differences—determine and shape our interactions in markets and, consequently, reflect in an economy's complex and complicated behavior as a whole.

B. Microeconomics and Macroeconomics

Acknowledging and understanding the reality of scarcity, the problems of tradeoffs, and the value of incentives in decision-making provide us the much-needed basic foundation in studying Economics. As earlier mentioned, the discipline of Economics deals with the study of production, distribution, and consumption of economic goods, which involve economic agents. And behold, these economic activities could be complex, complicated, and cumbersome.

To better understand how economic activities are organized to allocate finite resources and how economic agents maximize the utility of economic goods, the disciplines of *Microeconomics* and *Macroeconomics* came to the fore. These two significant branches converged to form modern Economics.

For common understanding, we refer to the household (or consumer), business (producer), governments (regulator), and market (economy) as *individual economic agents*. This characterization is necessary as we split Economics between analysis of how single markets function and how the overall economy works.

1. Microeconomics

As a logical starting point of your Economics journey, Microeconomics investigates how individual economic agents make decisions and establish discrete interactions and relationships. Owing to the brilliance of Adam Smith[151], Microeconomics became a distinct field of study.

If you take the micro economist hat, you would devote much of your energies in determining how changes in supply or demand drive the price of oil and automobile, examining how

[151] Considered as the "father of Economics" and "founder of Microeconomics" because of his contributions as presented in his *An Inquiry into the Nature and Causes of the Wealth of Nations (1776)*, more widely known as "The Wealth of Nations."

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income levels determine the production of necessity and luxury goods, inquiring how taxes on imported goods affect domestic consumption patterns, reviewing the ramifications of removing rent control on housing for college students and increasing daily wage for factory workers in Metro Manila, and so on.

Still wearing the hat, you decided to take a vacation on an island destination that your colleagues endlessly talk about. You browsed the internet and found yourself asking: Why domestic flight tickets in the Philippines cost so much and even costlier on weekends? With so little time and not much of an option, you declared the transaction pretty reasonable. While on the plane, you began wondering why none of the passengers paid extra pesos for front-row seats. And then you found yourself wondering again why other airlines play recorded pre-flight safety briefings while you have live demonstrations. You are about to close your eyes when the flight attendant tapped your shoulder and confirmed your cooperation in assisting them in case of emergency. You suddenly remembered that you unmindfully agreed to be seated in the exit row along with its promise of little comfort for your tired feet. After all, those extra legroom has a catch. You are equally and highly responsible for the it-almost-never-happens-but-could-happen event. Indeed, there is no such thing as a free seat[152].

Situations like these allow you to take off into the realm of microeconomic theories and touch down to the nitty-gritty of supply and demand, consumer and producer preferences, including price competition, government regulations, market failures. In doing so, you will find the *theory of the consumer* and *the theory of the firm* very helpful. Utility-maximizing consumers and profit-maximizing producers are usually painted on the colorful canvas of Microeconomics.

Since individual microeconomic actions and decisions have influences and repercussions on the overall macroeconomic phenomena of a given economy, the realm of Microeconomics is closely entwined with that of Macroeconomics. Despite their inherent, natural, and causal link, the two branches are distinct. As you continue, you will see for yourselves the unique questions and concerns macroeconomists have to confront.

2. Macroeconomics

The pioneering works of Irving Fisher[153] and Knut Wicksell[154] on price and interest, coupled with the influential masterpieces of John Maynard Keynes[155] on the instability of aggregate variables, led to the popularity and acceptance of Macroeconomics as a branch of knowledge.

Any economy, emerging or developed, is a system of tremendous complexity. As millions of individual economic agents almost incessantly interact through factors of production and money markets, goods and services are exchanged at a dramatic rate and almost endlessly. The interactions determine the overall economic performance.

[152] A little departure from the famous adage "There is no such things as free lunch." Although the origin was known, Milton Friedman's free market ideologies popularized its use. Gregory Mankiw also used it in his book, Principles of Economics.
[153] Considered as one of America's greatest mathematical economists. He is best known for his 1930 book "*Theory of Interest, as determined by Impatience to Spend Income and Opportunity to Invest it.*"
[154] A Swedish economist known as pioneer in monetary theory with his *Interest and Prices (1936)* and *Value, Capital and Rent (1954)* masterpieces.
[155] Founding Father of Macroeconomics. *General Theory of Employment, Interest, and Money* published in 1936.

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This time you would need a bigger hat. As a macroeconomist, you are tasked to study the implications of internal and international borrowings by the government, the enactment of policy changes on foreign investments, the actions by the central bank on key interest rates, the changes in unemployment and underemployment conditions, the movements in consumer price indices, the valuations of domestic and foreign currencies, and many more. All determine the country's level of output and overall standard of living. Given these, Macroeconomics as a distinct field of study is primarily concerned with economy-wide phenomena and essentially, the workings of the whole economy.

But before things get a little messy and lead you to feeling overwhelmed or intimidated, let us put aside the discussions of aggregates and equilibria, savings and investment, business cycles and recessions, and exports and imports. Let us switch to an airplane mode and learn Microeconomics without nosy notifications.

C. Law of Demand and Law of Supply

You have safely landed—without having to perform the responsibility for the exit door—and experienced your first of many compliments from your hotel—ignoring the metered taxis and being chauffeured around town. As soon as you reached your accommodation, the primal urge to rest did not kick in. You thought of an island getaway instead where you would break free on a deserted beach and kayak in crystal-blue water, among others. Suddenly, your bubble burst. The cost of your ultimate private escapade is three to four times the cost of an overnight hotel stay! It is not even summertime, and you are not even in Panglao or the Maldives. First, you learned that the package price is not fixed. Second, there are only two private boats and one hotel-owned yacht available. Third, the boatman could only take one tourist at a time. Fourth, there are 10 of you who want the same thing.

Quite obviously, the forces of *demand* and *supply* are at play—two words economists use most often and two of the most recited economic terms.

You must learn demand and supply—for good reason. They determine the quantity of each good produced and the price at which it is sold in a market economy. If you want to know how any event or policy will affect the economy, you must think first about how it will affect demand and supply. You have gone far enough understanding market economy if lessons in supply and demand are mastered.

This section introduces the law of supply and demand. It helps you examine how buyers and sellers behave and how they interact with one another. It shows how supply and demand determine prices in a market economy and how prices, in turn, allocate the economy's scarce resources.

Before discussing how buyers and sellers (otherwise known as consumers and producers) behave, let's first consider more fully what we mean by the economic term *goods* in a competitive and non-competitive markets. Although distinctions are made based on their value in a supply chain or in production, *products* and *commodities,* including *services* in some sections, are synonymously used with *goods* in this Module and defined in Table 2.

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Table 2 Types of Goods

Classification	Description
Public vs Private Goods	▪ Public goods are goods that are non-excludable (i.e., no one is excluded from consumption), non-rival (i.e., benefits of those already consuming is not diminished) and for which it is usually difficult to charge a direct price (ex. bridges, street lights, lighthouse). ▪ Private goods are goods consumed by someone at a time and not available to anyone else, but if available, the access is limited, therefore excludable and rival (ex. home goods, private swimming pool).
Merit vs Demerit Goods	▪ Merit goods are goods which have assumed positive side effects when consumed (ex. vitamins, painkillers, inoculation against COVID-19 virus). ▪ Demerit goods are goods which have adverse side effects, often when overly consumed (ex. junk foods, recreational drugs, tobacco).
Normal vs Inferior Goods	▪ Normal goods are goods whose demand increases with increases in consumer income (ex. staple food, clothes). ▪ Inferior goods are goods whose demand decreases when income of a consumer increases. ▪ Interestingly, normal goods may transition to being inferior goods, and vice versa. Demand for train and air transport services depend on so many factors other than consumer's level of income. In most countries, traveling by railway is a cheaper alternative, making it an inferior good. A faster way of traveling, airplane is preferred by frequent flyers. Taking a trip on a business class is normal for business people but not necessarily a normal good. In normal circumstances, the cost of the trip is borne by their respective companies and not charged against their paycheck. But for individually-paying passengers, low-cost or budget airline is a typical inferior good. Alternatively put, for someone on a high income a good can be an inferior one while for someone on a low income, a good can be a normal one.
Necessity vs Luxury Goods	▪ Necessity goods are goods which are essential to human survival (ex. basic food, water and electricity) and are less sensitive to price changes. ▪ Luxury goods are goods which are perceived to be not essential for humans to survive (ex. designer clothing, fancy jewelries, limousine, private jet). ▪ However, something considered essential or necessary is a subjective reality. Necessities are needs and often "must-haves," and "things that we cannot live without", while luxuries are wants and desires "which we hope to have but can live without." This, however, challenges the necessity of satisfaction and happiness.

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Classification	Description
Substitute vs Complementary Goods	▪ Substitute good is a good with essentially common or comparable characteristics of your original, usual good. The consumer desires the substitute good when the price of original good increases (ex. Android phone and iPhone; Philippine Airlines and Cebu Pacific flights; LBC Express and JRS Express courier services). There are perfect and imperfect (or less perfect) substitutes. Not all goods are good alternatives to each other, if they are, demand for each is principally affected by non-price factors. ▪ Complementary good is a good that adds value or utility to another good when consumed altogether. The two goods are also known as "paired goods" (ex. ink jet printer and ink cartridge). For a good A to be a perfect complement of good B, the price increase in good A will not only lead to a decrease in quantity demanded for good A but also a decrease in demand for good B. ▪ In some instances, two goods are produced to complement each other or marketed as perfect substitutes or complements, however, consumers are taking them separately or individually at a particular period in time. In this case, changes in price of one good will not affect the demand of the other good.
Veblen[156] and Giffen[157] Goods	▪ Veblen goods are luxury goods where demand for it increases as the price increases. Consumption of these goods are considered "conspicuous" and a mode for "status-seeking" (ex. exclusive designer items, auctioned paintings, rare collectibles). ▪ Giffen goods are special type of inferior goods where demand stays or increases despite an increase in its price (ex. rice for Filipinos, bread consumed by the impoverished). This special type of good is commonly essential but does not have close substitutes.

1. Demand

When economists refer to demand, they mean the quantity of a good the consumers or purchasers are willing to buy and able to pay at various prices in a given time, all other things being equal. Let us break this definition down.

First off, *quantity* of goods being demanded is normally expressed in numerical units. However, the intention or *willingness to buy* of a good alone doesn't constitute a demand for that good. The "notional" demand must be backed up by its *purchasing power* (or the "peso vote") for it to become an "effective demand" of economic value. One must be able to buy or capable of compensating the good with money or other forms of payment. Of course, demand is time-related. Consumers must indicate the *time period* over which the sales and exchange will occur.

The study of demand is not complete without regard to the crucial importance of *price* to the functioning of a market economy. As discussed, economic phenomena could be more complex and complicated than they already are. To be able to simplify our understanding of

156 Referenced to Thorstein Veblen, an American economist and sociologist. Read his work The Theory of the Leisure Class: An Economic Study of Institutions (1899).

157 Named after Sir Robert Giffen, a Scottish economist and statistician.

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an economic situation, we only factor in a change in one determinant at a time. In Economics, the phrase "all other things being equal," "all other things are held constant" or "all other things remain equal" emanated from the Latin term "ceteris paribus."[158] This simply means that as we vary the price of a good to see its influence on demand we do not change any of the other determinants—everything else is unchanged.

1.1. Law of Demand

In a market economy, the law of demand (otherwise known as *theory of demand*) becomes a very powerful model in explaining how consumer behavior is shaped by costs and benefits and how consumer demand for goods is determined by choices.

Our personal experience, or even our scientific observations, will convince us that our demand for any good depends on its price. We normally take the changes in the market price of a particular good to see demand at work. Essentially, the higher the price of a good, the fewer quantities we are willing and able to buy. Alternatively put, when the market price goes down, we would normally buy more. Obviously, the behavior of the price of the good and quantity demanded are inversely related.

As we continue the discussion on the law of demand (and supply), we set aside the other types of goods that do not follow the usual laws of demand (and supply) such as Veblen and Giffen goods.

1.2. Determinants of Demand

The most important variable that determines the quantity of a good is the good's own price. Other variables that determine the quantity of a good that we willing and able to pay are mostly non-price factors. Let us explore the major *determinants of demand* and its effects.

Table 3 Determinants of Demand

Other Determinants	Effect on Demand
Income	Demand for goods invariably depends on income. Income determines our purchasing power (or peso vote). As our income rises, we tend to buy more of the goods we normally have and buy other goods we don't typically buy, even if price remains the same. For inferior goods, the demand tends to decrease, except during a period of decline in the economy.

[158] In William Petty's *Treatise of Taxes and Contributions* (1662), caeteris paribus clause was used to qualify generalizations. John Cairnes, in his masterpiece *The Character and Logical Method of Political Economy* (1857), is being credited to popularizing the idea by emphasizing that the conclusions of economic investigations hold "only in the absence of disturbing causes."

Other Determinants	Effect on Demand
Price and Availability of other goods	The influence depends on the type of the relationship the original good has on other products. For substitute goods, the extent of the change in demand depends on the degree of substitutability. Granting that we find Coke and Pepsi as very close substitutes, a change in price of Coke is likely to have an impact on the demand for Pepsi. Although not as close substitutes, the demand for other similar cola products could also be affected by price changes in any of two well-known brands in the same segment. Following our earlier discussion, complementary goods have a joint demand and utility enhancing effect. A typical example of complementary goods are car and gasoline. The change in the price of gasoline, as well as its availability, will have an effect on our demand for cars. An increase in the price of gasoline is likely to result in the demand and use of cars.
Tastes and Preferences	The subjective elements and variety of sociological, cultural, psychological, and traditional influences make taste and preferences unique as our attitudes. Changes in these determinants significantly influence and shape the demand of any good. When we all like a particular good, the level of demand for such good will likely to increase. Let us use our Coke and Pepsi example: If a bottle of Coke and Pepsi each sell at PhP30.00, what will you buy? Perhaps the one that tastes better right? According to your palate, you prefer Pepsi. But what if Coca-Cola decides to temporarily cut price of a bottle of Coke to PhP25.00. What will you do? Unbothered by price changes, you take Pepsi to show your preference and remain a loyal customer.
Expectations on Future Price	A rational consumer takes advantage of future prices of the same good, thus altering its current demand for such good. The current demand tends to increase if future prices is expected to be higher. If future prices will be lower, demand decreases. You would notice that car owners have their car filled with gasoline when a scheduled price hike of gasoline is announced. As a consequence, demand for gasoline for that period skyrockets.

1.3. Demand Function

We are now ready to capture the determinants that influence consumer's demand in a relationship economist call *demand function*[159].

[159] In Statistics, a function is a relationship that assigns a unique value to a dependent variable for any set of values of a group of independent variables.

Most often, economists use equations and graphs in presenting their ideas in a logical and intuitive ways. There are two ways of understanding our demand function of a given good:

In mathematical form

$QD_X = f(P_X, I, P_Y, TP, PE)$

where

QD_X = the quantity demanded of good X
f = a symbol for "is a function of"
P_X = Price per unit of good X
I = Income of a consumer
P_Y = Price per unit of good Y
TP = Tastes and Preferences
PE = Price Expectations

Note that good Y could either be a substitute or complementary good.

In descriptive form

"The quantity demanded of good X depends on the price of good X, consumer's level of income, price and availability of good Y, consumer tastes and preferences, and price expectations on good X, Y, and other goods."

When we study demand more deeply, we concentrate on the relationship between quantity demanded of the good (**QD_X**) and price of the good itself (**P_X**), while holding other determinants not changing (remember, ***ceteris paribus***) as presented Equation 1. Note however that the income of the consumer, price of other goods, and other determinants of demand are not ignored. Equation 2 merely simplified our demand function of good X for us to concentrate on a key determinant—the good's own price.

Equation 1

$$QD_X = f(P_X, \underbrace{I, P_Y, TP, PE}_{\textit{ceteris paribus}})$$

Equation 2

$$QD_X = f(P_X)$$

1.4. Demand Schedule

Let us take a hypothetical demand and choose laptop as our good under investigation. Following our discussion, we would note that price of a laptop is a major consideration which influence demand of it.

Consider taking the case of a parent who must make an important economic decision for his/her four grade-schoolers with a PhP100,000 budget in mind. Taking current income, preference to any brands, prices of close substitutes, and price expectations all at constant level, the parent's willingness and ability to buy laptop, at this point in time, is solely dependent on changes in price.

In an ideal situation, economists present demand for certain goods in aggregates[160]. In order to present the data collected from consumers, economist use *demand schedule*—is a table that presents the quantity demanded of a good at varying price levels. For simplicity, we will only present the parent's demand for laptop.

Table 4 Demand Schedule for Laptop

Price (*in Philippine Peso*)	**Quantity Demanded** (*in units*)
70,000.00	0
60,000.00	1
50,000.00	2
40,000.00	3
30,000.00	4
20,000.00	5
10,000.00	6

Table 4 shows us how law of demand works. As price of laptop decreases, the parent's demand for laptop increases, *ceteris paribus.* With the price of PhP60,000, the parent could only afford one unit of laptop. And when price reaches PhP20,000 per unit, the parent can afford 5 units. If this price exists, each one of them could have their own laptop—four for all grade-schoolers and one for the parent. How much more having six laptops, PhP10,000 each.

Intuitively, the case we had just examined presents the inverse relationship between price and quantity demanded.

1.5. Demand Curve

The information in a demand schedule can be represented on a graph[161]. But before you take a closer look at the graphs in the succeeding sections or acknowledge some sort of graph-induced anxiety or statistics-related panic, let us acknowledge that a working knowledge of graphs is important in understanding (and mastering) Economics. Graphs are essentially constructed by representing each of a table's data pairs into a single point on a two-dimensional coordinate plane[162]. The horizontal line (or the X axis) and vertical line (Y axis) correspond to two variables[163]. In Economics, usually the price and quantity or sometimes, time and any economic variable.

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[160] Aggregated demand refers to the sum of all individual demand of a good in a given period.

[161] A diagram showing how two or more variables are related to one another thus determining the nature of the relationship (either direct or inverse).

[162] More precisely known as the Cartesian plane, which is specified in terms of two perpendicular number lines: the x-axis (horizontal) and the y-axis (vertical). With these two axes, one can plot at any points in the coordinate plane using an ordered pair of numbers. In most cases, economists use the first of the four quadrants, where X and Y axes are positively charged (signs are positive).

[163] An X variable is typically considered an independent variable, while Y variable as a dependent variable.

Using a graph, we can immediately see at glance the relationship of the price of laptop and the quantity demanded, for instance. Figure 2 illustrates the change in price at the vertical axis to the quantity demanded on the horizontal axis. To draw the economic relationship, points from *a* to *e* have been connected creating a straight line. This line is referred to as the *demand curve* (labelled as D_1). As a graphical representation of a demand schedule, a demand curve shows the relationship between the price and quantity demanded of a good in a particular period of time, all other things remain unchanged.

Figure 2 Hypothetical Demand Curve for Laptop

You might notice that our demand curve is not at all "curvy" but a straight, steep line. In an attempt to simplify the explanation of an economic phenomena, and given the limited samples of price points and quantities, straight-line demand curve comes handy. What is worth noticing though is that our demand curve is downward sloping, showing an inverse relationship between our two variables. As shown in Table 4 and Figure 2, the price of laptop and quantity demanded move in different order and opposite direction, respectively—quantity demanded increases as price decreases.

When *ceteris paribus* was used, the only thing that changes are the price and resulted to changes in quantity demanded. These changes are shown by point *a* to point *b*, point *b* to point c, and so on. Therefore, a change in the price of laptop leads to a *movement along the demand curve*. This only means there are no other factor that influences demand for laptop, except its own price.

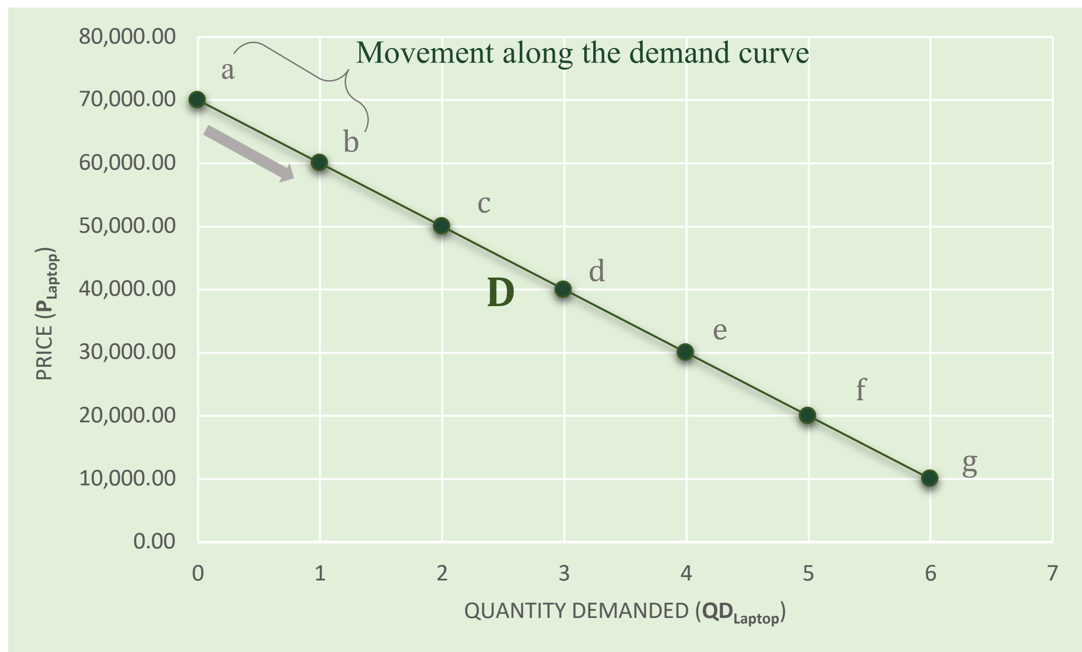

Figure 3 Movement Along the Curve

But what if the parent's income, prices of substitutes, or future price expectation changed? What will happen to the demand curve? If one or more determinants of demand change, the overall demand at any price level could change. This condition will not lead to a movement along the demand curve, but rather a shift in the demand curve (Figure 4). As a matter of fact, the demand curve itself will shift to the left or to the right, depending on the nature of the change. The demand curve (D_1) in Figure 3 may shift to the right (D_2) due to any of the following reasons:

(a) The parent's income has increased;
(b) The price of personal computer, a substitute for laptop, has increased relative to the price of laptop;
(c) The preference in the use of laptop has been heightened as fellow parents share their positive feedback on its use; and
(d) The price of laptop has been expected to increase in the coming day.

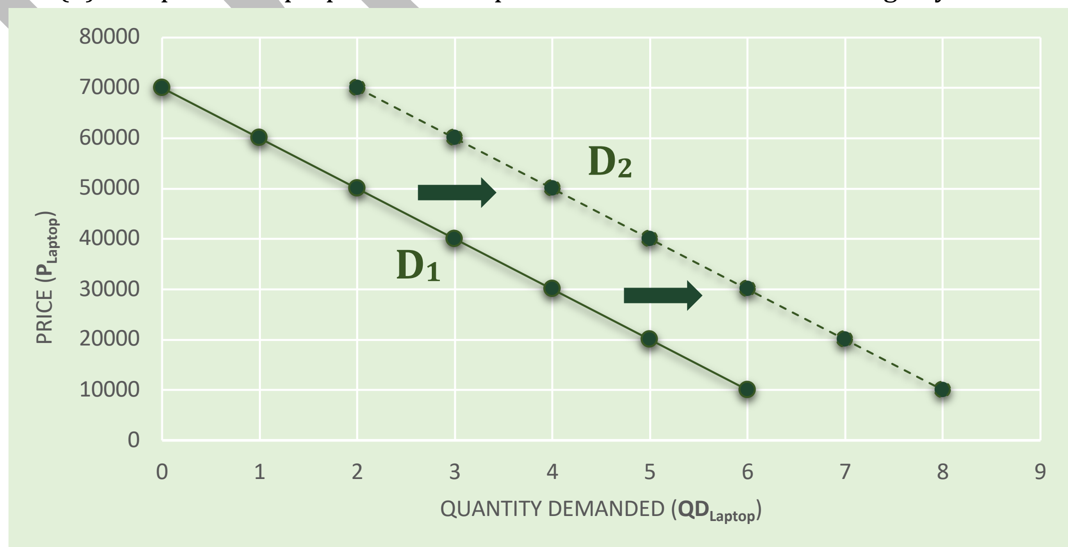

Figure 4 Shift in the Demand Curve to the Right

In an opposite situation, the quantity demanded may decrease despite having an unchanged price of laptop. This could be due to a decline in the parent's income, diminishing preference of laptop linked to unfavorable reviews, drop in the price of desktop and tablet computers, or delay in purchase due to anticipated price drop of laptop in the coming days. In any case, the demand curve (*D₂*) will shift to the left (*D₃*), indicating lessened attractiveness of laptop.

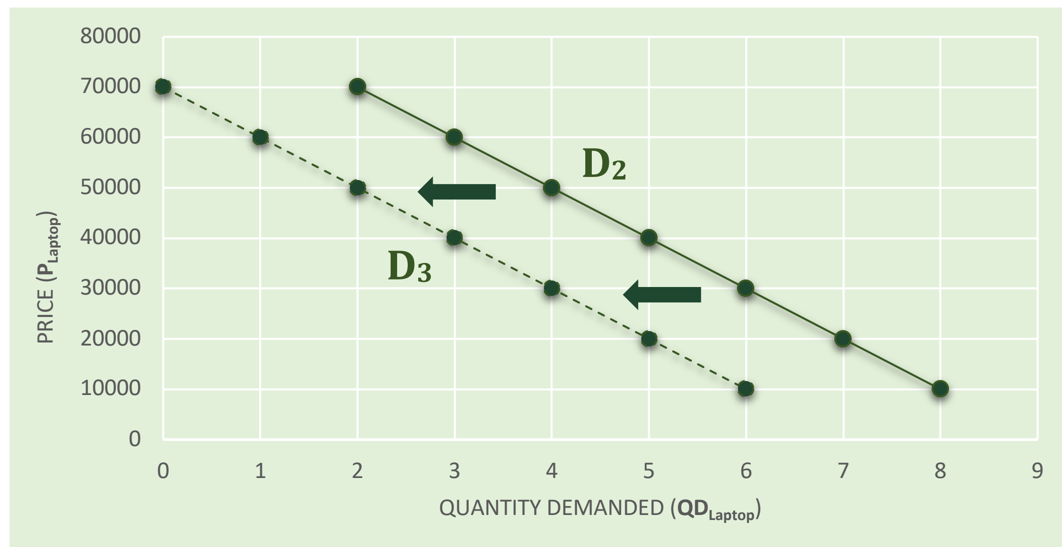

Figure 5 Shift in the Demand Curve to the Left

In both scenarios, the level of prices of laptop has not changed, but the quantity demanded at each price has changed.

Before we proceed to the law of supply, we take a detour and instead discuss the *law of diminishing marginal utility.*

As we satisfy our needs, wants, and desires through the choices we make, we look at the benefits that we derive from the good. To quantify satisfaction, economists use the term *utility* and assign *util* as unit of measurement of the satisfaction, benefit, or usefulness of the consumed good (this perhaps the reason why we often use the pejorative word *inutile* if something is not useful or beneficial).

Most often than not, we get positive, negative or zero marginal utility as we consume. Marginal utility is that extra benefit or utils we derive from consuming more units of a good. However, every additional consumption adds less and less utility. This economic phenomenon is commonly known as the *law of diminishing marginal utility*. Imagine receiving a number of fluffy, spongy, gooey, and moist cakes on your birthday and let us say all are your favorites. At some point in time, you are convinced that your excitement and satisfaction levels increase as you stare at them, slice, and clear your dessert fork. But as more impeccable slices are brought in, excitements start to drop, satisfaction settles.

From a marginal utility perspective, the first slice recorded the highest utils. The way you look at the cake and the effect of each nibble are not the same. For some people who could devour a whole regular-sized cake experiences positive marginal utility. But for the most of us, the law of diminishing marginal utility is something we can accept. And in some instances, we experience zero marginal utility when extra slice of cake could no

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longer be appreciated. Negative marginal utility, on other hand, is experienced when eating more causes us harm and discomfort (e.g., indigestion, sore throat).

2. Supply

Studying supply, law of supply, supply schedule, and supply curve comes intuitively easy for you this time.

At the heart of discussion of supply is a producer, a collective characterization of the businessperson, capitalist, and entrepreneur, who takes the lead in manufacturing, trading, and selling of goods, services, products, or commodities. As an economic jargon, supply is the quantity of a good the producers are willing to produce and able to sell at various prices in a given time, all other things being equal. Just like what we did with demand, we also break this definition down for common understanding, but with fewer explanations.

The *willingness to sell* of a producer must be coupled with the producer's *ability to produce* a particular good given available raw materials or factors of production. Supply, as well as the production process, is also time-bound.

Price, on the other hand, is also critical to producer's decision making of what to produce, when to produce, and how many to produce. As in the case of that of demand, the phrase *ceteris paribus* applies to our discussion of supply.

2.1. Law of Supply

We now turn from law of demand to law of supply. In general, producer's behavior tend to be opportunistic having to produce only when the perceived price is at least as high as the cost to produce an additional unit of a good. The extent of willingness and ability of a producer to supply the good is determined difference between those two variables—cost to produce the good and the price of the good. Compared to the law of demand, where price of the good and quantity demanded are inversely related, law supply shows a positive relationship between the price and quantity supplied. A rise in price normally results in a greater quantity supplied, and a drop in price results in a lower quantity supplied.

2.2. Determinants of Supply

The market price level may incentivize or disincentives producers to transform inputs or factors of production into finished goods and services. Other than the price of the quantity being supplied, there are other influences that determine the behavior of the producers as suppliers of goods. Let us discuss these considerations.

Table 5 Determinants of Supply

Other Determinants	Effect on Supply
Technology	Technology is critical ingredient to transforming factors of production at its simplest level, scientific and technological breakthroughs facilitates transformation of land, labor, capital, and other inputs to production. Presence and absence of a technology determine the producer's overall production, thereby affecting market supply level.

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Other Determinants	Effect on Supply
	Producers endeavor to exploit and explore technological advances to manufacture and deliver goods more efficiently and effectively. Because of these, greater quantity of goods is produced and wider consumers are reached.
Price of Inputs of Production	The decision to manufacture is invariably driven by the cost of production and distribution. For it to be profitable for producers to supply in greater quantities, production costs must be low relative to the market price. Lower production costs, which may be the result of cheaper manufacturing technologies or lower cost of labor, will translate in increased supply for a given price. Otherwise, firms produce less or switch to producing other goods requiring low cost raw materials. As a result, supply of a given good will likely to lower than market expectation.
Price of Related Goods	Competition pushes producers to constantly check market prices of similar or related goods. Let us take the following typical market conditions If competitors lower their price, quantity supplied will likely be lowered by a producer who keeps the price of a good unchanged. If competitors increase its price, others may gain and will be able to supply more, while keeping their costs under control. If price of a substitute good decreases, the supply of another substitute good decreases also.
Government Interventions	Government actions in the form of policies and regulations influence producers and their supply decisions in so many ways. A new tax on a good will likely reduce supply, while subsidies[164] will eventually raise supply. New minimum-wage laws and environmental and health compliance regulations could significantly push input prices up, which will then result in fewer supply. Removing quotas and reducing tariffs could incentive increase in production volume. Clearly, government interventions have a major impact upon supply.
Special Influences	Producers are like consumers. They grab opportunities as they come and wait other opportunities to manifest itself. Sometimes, create opportunities themselves. Special influences, such as anticipated social activities and regular changes in weather or season, assist business scheduling their production and determining supply level. Supply of swimming apparels are like to rise in summer seasons. However, uncertain weather conditions (e.g., typhoons and floods) and

[164] Subsidy is a fiscal tool government uses to encourage development and market development. Examples include government granting relief from taxes on certain products or technologies, keeping prices artificially high or paying producers to reduce market price*(IMF, 2018)*.

Other Determinants	Effect on Supply
	unprecedented economic shocks (e.g., recession, pandemic-induced market crash) affect availability of inputs to production.

2.3. Supply Function

We have just learned that when price goes up, there is an increase in quantity supplied Same thing goes when price goes down, there is a decrease in quantity. Obviously, changes in price including changes in other determinants cause change in our supply. This relationship is aptly shown in a *supply function*.

In mathematical form

$$QS_X = f(P_X, TA, P_Y, P_Z, GI, SE)$$

where

- QS_X = the quantity supplied of good X
- f = a symbol for "is a function of"
- P_X = Price per unit of good X
- TA = Technological Advances
- P_Y = Price per unit of good Y
- P_Z = Price per unit of good Z as an input to production
- GI = Government Intervention
- SI = Special Influences

Note that good Y could either be a substitute or complementary good.

In descriptive form

"The quantity supplied of good X depends on the price of good X, availability of technology, price of good Y as an input to production, extent of government intervention, and presence of special influences."

Filling in *ceteris paribus*, the causal relationship between supply and its determinants is presented in Equation 3. Isolating other determinants of supply in Equation 4, from technology to special influences, we can look closely the effects of price changes of the good itself to quantity supplied.

Equation 3

$$QS_X = f(P_X, \underbrace{TA, P_Y, P_Z, GI, SE}_{ceteris\ paribus})$$

Equation 4

$$QS_X = f(P_X)$$

2.4. Supply Schedule

Assuming we have collected data from a laptop reseller, we could tabulate the data into a *supply schedule* to show intentions of the producer to supply laptop based on the variations in price.

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Table 6 Supply Schedule for Laptop

Price (*in Philippine Peso*)	Quantity Supplied (*in units*)
70,000.00	6
60,000.00	5
50,000.00	4
40,000.00	3
30,000.00	2
20,000.00	1
10,000.00	0

With PhP60,000 as the starting price, the laptop reseller is willing and able to sell 50 units. However, the reseller then lowers the number of units as price decreases. The supply becomes zero when price reaches PhP10,000. This happens when the total cost of production or distribution is higher than the market price.

2.5. Supply Curve

One thing is clear in our analysis using supply schedule: the higher price the higher quantity supplied and the lower price the lower quantity supplied. To see this positive or direct relationship, we can plot the data:

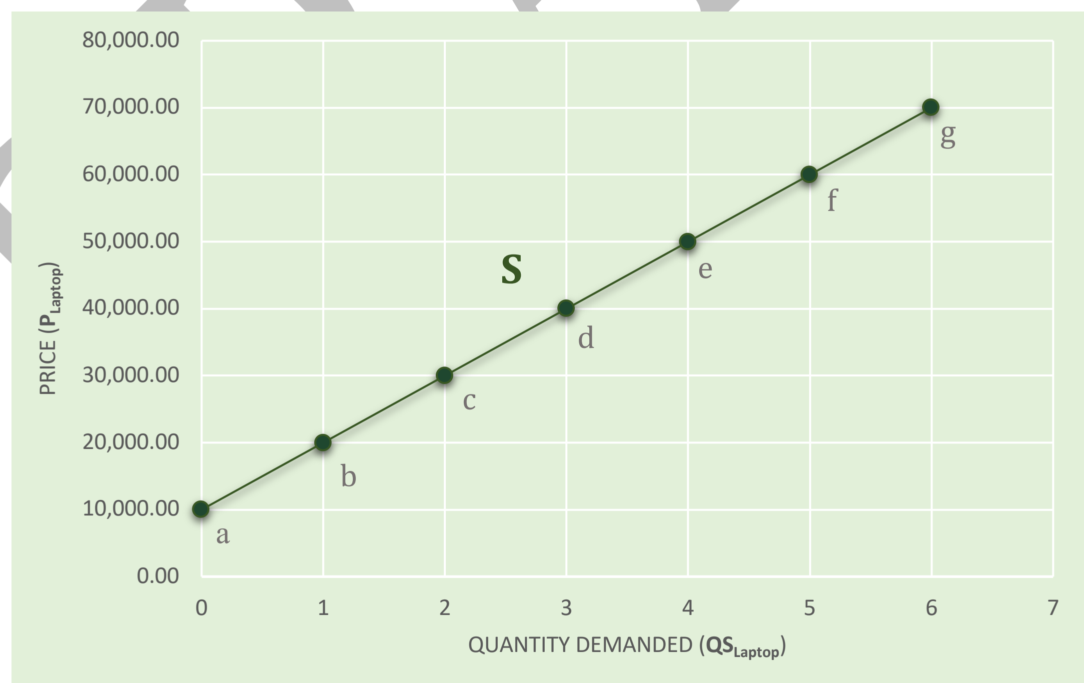

Figure 6 Hypothetical Supply Curve for Laptop

Again, the supply curve has been drawn for simplicity as a straight line connecting point *a* to point *g*, where an increase in the price will result in a corresponding direct increase

in the supply. This of course under the assumption that other factors influencing supply remain unchanged.

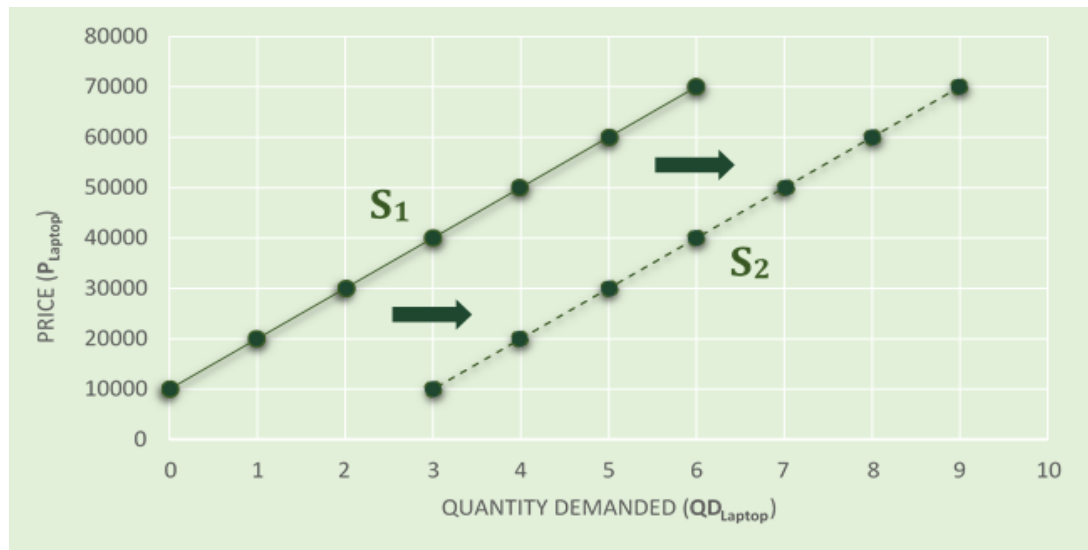

Figure 7 Shift in the Supply Curve to the Right

Let us see how quantity supplied of laptop depends upon variations in other factors. A discovery of a more efficient technology or availability of low-cost electronic components to produce laptops could shift the supply curve to the right, from S_1 to S_2 (Figure 7). The same thing happens when government gives tax holidays to laptop manufacturers to encourage local employment. But when government decided to increase tariffs on imported electronic components in the country, production of laptop decreases and as consequence, there is a supply curve shifts to the left, from S_2 to S_3 (Figure 8).

Figure 8 Shift in the Supply Curve to the Left

3. Market Price and Price Equilibrium

We have been studying demand and supply separately up until now. Using our tables and graphs, we learned how quantities demanded and supplied at different price points. But how

exactly prices are set in a world of demand and supply? A consumer or producer cannot just individually declare the price they have in mind. In Economics, it is vital to fully understand the concept of equilibrium.

Let us work through the laptop example and put together demand and supply.

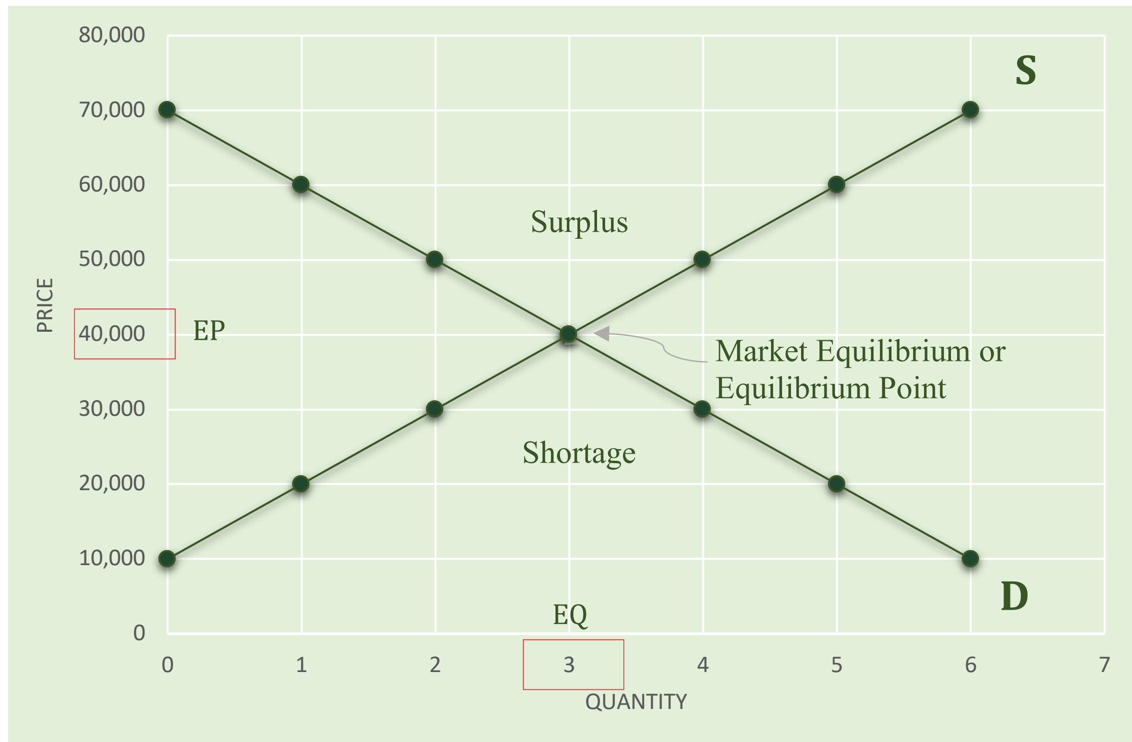

Figure 9 Interaction of Demand and Supply Curve

When demand and supply interact, *market equilibrium* occurs. It is condition when an equilibrium price (EP) and an equilibrium quantity (EQ) determined are. When the demand and supply forces are at an equilibrium or in balance, neither buyers nor sellers have the reason for price to change, ceteris paribus.

Alternatively, market equilibrium (MP) is reached at a price where quantity demanded equals quantity supplied.

In Figure 9, we see that our supply curve *S* and demand curve *D* intersect. We can find that the price PhP40,000 matches with demanded and supplied laptop of three (3) units.

4. Surplus and Shortage

At any price above EP, a producer desires to supply laptop in more quantities than what consumer desires to buy. This will result in *surplus* or a condition where there is more quantity supplied than quantity demanded.
Conversely, at any price below EP, a consumer desire more. This time, the market is at a *shortage*. It occurs when there is excess of quantity demanded over quantity supplied.

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Table 7 Demand and Supply Schedule for Laptop

Price (*in Philippine Peso*)	Quantity Demanded (*in units*)	Quantity Supplied (*in units*)	State of the Market
70,000.00	0	6	Surplus
60,000.00	1	5	Surplus
50,000.00	2	4	Surplus
40,000.00	3	3	Equilibrium
30,000.00	4	2	Shortage
20,000.00	5	1	Shortage
10,000.00	6	0	Shortage

In a highly competitive market, equilibrium price signals the absence of shortage nor surplus.

D. Elasticity

Following our law of demand and supply lessons, we dare say consumers would normally buy less of a good and producers sell more when market prices go up. This means that we are sensitive to price? But how sensitive are we?

The focus should not only on understanding the directional effects of price changes on quantities. We need to look at the extent of such change in price to quantities demanded and supplied. And we begin to ask: how much supply and demand respond to changes in price?

There are purchases that are very sensitive to price changes. How often to do you normally stay in a four-star hotel for leisure, dine in a restaurant for a fancy meal, attend a live concert, or choose cinema equipped with reclining leather chairs and free popcorn? You might probably agree that price fluctuations matter, especially for those earning within and below minimum wage. Even a minimal increase in price of any of these "luxuries" has a much larger effect on your demand. But for basic "necessities," a large change in price will only have a modest impact on your demand for it.

These variations are analyzed using a concept referred to in Economics as *elasticity*.

As defined, elasticity is the numerical measure of the responsiveness of a given variable to a change in another variable, all things held constant. Elasticity, also defined as the *ratio of percentage changes*, can be applied to both demand and supply side of any market. The two widely used elasticity measures are own price elasticity and income elasticity.

Price Elasticity of Demand

When demand is very sensitive to price, we say demand is *elastic*. Otherwise, we demand is classified as *inelastic*.

$$\textbf{Elasticity}_{\text{Demand}} = \frac{\Delta Q}{(Q_1 + Q_2) \div 2} \qquad \frac{\Delta P}{(P_1 + P_2) \div 2}$$

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Table 8 Numerical Calculation of Elasticity Coefficient

Q	ΔQ	P	ΔP	$\frac{Q_1 + Q_2}{2}$	$\frac{P_1 + P_2}{2}$	$\frac{\Delta Q}{(Q1 + Q2) \div 2}$		$\frac{\Delta P}{(P1 + P2) \div 2}$		Elasticity
0		70								
	1		10	0.5	65	$\frac{1}{0.5}$	÷	$\frac{10}{65}$	=	13.33 (elastic)
1		60								
	1		10	1.5	55	$\frac{1}{1.5}$	÷	$\frac{10}{55}$	=	3.72 (elastic)
2		50								
	1		10	2.5	45	$\frac{1}{2.5}$	÷	$\frac{10}{45}$	=	1.82 (elastic)
3		40								
	1		10	3.5	35	$\frac{1}{3.5}$	÷	$\frac{10}{35}$	=	1.0 (unit elastic)
4		30								
	1		10	4.5	25	$\frac{1}{4.5}$	÷	$\frac{10}{25}$	=	0.55 (inelastic)
5		20								
	1		10	5.5	15	$\frac{1}{5.5}$	÷	$\frac{10}{15}$	=	0.27 (inelastic)
6		10								

Table 9 Price Elasticities of Demand

Value	Type	**Example**
Elasticity = 0	Perfectly Inelastic Demand	An increase in price leaves quantity demanded unchanged
Elasticity < 1	Inelastic Demand	A 15% increase in price leads to an 5% decrease in quantity demanded
Elasticity = 1	Unit Elastic Demand	A 15% increase in price leads to 15% decrease in quantity demanded
Elasticity > 1	Elastic Demand	A 15% increase in price leads to a 25% decrease in quantity demanded
Elasticity = ∞	Perfectly Elastic Demand	At any price above price A, quantity demanded is zero or At exactly price A price, consumers will buy any quantity or At any price below price A, quantity demanded is infinite

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Part II. Macroeconomics

LEARNING OUTCOMES

- Define macroeconomics and describe why macroeconomic considerations are important to an investment firm and how macroeconomic information;
- Understand gross domestic product (GDP) and other approaches in measuring economic activity;
- Explain economic growth and economic development
- Describe phases of a business cycle and their characteristics
- Describe economic indicators and their uses and limitations
- Define inflation, deflation, stagflation, and hyperinflation, and describe how these affect consumers, businesses, and investments;
- Understand monetary policy and identify basic components;
- Define fiscal policy and the dynamics of government spending; and
- Explain limitations of monetary policy and fiscal policy.

A. Key Concepts and Key Players in a Macroeconomy

In the previous part of this module, we discussed Microeconomics and were able to examine the decision-making regarding the allocation of resources and prices of goods and services on an individual household and business level. However, an economy consists of thousand, if not millions, of consumers and producers. This is where Macroeconomics comes in.

Macroeconomics is concerned with the movement, structure, and decision-making of the economy as a whole. It focuses on the interplay between economic agents (consumers, firms, government agencies, and financial intermediaries) as they exchange goods, services, and assets on a regional, national, and global level. It includes the study of broad issues, such as growth, unemployment, inflation, balance of payments, exchange rates, and monetary and fiscal policies among others. To put simply, macroeconomics gives us the bigger picture.

While Microeconomic and Macroeconomics are distinct subfields of economics seeking to answer different economic problems, the two offer interdependent perspectives on the overall subject of the economy. To further appreciate the importance of both perspectives, consider the study of the Solar System. One astronomer might focus on studying specific topics: a planet, the comets, the asteroid belt, or the Sun. Another astronomer might study the Solar System as a whole; looking at the overall view and observing how the different components (planets, moons, comets, etc.) form the system. Both methods are important and both astronomers study the same planetary system, just from different perspectives. Analogously, both microeconomics and macroeconomics study the same economy, but each has different concentrations.

Whether we are studying planetary systems or economies, both the micro and macro perspectives offer complementary insights that will help us understand the subject deeper. Changes on microeconomic variables in the economy, whether on individuals or firms, can impact macroeconomics in the long run. Similarly, micro variables depend on the interaction among macroeconomic factors. For example, micro decisions of households and firms such as their savings and spending ultimately affects the macroeconomy. On the other hand, if the macroeconomy is robust, it is likely to influence the micro decisions of individual firms regarding hiring workers and capital investments.

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1. Macroeconomic Principles and Theories

GDP Growth. Inflation Rate. Unemployment. More likely than not, you have heard these terms in the news or read them in newspapers. We know that these figures play key roles in the economy. But how are they measured? Why do they behave in specific manners? What is their importance in our daily lives? To answer these questions, we turn to macroeconomics.

Earlier, we have established that macroeconomics studies the economy holistically through its many facets. To capture the essential elements of how these facets, work in the real world, economists use models. In this section, the three models in macroeconomics will be discussed.

The first model is the Growth Theory which focuses on the very long run time frame. This theory focuses on the growth of an economy's capacity to produce goods and services when labor, capital, and raw materials are fully employed. The assumption is that in over very long periods these factors of production are variable and can change significantly. For example, improving labor conditions in terms of diversity and rights, creation and adoption of new technology, and changes in government policy.

Another model is the Classical Theory or the Long Run Model. In contrast to the very long run model, classical theory sees productive capacity as fixed, meaning output is determined by aggregate supply (AS) alone. This is represented by a vertical but motionless AS curve (Figure 10). Meanwhile, prices and inflation are flexible and determined by changes in aggregate demand (AD).

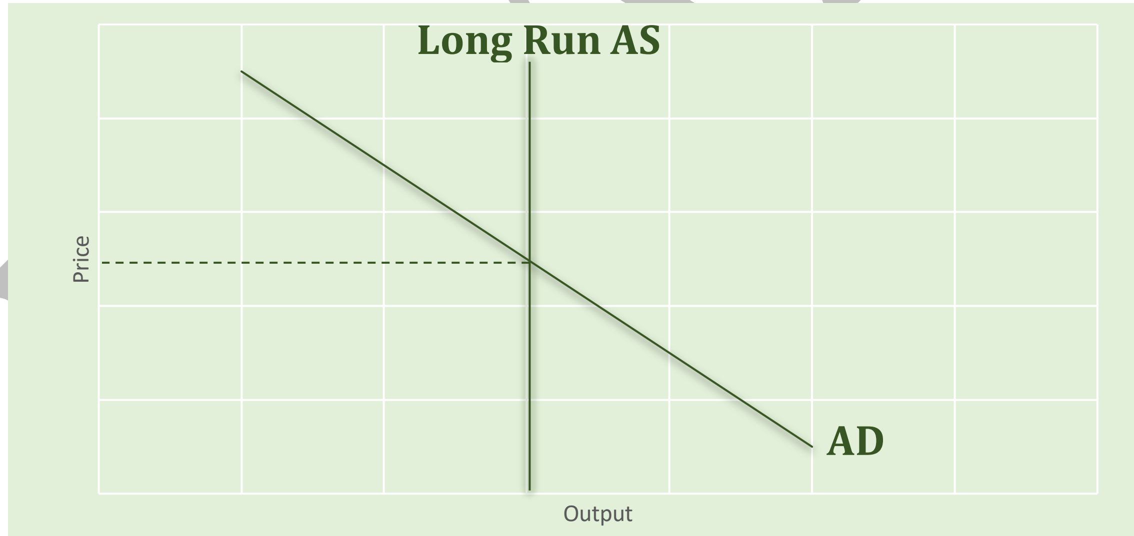

Figure 10 Long Run: Aggregate Supply and Aggregate Demand

The third and final model which operates in the short-run time frame is called the Business Cycle Theory. This describes the scenario where price is fixed and changes in aggregate demand (AD) determine the level of output. Figure 11 depicts an economy in the short run, wherein the aggregate supply curve is flat and output is flexible, depending on the changes in AD. In turn, AD is determined by elements such as consumer confidence, business sentiments, and monetary and fiscal policy[165].

[165] N. Gregory Mankiw. *Macroeconomics.* (2009).

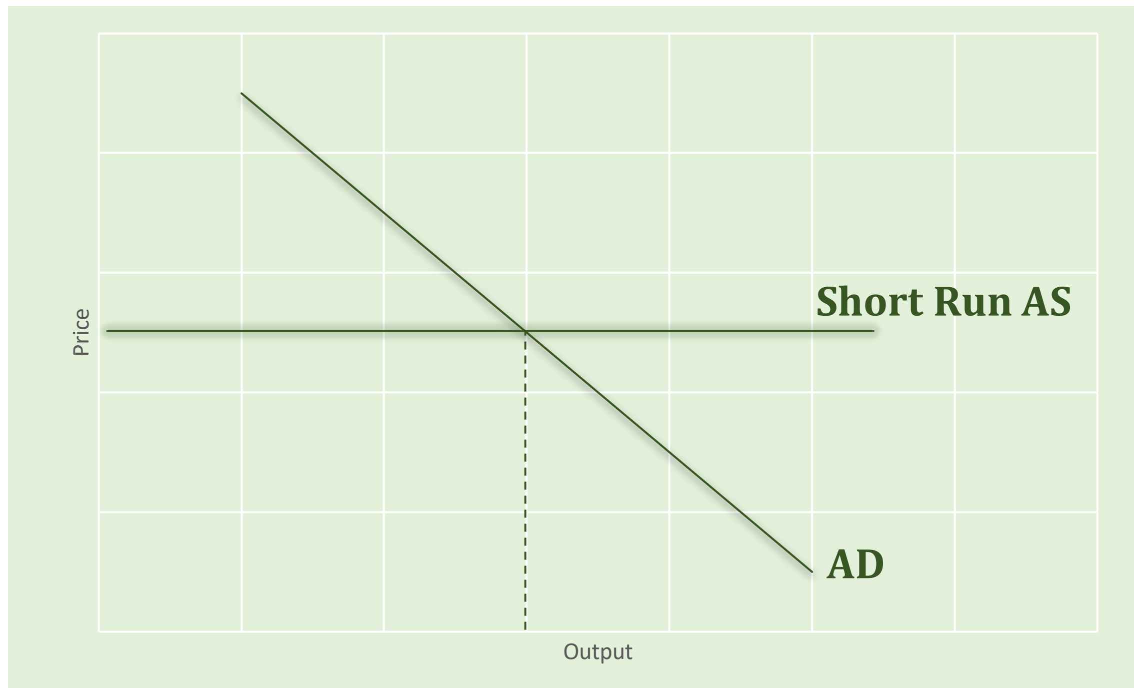

Figure 11 Short Run: Aggregate Supply and Aggregate Demand

It is worth noting that the macroeconomics we study at the present, focuses on the macroeconomy in the short-run and traces its roots from John Maynard Keynes' 1936 book, General Theory of Employment, Interest and Money. Before its publication, economists relied on the premise of Adam Smith's 'invisible hands', wherein buyers and sellers in the market are driven by rational self-interest, and therefore will result to the market finding equilibrium without interventions. This theory is challenged by Keynes who advocated for government intervention to correct the economy during an almost two-decade period of high unemployment in the UK between 1921-1939. In his book, he argued that the government needs to increase its spending to increase the total demand of the economy, pushing firms to produce more output, and employ more people[166]. To offer a simple point of view, Keynes' Law points states: "Demand creates its own supply". This theory was regarded as revolutionary and lays the foundation of modern macroeconomics we know today. Although the theory faces criticism for promoting deficit spending and crowding out, it applies relatively well in the short-run[167].

To close this section, be forewarned that these models rest on a number of assumptions and do not provide complete explanations nor accurate predictions of the phenomena in the field. Safe to say, there is no perfect "model" applicable to all scenarios.

2. Information Asymmetry

If you're a big fan of horror movies you have probably seen way too many movies about creepy houses, old buildings with shady past, dark basements, and so on. It is one of the most common horror movie tropes: buying a property at a good price only to find out they are haunted. More than a cliché plot, this is an example of information symmetry. The homeowner or seller normally has full knowledge about the property while the buyer in

[166] John Maynard Keynes. *The General Theory of Employment, Interest and Money*. (1936).
[167] Timothy Taylor. *Principles of Economics: Economics and the Economy*. (2011)

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contrast, is in the dark and may come up with a decision without having the complete information of the house.

Information asymmetry, also known as information failure, occurs when one party lacks or has unequal information than the other party in an economic transaction[168]. Typically, the seller possesses more relevant and up-to-date knowledge than the buyer which hinders the latter in making informed choices, which can possibly lead to the market failing to produce market equilibrium prices and undertake transactions efficiently[169].

To put simply, when sellers and buyers have asymmetric information, the economic transaction will mostly likely biased to benefit the party with more information.

Information asymmetry can potentially lead to Adverse Selection and Moral Hazard.

a. Adverse Selection

In his 1970 essay "The Market for `Lemons': Quality Uncertainty and the Market Mechanism", George Akerlof introduced the first formal analysis of Adverse Selection. He analyzed the market for used cars and its problem of quality uncertainty. Normally, there would be good used cars ("peaches") and low-quality used cars (lemons) in the market. Buyers are aware that the Sellers know more about their goods' quality and therefore would only be willing to buy a car at a price equal to the average of the value of a "peach" and "lemon" together. Assuming that the Sellers are profit-maximizing, this would mean that they would gain more if they sell the "lemon" and keep the "peaches" to sell at a higher price. This would lead to a feedback loop where Sellers of "peaches" leave the market and Buyers' adjust the price they are willing to pay because "lemons" now dominate the market supply. Worst case scenario, equilibrium price on this market is not achieved and no transaction occurs. Akerlof showed that the information asymmetry between the Buyers and Sellers can lead to adverse selection and potentially, market collapse[170].

With this example, we can describe Adverse Selection as the exploitation of unequal information by Sellers or Buyers about the quality of the product or service in a transaction to maximize their outcome, at the expense of the other party. This phenomenon distorts the market and leads to market failure.
Aside from the used-car market, other markets also suffer from adverse selection such as housing markets, labor market[171], health insurance[172], and markets for corporate securities. Following the theory, we can infer that only a fraction of the potential gains from trade are realized in these markets[173].

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[168] George Akerlof popularized the term "information asymmetry" in his paper *The Market for `Lemons': Quality Uncertainty and the Market Mechanism*.' (1970)
[169] Referenced to Joseph Eugene Stiglitz, Read his work *The Contributions of the Economics of Information to Twentieth Century Economics* (2000).
[170] George Akerlof. *The Market for 'Lemons*'. (1970)
[171] Michael Spence. *Job Market Signaling*. (1973).
[172] Michael Rothschild and Joseph Stiglitz. *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information* (1976).
[173] Referenced to Jonathan Levin, Read his work *The Contributions of Information and The Market for Lemons* (2001).

b. Moral Hazard

Another potential outcome of Information Asymmetry is Moral Hazard, which describes a scenario where an economic actor has an incentive to increase their exposure to risk knowing they are protected against the risk and another party will shoulder the negative consequences.

One famous example are insured individuals. Moral Hazard assumes that these individuals engage in riskier activities in the belief that their life or health insurance policy will cover some or all medical expense if something happens. This is also applicable to insured possessions such as house, car, and jewelries.

Moral hazard also occurs on a larger scale such as governments safety nets to the banking industry. This increases the probability of aggressive risk-taking from the banks' side knowing they will be bailed out by the government in the event of an unfavorable outcome.

The 2007-2008 Global Financial Crisis was a clear example of moral hazard in the financial system. Beginning in 1999, the subprime mortgage market skyrocketed in the US following a state sponsored effort to make home loans more accessible. This included lending to people with low credit scores and high default risk, also called "subprime borrowers". U.S. government-sponsored mortgage lenders Fannie Mae and Freddie Mac supported lenders underwriting these subprime loans which emboldened lenders to take more risks with the assumption that the quasi-government institution will bear the costs in the event of default (which eventually happened and led to the global financial crisis).

The study of information asymmetry reveals that human behavior adds another dimension to the already complex field of economics. We learned in this section that people are not always rational nor predictable, thus, having access to information plays an important role in their decision-making.

B. National Income Accounting

One of the most common adage we hear today is "money can't buy you happiness." Debates regarding this has been going on for a long time. Ultimately, it is very subjective because each person has different definition and threshold of happiness. Nevertheless, this does not stop scientists from settling this debate. Numerous papers point out that higher income (more money) does buy happiness[174]. Which makes sense given the higher the income of a person, the more they can easily afford life's necessities and luxuries. Higher income means higher standards of living - safer housing, better healthcare and nutrition, access to good schools, and more leisure time, and so on. The same logic applies to an economy. Measuring the income of a nation is enables us to gauge the standards of living of the population. Naturally, nations want higher income to be able to provide better standard of living for their population.

National accounts or national account system is a statistical framework that provides complete and consistent accounting techniques to measure the economic activity of a country. These accounts are used for policy making, policy evaluation, and research.

[174] Notable research on this include Daniel Kahneman and Angus Deaton's *High Income Improves Evaluation of Life But Not Emotional Well-Being* (2010) and Matthew A. Killingsworth's *Experienced Well-Being Rises with Income, Even Above $75,000 Per Year* (2021)

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1. Gross Domestic Product (GDP)

The Gross Domestic Product (GDP) is the most frequently used measure of national income. It is usually mentioned in television news, newspapers, and government reports. GDP is the market value of all final economic goods and services produced (output) within the boundary of a country in a given period. It includes the value of goods produced such as burgers, laptops, and trains, and the value of services rendered such as massages, food delivery, and book editing.

This modern concept originated from then works of Simon Kuznets in 1934. Aiming to aid the government in expressing and measuring the impact of the Great Depression, Kuznets came up with a way to assess and estimate the total productivity of the economy. The result—gross domestic product (GDP)—remains our basic measure of macroeconomic activity until today.

2. Gross National Product (GNP)

Gross National Product is the total output produced with labor and capital owned by a nation. GNP takes into account the value of goods and services produced by all citizens of a country, regardless of where they are located (within the country or abroad).

Table 10 GDP and GNP Comparison

GDP	GNP
Location > Nationality	Nationality > Location
All output generated in a country regardless of producer nationality	All output generated by a country's citizens regardless of production location
E.g. Included in Philippines' GDP are the cars produced by a Japanese manufacturer in Laguna, and the medicines produced by an American pharmaceutical company in Quezon City	E.g. Included in Philippines' GNP are the computer chips produced by a Filipino technology company in South Korea, and the books produced by a Filipino publishing company in Thailand

3. GDP by Expenditure (spending) approach

GDP can be measured in different ways and one of them is through the expenditure approach. This method adds up all goods and services purchased in an economy in a given period. This includes consumer and government spending, investment spending, and net exports.

The expenditure approach is the most frequently used method to calculate GDP, which is based on the spending of various sectors that participate in the economy.

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In mathematical form **GDP = C + G + I + NX**

Where
C = Consumption spending by the household sector
G = Government purchases of goods and services
I = Investments by businesses on assets such as capital equipment, inventories, and housing
NX = Net exports or the difference between a country's exports and imports

4. GDP by using an Income approach

Another method of measuring GDP is through the Income approach. This method consists of summing the earnings from the production of goods and services in a given period. This includes wages, rents, consumer taxes, and profits.

In mathematical form **GDP = Total National Income + Sales Taxes + Depreciation + Net Foreign Factor Income**

Where

Total National Income = Sum of all wages, rent, interest, and profits
Sales Taxes = Consumer taxes imposed by the government on the sales of goods and services
Depreciation = Decrease in the value of capital that results from its use and obsolescence
Net Foreign Factor Income = The difference between an economy's GNP and GDP

5. GDP per Capita

GDP per Capital is calculated by dividing a country's GDP by its total population. It is an indicator of a country's economic output per person which makes it a good measurement of average living standards in a country. While an important tool in gauging individual economic welfare in a country, one of GDP per capita's limitation is that it gives no indication of how GDP is distributed between the population (income equality).

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C. Measuring Growth and Development

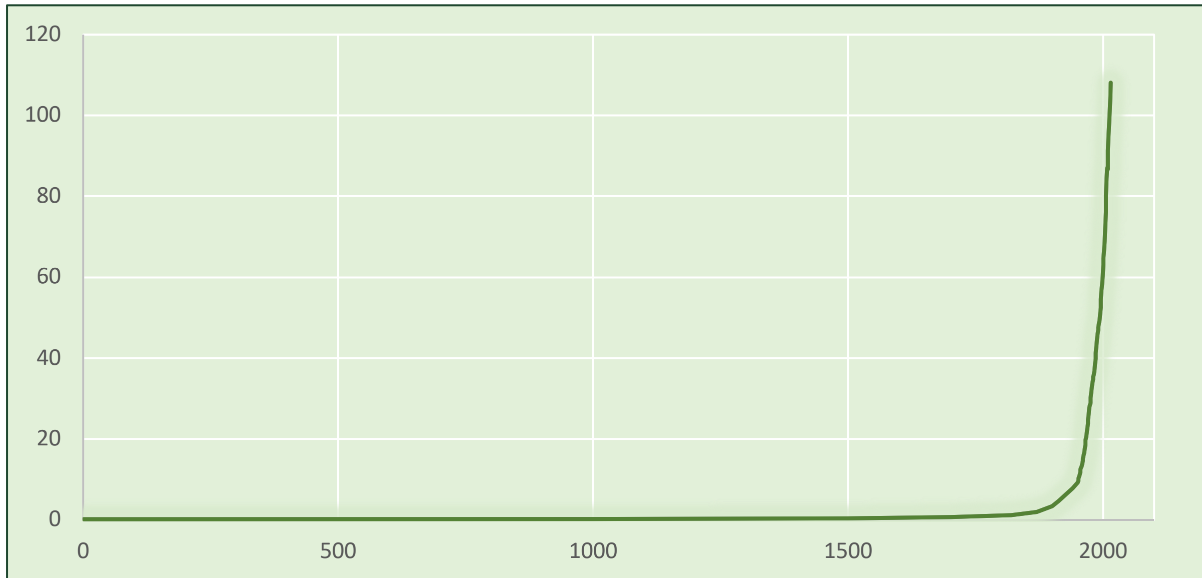

Figure 12 World GDP: Historical Data until 2015, adjusted for inflation, in Int$ trillions

From the long-term perspective of social history, "economic growth" was a recent feat. The chart above shows that until 1750, based on the limited data and informed estimations, societies achieved little to no economic growth. Does this mean there was no progress at all in terms of living standards and technology? Of course there is. However, there was no sustained increase in the productivity of human labor due to the natural resource scarcity. While technology lead to higher living standards which then drove population growth, natural resource scarcity curtails efficiency of labor (productivity). This then results to the decline of living standards and population growth. In simple terms, any progress in technology is neutralized by natural-resource scarcity. This theory is introduced by Thomas R. Malthus[175].

So what changed then? What saved the world from the Malthusian trap? We have to thank the Industrial Revolution for that. The invention of steam engines, power looms, railroad locomotive, and electric motors among many inventions revolutionized industries, boosted efficiency of labor, and generated significant improvements in living standards. The Industrial Revolution coupled with the demographic transition[176] offset the natural resource scarcity. Ever since, the economies worldwide continued to grow. Now, nations have a new challenge, measuring their economy's growth to gauge its general performance and health. The next segment will discuss the different ways economists measure economic growth and economic development.

1. Economic Growth and Economic Development

a. Real GDP as Economic Growth Measure

As John Henry Newman simply put, "Growth is the only evidence of life". It is everywhere. Humans grow from infancy to adulthood, trees grow from seeds to plants, and the economy grows too.

[175] An economist best known for his influential theories on population growth, author of An Essay on the Principle of Population (1978).
[176] Historical shift from high birth rates and high death rates to low birth rates and low death rates in societies driven by advanced technology, education, and economic development

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Throughout the years, economists have defined economic growth in different ways but almost all can be synthesized to this definition, “an increase in the market value of economic goods and services produced by an economy over time in a given time period”. Economic growth occurs when resources are used more efficiently to increase both quantity and quality of output.

Also, notice the key word “economic” in goods and services. This is to highlight that not all goods and services are included in our definition of economic growth. Only those that command a price and are not freely available due to scarcity are considered economic goods and services.

Table 11 Examples of Free and Economic Goods and Services

Free Goods and Services	Economic Goods and Services
Air	Smartphone
Sunlight	Concert ticket
Sea	Medicine
Services of parents for their children	Food delivery
Volunteer work	Book publishing

But how do we measure economic growth? The answer goes back to the industrial revolution when the economic growth paradigm propagated and came to be seen as the key metric of national progress and wealth. The paradigm was rooted on classical economics where growth in national income was equated to the growth in the wealth of a country. This national income accounting eventually paved way for the Gross Domestic Product (GDP).

Today, the most common measure of economic growth is the GDP, which as discussed prior, considers the country's entire economic output.

Table 12 Two Versions of GDP: Nominal and Real

Nominal GDP	Real GDP
The value of all final goods and services produced by an economy in a given time period **using current prices**	Nominal GDP + **accounting for price increases (GDP Deflator)**
GDP in Current Price	GDP in Constant Price
used in the computation of other economic indicators i.e. debt-to-GDP, Gross Capital Formation as % of GDP, etc.	used to assess and compare total output of an economy across time

To measure economic growth, Real GDP is used as it provides a more accurate gauge of growth without the distorting effects of inflation. While Nominal GDP takes into account

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both the changes in price and quantity of goods and services from one period to another, Real GDP only tracks the changes in quantity.

Real GDP is important for policymakers, government employees, firms, investors, and the public in gauging the economy's welfare and how a country is developing its economy.

While the concept may seem broad and nebulous at first, economic growth is related to many aspects in our daily lives. It affects what we spend on, how much we spend, our living standards, access to education, health, and even happiness. In short, economic growth is not just an indicator of an economy's welfare but also the welfare of the people living in a country.

b. Economic Development as a Multidimensional Approach (human development indices, poverty indices, income indices, etc.)

Moving beyond using only GDP, some economists[177] also emphasized that other factors such as equitable distribution of income, life and health expectancy, access to education, gender equality, and other living standard indicators should be considered in assessing an economy's progress.

Economic development is the positive change in an economy's output along with positive changes in mass living standards which contribute to material progress. It is a broader concept than economic growth as it relates to structural changes that improve the quality of life of the population.

Table 13 Comparing Economic Growth and Development

Economic Growth	Economic Development
Positive change in the real output of an economy	Economic growth + positive changes in mass living standards
Quantitative in nature	Qualitative in nature
In a given period of time	Continuous process

While economic growth is measured quantitatively through Real GDP, economic development is measured qualitatively through the indices such as Human Development Index, Human Poverty Index, and Gini Index.

The Human Development Index (HDI)[178] is a statistic constructed and aggregated by the United Nations Development Programme (UNDP) as a tool to measure overall achievements in human development. The HDI focuses on three key dimensions (1) life expectancy, (2) knowledge, and (3) decent standard of living measured by income of

[177] Notable development economists include Amartya Sen author of *Development as Freedom* and Nobel Prize winner, Mahbub ul Haq Minister of Finance of Pakistan and Project Director of the Human Development Report, and Peter Thomas Bauer author of *Dissent on Development*

[178] For more information on HDI, visit *https://hdr.undp.org/en/content/human-development-index-hdi*

individuals in an economy[179]. While the index has been criticized for representing a limited measure of quality of life, the HDI captures a simple measure of economic standard of living, and has evolved over time.

The UNDP publishes the Human Development Report which is an annual report of the HDI, providing broad measures of well-being worldwide.

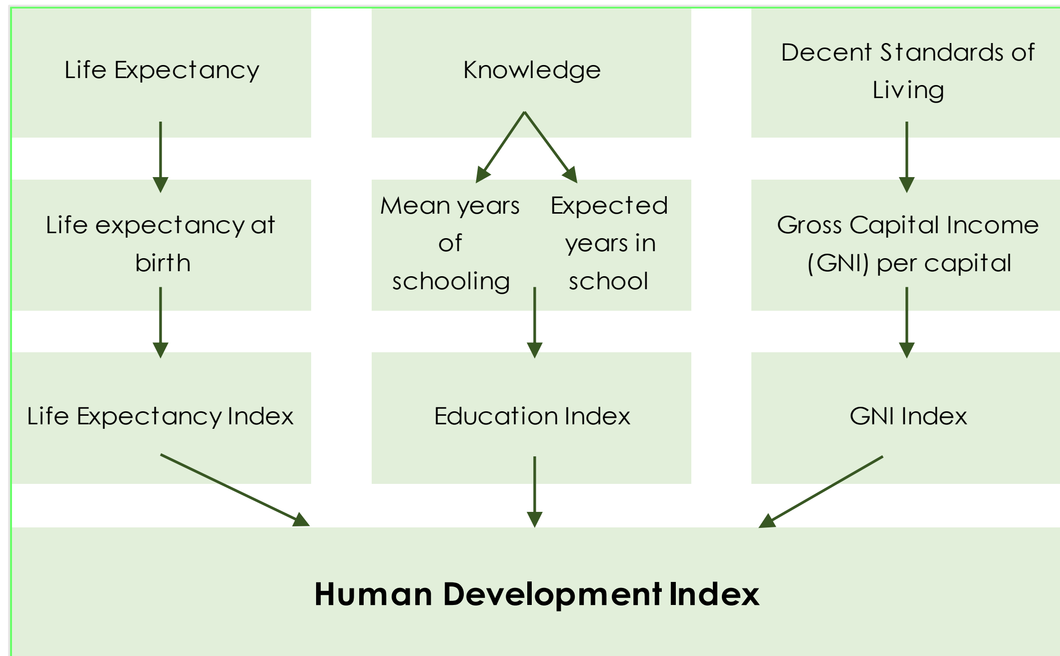

Figure 13 Human Development Index

Another index commonly used in measuring economic development is the Human Poverty Index (HPI), a summary statistic on the economic welfare of the poor in an economy. Like the HDI, HPI is also developed by the UNDP as an indication of the standard of living in a country.

The HPI measures the deficiencies in the three indexes from the HDI: longevity, knowledge, and standard of living. In 2010, the UNDP introduced the Global Multidimensional Poverty Index (MPI)[180] which is an improvement upon the HPI.

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[179] Mike Stockbridge and Andrew Dorward. *Economics and Institutions for Development*. [Module study guide]
[180] For more information on MPI, visit *https://hdr.undp.org/sites/default/files/mpi_trainingmaterial_mcc_mk_clean_june_2015.pdf*

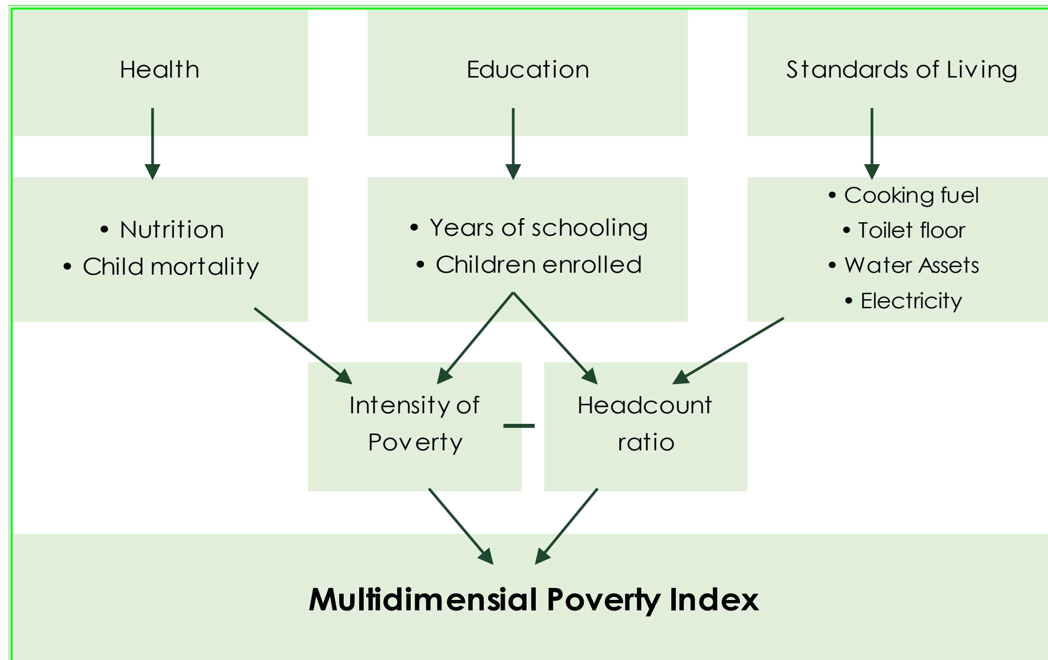

Figure 14 Multidimensional Poverty Index

The last example is the Gini Index (Gini coefficient or Gini ratio). Developed by sociologist and statistician Corrado Gini in 1912, the Gini Index is a statistical measure of income or wealth inequality in a population. It is a way of comparing how distribution of income in an economy compares with a similar economy where everyone has equal wealth. The index is scaled from 0 to 1, with 0 representing perfect equality and 1 representing perfect inequality. This means that the higher the Gini index is, the higher the income inequality within the population, meaning high-income individuals receive much larger share of the total income in an economy. The index recently became a subject of criticisms due to limitations in sampling and data accuracy.

2. Phases of a Business Cycle and their Characteristics

Is the economy growing or contracting? Is it in a boom or a bust? Economic activity is represented by a series of fluctuations, that while we cannot specifically pinpoint when will happen, we know follow the same pattern and rhyme most of the time.

a. Boom-bust

The boom-and-bust cycle, also known as the business cycle or economic cycle, is the alternating pattern of economic expansion (boom) and recession (bust) that an economy experiences over time. It is marked by fluctuations in national output, income, and employment. In a given period, the cycle is completed when it goes through a single boom and a single bust in succession. As to its duration, there is no exact formula yet that can be used to accurately predict the timing of the cycle.

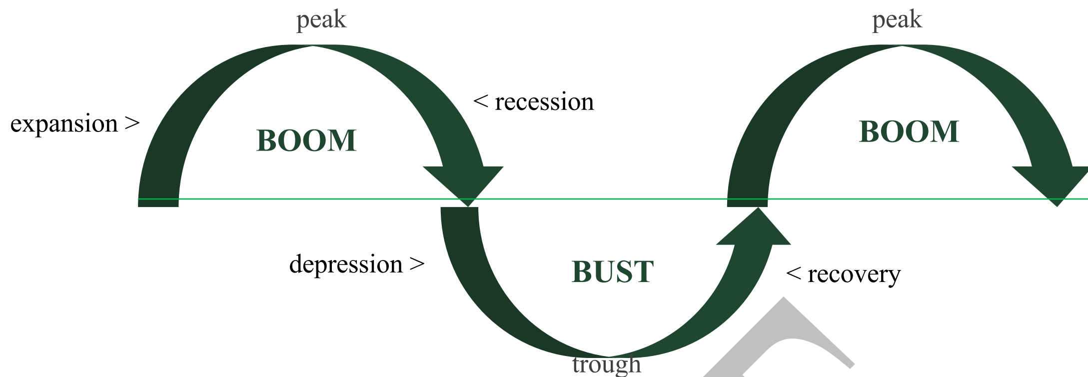

Figure 15 The Boom-and-Bust Cycle

In the graph above, the straight line in the middle is the steady growth line. The boom-and-bust phases moves about the line.

The first phase is the boom phase or expansion which occurs when the economy experiences positive economic growth. The end of the boom phase is called the peak, which marks the maximum limit of growth attained and a turning point in the cycle. This is followed by the bust phase or recession which is a recurring period of decline in total output and other economic indicators such as income and employment. A prolonged and large-scale recession is called depression. Eventually, the trough or the end of the bust phase is reached, and recovery begins where the employment of factors of production once again increases.

b. Brief Discussion of Financial Crisis

Economists differ in their theories as to the reasons for business cycles. These theories can be classified into two categories: exogenous (external) and endogenous (internal).

Exogenous theories consist of fluctuations of factors outside the economic system such as wars, elections, advancement in technology, oil-price shocks, and weather.

Meanwhile, endogenous theories look for sources of fluctuation on random shocks to the beliefs of the economic agents within the system itself. In this method, every boom leads to bust, and every bust eventually leads to the boom phase. Historically, numerous business cycles were endogenous in nature that originated in the financial system[181]. Speculative booms and busts led to financial crises which are economic disturbances where significant financial assets see sudden and sharp decline in value. Financial crises is often preceded by periods of economic boom and if left uncurbed, can lead to an economic recession or depression.

Recent examples of financial crises include the 2007-2008 Global Financial Crisis and the bursting of dot-com bubble around the early 2000s.

[181] A financial system refers to the circulatory system that links resources between lenders and borrowers, financial markets, and other financial intermediaries.

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3. Economic Indicators and their Uses and Limitations

Key economic indicators help us understand the current situation and future direction of an economy. There are dozens of economic indicators that can guide policymakers, investors, and the public in assessing the overall health of an economy and making informed decisions, but only a select few released by the government and international financial institutions have become widely accepted.

a. Employment

Statistics including unemployment level and rate, employment, and labor force provide snapshots of labor market in an economy.

Unemployment rate refers to the proportion of the labor force[182] that is without work, seeking work, and waiting for rehire. Employment rate is the opposite of unemployment rate and refers to the fraction of persons reported either as at work or with a job or business to the total labor force.

Another employment statistics is the underemployment rate or the proportion of underemployed persons to total employed persons. In the Philippines, the underemployed population consist of employed persons who express the desire to have additional hours of work in their present job or an additional job, or have a new job with longer working hours.

While these labor market indicators serves as good measurements of the utilization of labor market and the economy in general, they are inadequate in determining the economic well-being of the population. It is possible that a country records a low unemployment rate but at the same time indicate deficient living standards due to low wages and lack of welfare benefits for its citizens.

b. Debt

Another measurement commonly used in economics is the debt-to-GDP ratio which refers to the fraction of a country's debt to its gross domestic product GDP over a given period. Rather than measuring indebtedness at its absolute value, we are measuring its magnitude relative to the size of the economy in, for example, a year.

The debt-to-GDP ratio is an informative indicator of the financial leverage of an economy and its ability to repay its debt. However, the ratio is often misinterpreted. Aside from depicting the debt-to-GDP ratio as a "percentage", a more accurate unit of the ratio is time (usually the number of years). With this approach the ratio can be interpreted as, the number of years it would take to service the total government debt of a country if the entire GDP was used for repayment.

[182] The sum of people who are currently employed and the number of people who are unemployed and seeking employment. In the Philippines, labor force refers to the population fifteen (15) years old and over who contribute to the production of goods and services in the country.

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Table 14 Comparing Debt-to-GDP Ratio of Two Countries

	Country A	Country B
Government Debt	200,000	200,000
GDP in a year	200,000	100,000
Debt-to-GDP Ratio	1	2

Using the more accurate interpretation, Country A would need one year's worth of its GDP while Country B would require two years' worth of its GDP to pay off all of their respective government debts.

While a high debt-to-GDP ratio is seen as undesirable, the ratio does not offer accurate projection of a country's growth prospects. A debt-to-GDP ratio of 60% is often used an optimal threshold by many countries, but empirical data suggests that any level above this does not automatically compromise the economic growth of a country[183].

c. Price Indices

A price index (indices for plural) is a measure of the change in prices of a particular combination of goods (market basket) during a given time interval.

No single price index is perfect. Some notable price indices include the consumer price index and producer price index which will be tackled later.

d. Current Account Balance

An indicator closely watched by countries as economies become more closely linked due to globalization is the Current Account Balance (CAB). This records the net imports and exports of goods and services, investment income, and current transfers.

In mathematical form $\mathbf{CAB = (X\text{-}M) + (I + CT)}$

where

X = Exports of goods and services
M = Imports of goods and services
I = Investment income e.g. dividends, interest and migrants remittances from abroad
CT = Current transfers e.g. remittances, aids, donations, and grants

CAB together with capital account and financial account make up an economy's balance of payments.

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[183] Thomas Herndon, Michael Ash, Robert Pollin. *Does high public debt consistently stifle economic growth?* A critique of Reinhart and Rogoff. (2013), and Andrea Pescatori, Damiano Sandri, and John Simon. *Debt and Growth: Is There a Magic Threshold?* (2014).

e. Interest Rates

Among the wide array of economic indicators, interest rate is the most significant in the financial system. Interest rate is the cost of borrowing money for a given period of time, and is normally a percentage of the amount loaned (principal).

When we borrow money from a bank, we pay an interest for our loan. On the other side, when we put our money in a bank savings account, interest is what we earn because technically the bank is borrowing the money from us.

There are many kinds of interest rates which vary depending on various factors such as the loan term, risk of investment, type of borrower, and tax treatment. These include Lending Rates, Time Deposit Rates, Overnight Reverse Repurchase Rates, and Interbank Call Loan Rates among others.

We will not delve deeper into the different kinds of interest rates but it is important to note that all the interest rates can be classified into two. The first one is Nominal Interest Rate (NIR) which is the rate that is actually agreed and paid while the second one is the Real Interest Rate (RIR) which is the NIR minus inflation. RIR is calculated to give the cost of borrowing a constant value.

D. Price Levels

Have you seen an older menu of your favorite restaurant? Or glimpsed at the ten-year-old catalogue of that shoe brand you really liked? Chances are while the selection products generally remain the same, their prices before are completely different from their current market prices. Though it can be frustrating to think about not being able to buy your favorite fast food meal for 50 pesos or pay rent at its value five years ago anymore, most economists consider moderate and small increase in prices signs of a healthy economy. Nevertheless, nations still watch the prices of goods and services to ensure they do not get out of hand and rise dramatically.

1. Inflation

Incomes and prices from the past were far from what they are this day due to inflation or the increase in prices of goods and services in an economy over a given period of time. In early 2000s, for example, a movie ticket costs 100 pesos on average. By 2021, the average price of a movie ticket had risen to 250 pesos. If you saved a 1,000 bill from 2004, it would only buy four movie tickets in 2021 versus the ten tickets it would have afforded seventeen years ago. This is inflation albeit a very simplified example thereof. In macroeconomics, inflation is measured in terms of higher prices across a sector or an industry, like the transportation or health sector, and ultimately the entire economy over time.

Inflation affects people's purchasing power as the more expensive an item becomes, the less of it people can afford. Because inflation erodes people's purchasing power, the cost of living, cost of operating a business, investments, savings, pensions, cost of borrowing, and unemployment are also affected.

Today, price indexes are used to measure inflation. The most widely used price index is the Consumer Price Index (CPI) which examines the weighted average cost of a basket of consumer goods and services. CPI will be discussed in detail later.

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2. Other Changes in the Level of Prices

The reverse of inflation is deflation –the decrease of general price in an economy. While this can occur in a country, it is rare and often considered harmful for the economy. In surface level, deflation may seem like a good thing for consumers but when people continue to delay spending in the hopes of further lower prices the economy suffers. Producers lower prices to move their goods and services, which leads to lower revenue, lower wages, and higher unemployment. This downward spiral is what impairs the economy.

Another phenomena involving price changes is stagflation. A portmanteau of stagnation and inflation, it refers to the state of the economy when economic stagnation is paired with high inflation. Stagflation is often a result of supply shocks which causes economic growth and inflation to move in opposite directions. A good example is the OPEC Oil embargo in 1973-1974[184]. The contraction in oil supply led to higher prices at the same time lower economic growth owing to oil being a major source of energy.

The last phenomena are hyperinflation, the rapid or extremely high inflation over a period of time. While there is no definite threshold, economists only use the term hyperinflation when general increase in prices exceeds 50% per month.

Hyperinflation is very rare and typically caused by significant growth in money supply when the government prints more money to cover budget shortfalls and debt. In extreme cases, the hyperinflation would drive money to lose value that the economy reverts to barter trade. One of the known examples of hyperinflation took place in 1923 Germany, post-World War I. The imposed reparation debt from the Treaty of Versailles lead the German government to print more money which resulted to currency devaluation. Prices rose by colossal levels even reaching 29,000% per month[185], which dragged down the German economy.

3. Measuring Inflation

Consumer Price Index (CPI) and Producer Price Index (PPI) are two main measures of inflation. Although both are used to track the changes in the prices of goods and services, CPI and PPI differ in composition and types of prices collected for their respective basket.

CPI measures the average change in the retail prices of a fixed basket of goods and services consumers have bought over a given period while PPI measures the average change in the retail prices of raw goods and services as they leave the producer. In short, CPI refers to the cost of living and PPI refers to the cost of production.

In the Philippines, the basket of fixed goods and services in CPI includes thirteen major commodities: (1) Food and Non-Alcoholic Beverages, (2) Alcoholic Beverages and Tobacco, (3) Clothing and Footwear, (4) Housing, Water, Electricity, Gas, and Other Fuels, (5) Furnishings, Household Equipment and Routine Household Maintenance, (6) Health, (7) Transport, (8) Information and Communication, (9) Recreation, Sport and Culture, (10) Education Services, (11) Restaurants and Accommodation Services, (12) Financial Services, and (13) Personal Care, and Miscellaneous Goods and Services[186].

Globally, the CPI is commonly used in calculating the inflation rate and purchasing power of the currency. It is widely used as a monitoring indicator of economic policies.

[184] Karen R. Merill. The Oil Crisis of 1973-1974: A Brief History with Documents. (2007).
[185] Cato Institute. The Hanke-Krus Inflation Table. (2013)
[186] Philippine Statistics Authority. Summary Inflation Report Consumer Price Index (2018=100). 2022

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However, like most indicators, price indices have their limitations. One shortcoming is that qualitative changes or substitutions between goods is not included in the scope of a price index. Moreover, it is argued that the price indices may not accurately reflect the level of inflation experienced by a consumer/producer as it only measures the price level and inflation based on the average expenditure of the sample population.

E. Monetary Policy and the Role of BSP

You may wonder why studying inflation, price changes, interest rates, employment, debt, and other economic factors are essential. In this section, you will realize the value of the previous chapter in the monetary policy and be familiarized with the concepts behind the monetary policy. Moreover, as you continue on this section, you will learn which government agency has the authority to implement the monetary policy of the Philippines and how to understand their role in the Philippine economy.

1. What is Monetary Policy?

Monetary policy is one principal means of the government authority to regularly influence overall economic activity, including aggregate level output, employment, and prices[187]. Monetary policy also involves:

a. Interest rate setting.
b. Margin requirements.
c. The standard of bank capitalization.
d. The last resort lender.

In most countries, the responsible government agency in the monetary policy is the central bank. It has the responsibility to develop policies that affect a country's supply of money and credit to achieve price and economic goals.

The general ethos among economists is that monetary policy is best conducted by a central bank that is autonomous of the elected government. In other words, it is not influenced by external pressures. A central bank is considered autonomous or independent when it can implement its means of monetary policy direction. The grant of the central bank's independence indicates that none of the established bodies, government, legislative bodies, or any of their members can intervene in the decisions exercised by the central bank in the fulfillment of its mission.

In the Philippines, the central bank is the Bangko Sentral ng Pilipinas (BSP). Its primary objective is to support price stability for sustainable economic growth and employment[188]. The concept of central banking may seem complicated at first but generally, it boils down to adjustment in money supply in the economy to achieve a both inflation and output stability. To illustrate further, let's put monetary policy as the faucet, the central bank as the controller of the faucet, and the water as available funds in the economy.

a. The Three Pillars of Central Banking

BSP adopted its existing logo in 2010. It highlights the Philippine Eagle – which signifies the BSP's ambition to soar toward shifting a world-class monetary authority

[187] Monetary Policy as defined by Friedman, Benjamin, *Monetary Policy (2000)*.
[188] The monetary policy role of the BSP in the Philippines includes controlling the availability and price of funds and credit, influencing overall demand for goods and services, and attaining price stability *(BSP, 2019)*

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It has three stars symbolizing the three pillars of central banking: price stability, financial stability, and efficient payment and settlement system.

Table 15 Three Pillars of Central Banking

Price Stability	Financial Stability	Efficient Payment and Settlement System
Involves keeping inflation low and steady to support a greater level of savings and investments, developing further excellent fruitful projects and employment opportunities, and in the process, helping enhance the well-being of Filipinos. The BSP controls inflation and keeps stable prices by influencing the valuation and quantity of money flowing in the economy.	The BSP endeavors to sustain the banking system's well-being to encourage more significant pooling of savings and the effective management of credits. This is necessary because banking is a company that flourishes on public trust. Banks must prudently control deposits committed to them by the public. In turn, they lend these deposits to borrowers. The BSP implements laws and regulations to guarantee that banks handle business cautiously and soundly.	Supports the warrant of secure, up-to-date, and reliable payment and settlement of financial activities in the economy. One essential service banks provide to their clients is the administration of payments-from fixed monthly bills to significant acquisitions such as properties.

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2. **How does BSP approach Monetary Policy?**

Table 16 Monetary Policy Framework[189]

Monetary Targeting (1985 – Q2 1995)*	Modified Monetary Aggregate Targeting (Q3 1995 – 2001)	Inflation Targeting (2002 – Present)
Central Bank publishes a yearly growth objective of monetary aggregates	More extensive attention on price stability instead of stringently reaching established goals for monetary aggregates	Government produces an inflation target (in discussion with BSP); BSP publishes the inflation objective.
Central Bank defines the level of money supply required to obtain an aspired level of inflation	Enhanced monetary policy' effectiveness through complementing monetary aggregate targeting with any inflation targeting	BSP evaluates monetary situations and estimates inflation

[189] The BSP develops, recommends, maintains, and amends frameworks, policies, guidelines, standards, and procedures *(BSP, 2021)*

M3 or domestic liquidity works as the money supply	Monetary objectives could be surpassed as long as inflation targets are reached	Is the inflation outlook in line with the objective? If Yes, no shift in policy frameworks. If No, BSP changes policy frameworks.
Base money as the operating objective	Monitors a more comprehensive set of economic variables in reaching conclusions about the proper position of monetary policy	BSP interfaces by newspapers announcements, highlights of Monetary Board agreements, inflation papers, and public letters to the President

**Assumptions:*

a. There is a constant and anticipated relationship between money, output, and inflation
b. Movements in money supply trigger variations in price or inflation
c. The constant velocity of money (the price at which currency flows or develops over a given time)
d. The central bank regulates domestic liquidity

a. *The Power of the BSP to Set the Overnight Interbank Interest Rate*

The Interest Rate Corridor (IRC) system

An interest rate corridor (IRC) drives short-term market interest charges towards the valuation policy/target of the central bank (CB). It consists of a rate at which the CB awards credits to banks (typically an overnight lending rate) and takes deposits (deposit rate). The lending charge will be over the CB target/policy rate (thereby creating an upper bound for short-term market charges). The deposit rate will be under the CB rate, making the lower bound (Figure 11).

The IRC system is designed to guarantee that funds market interest rates shift within a logically close area around the BSP's policy rate. The close connection between the policy and market interest rates gives the theoretical foundation for monetary policy communication. The BSP can create a more efficient policy signal by the IRC system as market rates approximately follow the policy target rate.

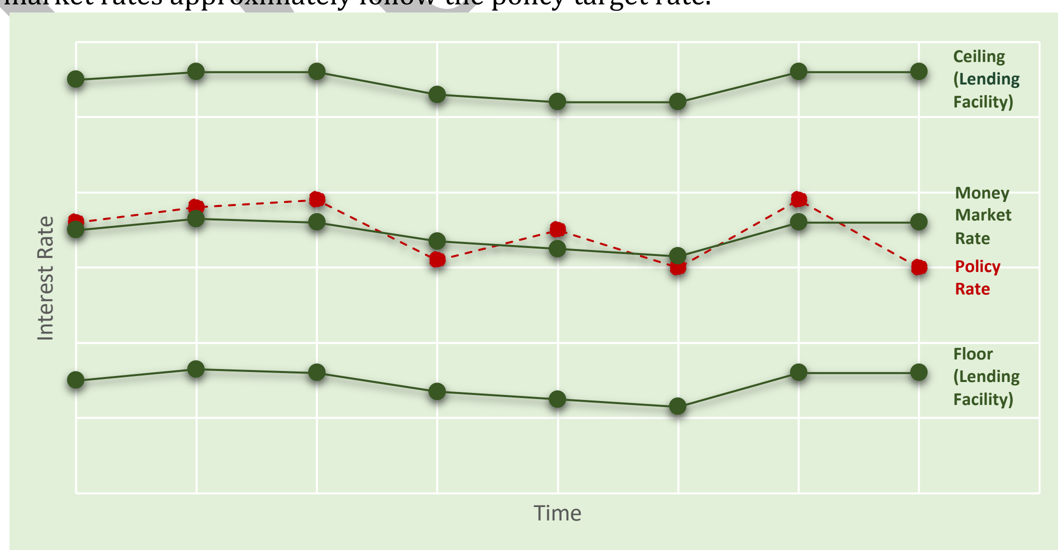

Figure 16 Interest Rate Corridor

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While there is no agreement on the width of the corridor, the global central banking system implies a conservative and balanced corridor. The selection of corridor width is primarily defined by the value specified by the central bank to the assessment of interest rate volatility, the central bank's decisions on the scope of counterparties' dependence on CB liquidity tools, and the level of interbank market action.

In the Philippines, a narrow corridor provides the BSP more specific direction to the market and restricts interest rate volatility, especially in the beginning steps of IRC implementation.

Objectives of the IRC system

In the implementation of the IRC system, the application of a narrow corridor mixed with auction-type liquidity methods will support the BSP to regulate short-term market interest rates to turn approximately with the BSP policy rate, in the means of increasing the delivery of developments in the monetary policy position to the rest of the economy.

Across time, the IRC is anticipated to help promote Philippine capital markets by raising money market activities and effective liquidity control by Philippine banks. Expanded dealing in money markets will increase the value development method in money markets by giving members and monetary authorities similar knowledge on the overall value of and need for liquidity in the monetary policy. This, in turn, will support the establishment of more precise interest rate benchmarks that will further promote the efficient and effective pricing of financial goods in the national market. The recommended change in the structure of the monetary administration is also in line with global most excellent applications in monetary policy regulations.

Features of the BSP's IRC system

The BSP's IRC system structure is displayed on the right-hand side of Figure 12. The interest rates on the standing overnight lending and the standing overnight deposit facilities make the upper and lower bounds of the corridor, sequentially, with the policy rate placed in the middle.

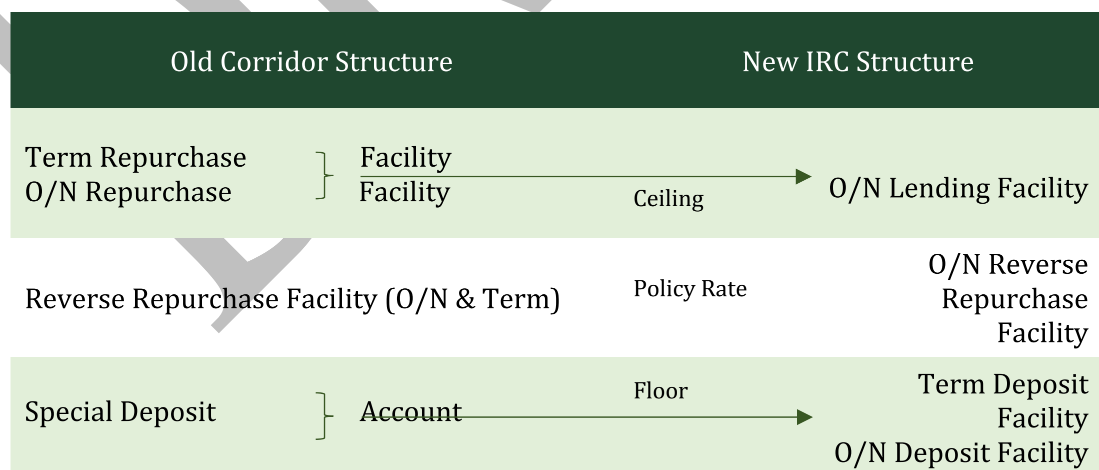

Figure 17 BSP's IRC Corridor Structure

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The two standing facilities' interest rates that make the upper and lower bounds of the corridor have been placed at ± 50 basis points nearby the target policy rate (the overnight RRP rate following the new IRC structure). Other modifications are as follows:

a. The RP facility was superseded by a standing overnight lending facility (OLF);
b. The RRP facility was converted into an overnight RRP administered at a fixed rate equivalent to the policy rate; and
c. The replacement of the SDA term facility into a standing overnight deposit facility (ODF) and therefore the auction-based TDF.

The BSP sustained the same adequate counterparties for the facilities under the IRC system (Table 1). Qualified counterparties for the RRP facility and the OLF consist of banks and non-banks with quasi-banking purposes (NBQBs). Meanwhile, TDF's and ODF's qualified counterparties include banks, NBQBs, and trust entities.

Likewise, the prohibition on non-resident capitals in the BSP's facilities for monetary processes (TDF and ODF) shall be kept. Similarly, the ban on the trade, discounting, assignment, or transactions of banks/quasi-banks of their credit claims in TDF, ODF, and RRP with the BSP to customers either on a "with or without recourse basis" shall be sustained.

Table 18 Eligible Counterparties

Instrument for Monetary Operation	Counterparties
O/N Lending Facility	Banks and Non-Banks with Quasi Banking Function (NBQBs)
O/N Reverse Repurchase Facility	Banks and NBQBs
Term Deposit Facility	Banks, NBQBs and Trust Entities
O/N Deposit Facility	Banks, NBQBs and Trust Entities

The purpose of doing active monetary procedures by the TDF and RRP facility is to lead market rates inside the corridor and more to approach the BSP policy/target rate.

The principal advantage of active monetary operations is that the size of transactions can be modified depending on monetary authorities' evaluation of how much liquidity will require to be siphoned or added to assure that market rates align with the policy rate. In principle, more complete and more frequent transactions can be initiated depending on the market's demands. However, the BSP opted to begin with small auction quantities to limit any unnecessary tightness in liquidity situations and warrant that counterparties adequately prepare to move to the latest operational structure.

Standing liquidity facilities

The standing overnight liquidity facilities are available as needed by eligible counterparties. The overnight lending facility (comparable to RP in the old system) is, in principle, not constrained in size but, in the application, depends mainly on the prepared security owned by BSP counterparties. Meanwhile, the overnight deposit facility is infinite in quantity to soak up any residual system liquidity and restrain market rates from dropping below the corridor.

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O/N RRP Facility

The current RRP facility is converted into an overnight facility. It is administered utilizing a fixed-rate and full-allotment system, where individual bidders have conferred a part of the total offer depending on their bid volume. Fixed-rate, complete allotment allocation assists guarantee that the overnight rate remains near to the BSP policy rate. Table 18 below outlines the traits of the O/N RRP facility.

Before using a pro-rata method for grants in the RRP window, the current stock of term RRP placements was permitted to grow without rolling over. This involved winding down the period RRP facility over a particularized transition time by enabling all the outstanding term RRPs to develop.

Table 18 Features of O/N RRP Facility

Feature	Details
Frequency of Operations	Daily (5 days a week)
Maturity	Overnight
Auction Type	Fixed-rate, full-allotment
Auction Size	Based on BSP liquidity forecast
Announcement of Auction Size	Same day
Submission of Bids	2:00 – 2:30 PM
Eligible Counterparties	Banks and NBQBs (same set of counterparties as present)
Type of Allocation	Pro rata based on bid size
Minimum Bid Amount	P10 million
Maximum Bid Amount	20% of Auction Size
Maximum No. of Bids	One (1)
Announcement of Results/Settlements	Same day

Term Deposit Facility (TDF)

The Term Deposit Facility is a significant liquidity consumption facility regularly used by CBs for liquidity administration. The implementation of TDF to withdraw a significant portion of the liquidity structure from the medium of exchange to require market rates be comparable with the BSP policy rate.

The BSP awards two tenors—seven days and 28 days—in its time deposit. The likelihood of allowing longer tenors can be recognized in the future, depending on the liquidity requirements and choices of the market.

Pre-termination is forbidden for the 7-day tenor but is granted for the 28-day tenor after a 7-day holding period at the applicable pre-termination rate.

The TDF auction will be conducted employing a variable-rate, multiple-price tender (English auction) to guide short-term interest rates within a logically close range to the policy rate.

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Table 19 Features of TDF

Feature	Details
Frequency of Operations	Once a week
Maturity	7 days, 28 days Flexible to offer longer-dated deposits in the future
Auction Type	Variable-rate tender, multiple price (English) auction
Pricing	Based on bids
Auction Size	Determined by liquidity forecast; small at first but to be scaled up gradually over time
Announcement of Auction Size	Indicative calendar released quarterly; auction offer released two weeks ahead
Submission of Bids	9:30 – 10:00 AM
Eligible Counterparties	Banks, NBQBs and trust entities; similar set of counterparties as in SDA facility
Minimum Bid Amount	P10 million
Maximum Bid Amount	20% of auction size per tenor
Maximum No. of Bids	Two (2) bid amounts per tenor at different rates
Pre-Termination	Not allowed for 7-day TDF, allowed for 28-day TDF after suitable holding period at the appropriate pre-termination rate
Announcement of Results/Settlements	Same day

Impact on the monetary policy stance

The change to the IRC system does not replace the BSP's position on monetary policy. The IRC improvements are principally operational and are not intended to modify general monetary policy frameworks upon implementation. The TDF is anticipated to have a rate between the RRP and the overnight deposit facility in the first stages. The weighted rate for monetary regulations will continue to be similar. Moreover, the interest rate at the corridor's ground, where the majority of the BSP's liquidity consumption with the market currently holds place, is being kept consistent at the IRC system's launch. Simultaneously, short-term liquidity situations are presumed to remain broadly consistent as funds will be consumed through monetary operations under the IRC system. The BSP will prudently calibrate the TDF offerings' size to ease the shift to the new system in directing financial operations.

It should be stressed that the IRC system is not a multiple interest rate management. The BSP's prime policy rate remains to be the overnight RRP rate.

Over time, the IRC system's implementation will provide recalibrations in other monetary policy instruments, including the potential modifications in reserve specifications in line with universal standards.

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Impact on money market and market interest rates

Money market action is foreseen to grow over time as the range of BSP active monetary operations, through the TDF, increases in the development of IRC implementation. The growth in TDF sizes and the resulting modification in money market rates and enhanced activity in the money markets will assist in maintaining the price development process and build more reasonable interest rate benchmarks, thus leaving the yield curve to adjust correctly.

The shift to the latest monetary operations management is anticipated to be progressive. Money market rates are not expected to grow significantly in the initial period of IRC implementation, given the sufficient liquidity in the financial system. Over time, however, as the range of BSP's active monetary operations (i.e., auction volumes in the TDF) develops, short-term money market rates are foreseen to expand continuously, following the BSP policy/target rate more strictly. Over time, interest rates in the primary T-bill market can also follow progressively with short-term market rates.

The BSP holds that, in the long term, the interest rate corridor system will boost capital market expansion by inspiring more interbank activities, promoting price discovery, and producing benchmarks for short-term interest rates. These improvements, in turn, can also help to advance the overall market positions for funding by the corporate sector.

b. The power to print money[190]

Currency Management

The Philippines' distribution of coins and notes is the sole jurisdiction and power of the Bangko Sentral ng Pilipinas. The BSP has lately started improved Philippine coins and notes that are more receptive to the aged and the visually impaired needs and highlight the newest anti-counterfeiting technology. The BSP also issues a restricted number of commemorative coins and notes for the acknowledgment of the significance of a personality, jurisdiction, and happenings in Philippine history.

The Philippine Cash Cycle

Production Currency

Philippine coins and banknotes are made in the Security Plant Complex (SPC) of the BSP. Over the past four decades, the SPC has grown into a world-class quality coins and notes generator. It has managed the layout, creation, and issuance of four generations of legal tender Philippine money.

Issuance, Distribution and Retirement

The Philippine Cash Cycle includes:

a. Issuing new coins and notes.
b. Delivering to the country's regions.
c. Retiring unfit currency.

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[190] The BSP has the independent power to print and issue money *(BSP, 2021)*

The BSP uses a Clean Note and Coin Policy to efficiently eliminate unacceptable money in circulation to sustain the integrity of Philippine banknotes and coins.

Currency in Circulation

The yearly quantity/amount of currency circulated is based on currency need calculated from a set of economic indicators that regularly measure the country's economic activity. The aggregated value of banknotes and coins circulated by the BSP should not surpass its total assets.

c. Raise or lower the reserve ratio requirement of banks[191]

The BSP may fix and alter the minimum reserve ratios to peso deposits and deposit substitutes, which each bank and/or quasi bank may maintain. Such balance shall be implemented consistently to all banks of the equal category and quasi banks.

Similarly, the BSP prescribes and modifies the smallest reserve ratios relevant to foreign currency deposits.

To help Bangko Sentral charge over the quantity of bank credit, the Monetary Board may set minimum reserve requirements for the remaining balances of overdraft lines.

The authorities of the Monetary Board to designate and adjust reserve requirements against unused balances of overdraft lines shall be identical to its powers concerning demand deposit's reserve requirements.

Whenever the Monetary Board's view becomes essential to raise reserve requirements against existing obligations, the addition shall be done gradually. It shall not surpass four percentage points in any thirty days. Banks and other concerned financial institutions shall be informed relatively in advance of the date such increment is to become effective.

The bank's or quasi bank's reserve position shall be computed every day based on the cost, at the end of business for the day, of the institution's reserves and the number of its obligation accounts against which resources are needed to be sustained: Granted, that concerning holidays or nonbanking days, the reserve position as measured at the close of the business day immediately preceding such holidays and nonbanking days shall implement on such days.

To calculate the reserve position of each bank or quasi-bank, its head office in the Philippines and all its branches and offices positioned therein shall be deemed a single unit.

Any bank's or quasi bank's reserve position, measured in the method stipulated above, is under the required minimum, payment shall be made by the bank or quasi-bank to the Bangko Sentral as a financial penalty as may be prescribed by the Monetary Board: Provided, however, That banks and quasi-banks shall generally be allowed to offset any reserve insufficiency happening on one or more days of the forty-three weeks with any excess reserves which they may hold on different days of the same week and shall be obliged to pay the fine following the tool adopted by the Monetary Board. If abused, the Monetary Board may reject any bank or quasi-bank the right of offsetting reserve deficiencies in the manner outlined above.

[191] It is the exclusive power of the BSP to raise or lower the reserve requirements of banking institutions *(BSP, 2021)*

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Assume a bank or quasi-bank chronically has a reserve insufficiency. In that case, the Monetary Board may restrict or prevent the production of new loans or investments by the institution and may order that portion or total of the net profits of the institution to be charged to surplus.

The Monetary Board may adjust or set aside the reserve loss penalties presented, for part or the whole period of a strike or lockout concerning a bank or a quasi-bank as described in the Labor Code, or of a state emergency affecting services of banks or quasi-banks, or in such other cases where the Monetary Board decides the award of a waiver of fines to be justifiable. The Monetary Board may also revise or set aside reserve deficiency fines for the recovery program of a bank.

F. Monetary Policy and Basic Components

In the previous section, you have learned monetary policy and who has the authority over its exercise in the Philippines. While it is true that the BSP has the independent power of the Philippine' monetary policy, it is also needed that you understand the value of the monetary policy and its component deeply. This section will dive into the mechanics of monetary policy, such as its demand and supply curve, the factors influencing monetary policy, and the impact of these changes in the economy.

1. What are the mechanics?

Monetary policy has been in various forms. But however it may look, it usually boils down to modifying the supply of funds in the economy to gain some mixture of inflation and output stabilization. Most economists would acknowledge that the output is fixed in the long term, so any differences in the money supply only make prices fluctuate. But in a short period, because prices and salaries are usually almost constant, shifts in the money supply can influence the actual production of goods and services. This is why monetary policy—traditionally administered by central banks —is a powerful policy instrument for reaching both inflation and growth objectives.

For instance, in a recessionary economy, consumers quit spending as they used to be; decline in business registrations, driving firms to lay off workers and cease funding in new capacity; and foreign appetite for the country's exportation may also decline. In summary, there is a deterioration in aggregate demand to which government can respond with a policy that leans opposite the direction in which the economy is going. Monetary policy is usually that countercyclical device of preference.

Such a countercyclical policy would commence with the desired enlargement of output (and employment). But, because it causes an increment in the money supply, it would also raise prices. As an economy gets closer to creating a total capacity, progressing demand will pressure input charges, including wages. Workers then utilized their improvised salaries and wages to purchase more goods and services, directing prices and salaries more and advancing general inflation upward— which outcome policymakers typically want to avoid.

a. Money Supply and Demand (Components of the money market)

There is extensive theoretical and empirical evidence that increases in income and inflation are often linked with increments in the money supply. Since, as a rule, monetary statistics are immediately and currently available. Similarly, inflationary pressure is a theory that is difficult to measure; it has become conventional to take monetary

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statistics as dependable indicators of inflation and deflation, of expansion and contraction. When it is recognized that the money supply is increasing, it is understood that expansionary elements must be functioning and that anti-inflationary policies should be presented. Likewise, when the money supply weakens, contractionary forces are expected to be more powerful, and anti-inflationary policies can cautiously be relaxed or reversed.

1) Law of supply and demand for funds

This part will discover how the demand and provide model connects those that wish to provide financial resources (i.e., savings) with those that demand monetary funds (i.e., borrowing). Whether individuals or businesses, those who maintain (or create financial investments, which is an equivalent thing) are on the supply view of the financial market. Those who take a loan are on the demand side of the monetary market.

Who Demands and Who Supplies in Financial Markets?

In every market, the price is what suppliers get and what demanders give. In financial markets, those who supply monetary funds through savings supposed to obtain a rate of return. In contradiction, those who demand monetary funds by collecting funds wish to pay a rate of return. This rate of return can come in many forms, depending on the kind of investment.

Fund Supply, Demand and Equilibrium Interest Rate

The simplest example of a rate of return is that the rate of interest. For example, once you supply money into a bank account at a bank, you receive interest on your deposit. The interest paid to you as a percent of your deposits is that the rate of interest. Similarly, if you demand a loan to buy for a car or a computer, you'll need to pay interest on the cash you borrow.

The concept of loanable funds theory will help us understand interest rates as it theory explains interest rates and its corresponding movements. This theory attracts consideration to how supply and demand for loanable funds define the interest rate's equilibrium.

The provision of funds to the financial markets through net suppliers is called the supply of loanable funds. This is the quantity of cash that the individuals, government, and businesses decide not to spend, i.e., save. At the same time, the demand or loanable funds is the total net amount of demand the users of funds necessitate—this is the extent of investment in search of financing.

The general rule is, other factors are held constant, there's more supply of funds as interest rates increase. The idea behind this is often that once you deposit your money in an increasing trend of rate of interest, you'll get more return from this sediment through interest income. Likewise, loanable fund's demand will decline because interest rates rise, i.e., there will be a growth in expenses from borrowing/using funds. In this sense, there'll then be surplus funds as there's a rise in supply but a decrease in demand. Therefore, the mixture quantity of funds supplied is positively associated with interest rates, while the amount demanded is inversely associated with interest rates.

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In the illustration below (Figure 15), draw your attention to "E." Every E is what we call the equilibrium interest rate. The aggregate quantity of loanable funds supplied equates with the number of loanable funds demanded financial security. In the graph on the left side, we have E and E*, i* and i**, and Q and Q** Let us analyze and assume amounts for this graph. Say, for example, Q* is the point where the quantity demanded is ₱1,000,000 and is equal to quantity supplied ₱1,000,000 also. Let us assume that in this scenario, i* 12%. Considering that 12% is an ideal interest rate for the investors, they will supply money to the financial market through investing, and it raised the aggregate quantity of loanable funds to ₱1,500,000. In this sense, the aggregate amount of cash supplied(SS*) will shift to the right (demand remained at ₱1,000,000). And will create surplus funds of ₱500,000. The general effect of the shift also lowers the equilibrium interest rate E*; let us assume E* is 9%. And as an effect, this will signal investors to halt supplying funds since 9% is lower than the ideal return. This concept is used in a country's fiscal and monetary policy.

To avoid a surplus of funds and create disequilibrium, the government lowers the advised general interest rate.

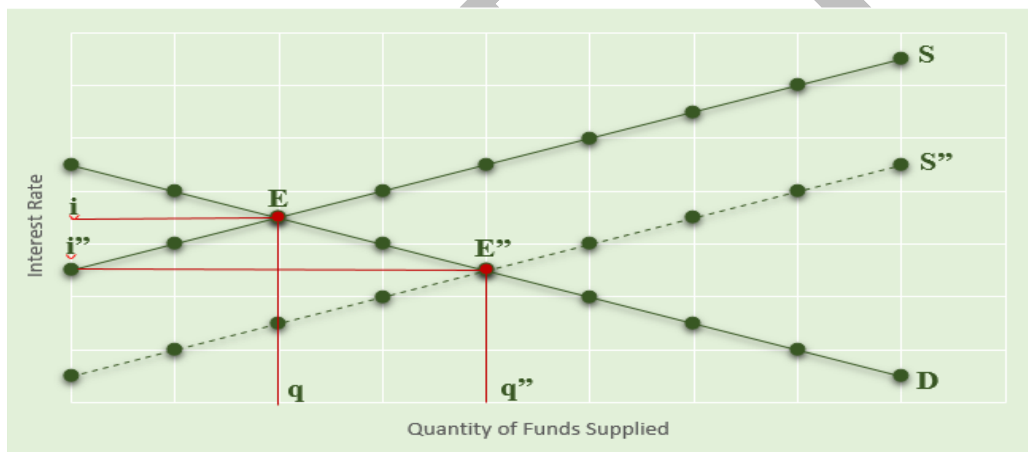

Figure 18 Demand, Supply and Equilibrium Interest Rate Relationship

Influential Factor of Supply and Demand Curves for the Shift of Loanable Funds

It is essential to notice that equilibrium interest is merely a short-lived equilibrium, changing due to underlying factors. Below are some and not all factors that affect the curves above other factors held constant. The first table pertains to providing loanable funds, and therefore the following table relates to the demand for loanable funds.

Table 20 Demand, Supply and Equilibrium Interest Rate Relationship

Factor	Impact to Equilibrium Interest Rate
Wealth	Inverse An increase in wealth will generally increase the availability of loanable funds. Hence, it will lower the equilibrium rate of interest.
Risk	Direct An increase in risk in investing will generally decrease the availability of loanable funds. Hence, it also will

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Factor	Impact to Equilibrium Interest Rate
	increase the equilibrium rate of interest.
Near-term Spending Needs	Direct An increase in near-term spending needs (investors will withdraw funds or will immediately use the money earned) will decrease the availability of loanable funds. Hence, it will increase the equilibrium interest rate.
Purchase of Asset Through Utilization of Borrowed Funds	Direct An increase in the desire to shop for assets will generally increase the demand for loanable funds. Hence, it will increase the equilibrium rate of interest.
Terms and Agreements on Nonprice Conditions of Borrowed Funds	Inverse An increase in restrictions on borrowing will generally decrease the demand for loanable funds. Hence, it will lower the equilibrium interest rate.
Economic Condition	Direct An increase/growth in economic conditions will generally increase the demand for loanable funds. Hence, it will increase the equilibrium rate of interest.

Logic for borrowing (High interest rate=more willing to provide funds but borrowers less demand)[192]

The loanable fund's market is where borrowers and lenders met together. Like any market, there is a supply and demand curve. In the loanable fund's framework, the availability represents the entire amount lent out at different interest rates or the quantity saved within the economy. In contrast, the demand curve represents the total demand for borrowing at any given interest rate.

Lending in the loanable fund's framework takes many forms. Any time a person saves some of their income, that income becomes available for someone to borrow. Money held in a bank savings account is a component of the supply of loanable funds. If you save money in a bank rather than consuming it, the bank can then loan the funds to an individual or business that wants to borrow. In this fashion, you are supplying funds into the loanable fund's framework (and the company or person using the funds adds to the demand for loanable funds).

For example, if a person has an available fund of PhP60,000, spends PhP58,000 on goods and services, and puts PhP2,000 into a savings account, the supply of loanable

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[192] The borrowing power of an individual is affected by many factors such as the interest rates *(California State University)*

funds will increase by PhP2,000. This PhP2,000 is now available for someone else to borrow.

When deciding how much to save, an individual looks at the benefit they can get by saving. As the rate of interest increases, the advantage that you simply get through saving increases (higher interest earnings), which tends to encourage people to save lots of more. In general, as the interest rate increases, the number of loanable funds supplied (the aggregate willingness to commit) will increase. The number of loanable funds provided increases as the interest rate increases. This is why the supply curve within the loanable fund's framework slopes upwards.

For example, if you have an extra PhP9,000 in your checking account and recognize that interest rates are at 1%, you can only gain PhP90 (.01*PhP9,000=PhP90) in interest by saving the funds for one year. You instead plan to spend the cash now on a replacement computer and stereo. On the other hand, if interest rates are at 15%, you can get PhP1,350 by saving the money for a year (.15*PhP9,000=PhP1,350), and now you choose to save the money.

The loanable fund's demand signifies a desire to borrow money at varying interest rates. The more expensive interest rates have inspired you to save lots of, and therefore the value of loanable funds supplied has grown. Borrowing happens essentially to meet Investment demand. For example, businesses borrow to create new factories or buy new machines, and individuals borrow to houses.

The demand for loanable funds is decreasing because the rate of interest increases. From the purpose of view of a borrower (the source of demand within the loanable fund's framework), as interest rates increase, the value of borrowing goes up. Hence, the person (or business) is likely to borrow a smaller amount. Therefore, as interest rates rise, the number of funds demanded decreases. This is why the demand curve slopes downward.

2) Interest rate (vertical axis)

The interest rate is paid by a borrower (the debtor) for the utilization of cash that they borrow from a lender (the creditor). It is seen as a "cost" of borrowing money. Interest-rate targets are a means of monetary policy. The amount of money demanded differs inversely from the rate of interest. Central banks in countries tend to scale back the interest rate once they want to extend investment and consumption within the economy. However, low-interest rates can create an economic bubble where significant investments are made but large unpaid debts and depression. The rate of interest is adjusted to remain inflation, the demand for money, and thus the economy's health during a particular range. Capping or changing the rate of interest parallel with the economic process protects the momentum of the economy.

Other Factors that Influence the Interest Rate

Interest rates fluctuate over time within the short-run and long-run. Within an economy, numerous factors contribute to the extent of the interest rate:

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a. Political gain: both monetary and monetary policies can affect the cash supply and demand for money.
b. Consumption: the extent of consumption (and changes therein level) affect the demand for money.
c. Inflation expectations: inflation expectations affect the willingness of lenders and borrowers to transact at a given rate of interest. Changes in expectations will therefore affect the equilibrium rate of interest.
d. Taxes: changes within the tax code affect the willingness of actors to take a position or consume, which may change the demand for money.

3) Quantity of money (horizontal axis)

In economics, the fund's demand is usually equalized with cash or bank demand deposits. Usually, the nominal fund's demand grows with the amount of the nominal output and diminishes with the nominal interest rate.

The money demand equation is Md = P * L(R, Y). this is often frequently the equivalent of claiming that the nominal amount of money demanded (Md) equals the price level (P) times the liquidity preference function L(R, Y)–the value of cash held in readily convertible sources (cash, bank demand deposits). The liquidity function, L(R, Y), is the nominal rate of interest, and Y is the actual output.

Money is essential to carry out transactions. However, the difference between the liquidity benefits of holding cash and the interest advantage of getting another asset is inherent to money holding.

When there's stability within the demand for money, monetary policy can support stabilizing an economy. However, when the necessity for cash isn't steady, real and nominal interest rates will change, and economic fluctuations will occur.

Control of the Money Supply

While the demand for cash involves the specified holding of monetary assets, the cash supply is the total amount of financial assets available in an economy at a selected time. Data regarding funds is recorded and published because it affects the worth level, inflation, the rate of exchange, and therefore the trade cycle.

Monetary policy also impacts the money supply. An expansionary policy increases the entire cash pool within the economy sooner than usual, and a contractionary approach expands the availability of cash more slowly than expected. Expansionary policy is employed to combat unemployment, while contractionary is used to slow inflation.

Factors that Cause Demand to Shift

A demand curve is worth on the vertical axis (y) and, therefore, the quantity on the horizontal axis (x). The cash demand curve changes when there's a move in any non-price determinant of demand, directing to a replacement demand curve. Non-price determinants are changes that cause demand to vary, albeit prices remain equivalent.

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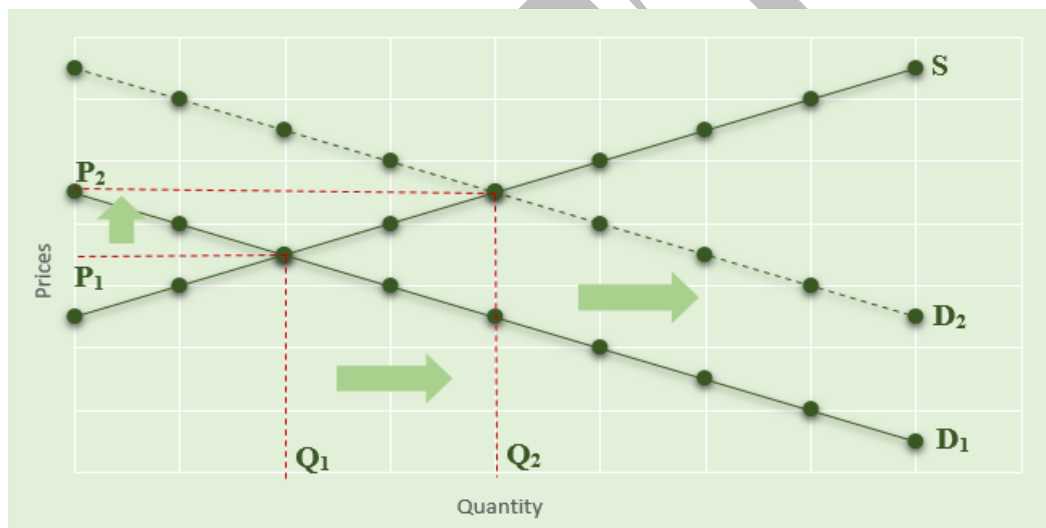
Factors that influence prices include:

a. Changes in disposable income
b. Changes in tastes and preferences
c. Changes in expectations
d. Changes in the price of related goods
e. Population size

Factors that change the demand include:

a. Decrease in the price of a substitute
b. Increase in the price of a complement
c. Decrease in consumer income if the great maybe a normal good
d. Increase in consumer income if the great is an inferior good

The demand for money changes out when the nominal level of output rises. It shifts in with the nominal rate of interest.



Implications of Demand Curve Shift

The demand for money may emerge from the trade-off between the liquidity benefit of holding cash and the interest return of taking other assets. The need for money determines how a person's wealth should be preserved. When the demand curve shifts to the proper and increases, the demand for money increases, and individuals are more likely to carry on to money. The nominal output level has increased, and there's a liquidity advantage in holding on to cash. Likewise, when the demand curve moves to the left, it exhibits a reduction in the demand for money. The nominal interest rate weakens, and there is a more significant interest advantage in holding other assets instead of cash.

2. Impact on the Economy

Fundamentally, monetary policy can influence the worth level—the rate of inflation, the mixture price index in an economy. And it's suitable to supply a more expansionary monetary policy when there's proof that inflation is declining or will drop beneath the desirable level.

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For example, there was evidence within the Treasury market that expected inflation had fallen. In the circumstances like that, an easing of monetary policy is an effort to stimulate the economy to help bring the rate of inflation and expected inflation back to target.

Again, the monetary policy only really affects the rate of inflation, the worth level. But within the short run, it can also influence the "real" side of the economy and thus influence employment and GDP growth.

And so, in an occasion where it seems that the economy could also be weakening or might slow down—particularly in a context where inflation expectations are going down—policymakers may recalibrate monetary policy to a more accommodative or expansionary level to cushion that decline, or hopefully provides it a lift back to the Fed's legislated goals of price stability and maximum sustainable employment.

By an equivalent token, if you see signs of overheating—inflation rising, maybe financial speculation deed such it'd cause problems within the economy down the road—it would be appropriate to calibrate monetary policy to a tighter stance, to undertake to resist that.

a. Expansionary Monetary Policy

When there's “too little money” within the economy which dampens overall demand for goods and services, the BSP ‘loosens’ the tap to expand funds.

This results to:

a. Lower Interest Rates
b. More lending/borrowing
c. Fewer savings
d. More spending

b. Contractionary Monetary Policy

When there is “too much money” in the economy supporting overall demand for goods & services, which, in turn, increases inflationary pressures, the BSP ‘tightens’ the faucet to reduce the money supply. This action dampens demand which could lead on on to lower inflation.

This results to:

a. Higher interest rates
b. Less lending/borrowing
c. More savings
d. Less spending

c. Relationship to Inflation, Interest Rate, Taxes, and National Output

Inflation is famously defined as an increment in price, where inflation decreases purchasing power from a currency. There are a couple of causes of inflation where aggregate demand increases faster than aggregate supply, therefore increasing the value of products and services. The imbalance of aggregate demand and provide is linked to the government's deficit, expansion of bank interest rates, and, therefore, foreign demand.

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Inflation also increases the worth of products and, therefore, the price of labor; thus, the value of products and asking price increases. Inflation features a few indicators like Consumer price level (CPI), Wholesale price level (WPI), and Implicit price level (deflator GDP).

Suva and Fiji (2004) state that inflation and GDP feature a negative outcome. At a particular level of inflation, there'll be a positive outcome towards GDP. A low level of inflation won't have a significant effect on GDP. It'd even be a positive impact. A substantial level of inflation will damage GDP. A rise in inflation will reduce the GDP per capita and investors. Therefore, inflation affects GDP.

In economic theory, the interest rate is often described as a worth gained within the effort of a value that has been accumulated or invested. These rates will exhibit the interaction between exchanges of cash. The financial institution influences short-term rates. Thus money is being monopolized accordingly. However, future rates show the present economy's condition and, therefore, the likelihood of inflation. Both of the rates are connected and work with each other. There are two methods of estimating the risks of interest rates: sensitivity analysis and repricing profiles.

Studying from the GDP's point of view, interest rates are among the factors indicating an economical process. However, a rise in interest rates also presents a shrinking GDP. The good news is that their research reveals that interest rates don't significantly impact the economic process. An uptick in interest rates will cause a reduction in actual growth rates. Hence, interest rates influence the financial cycle.

Tax Cuts and the Economy

It's a general belief that decreasing marginal tax rates would drive the economic process. The view is that cheaper tax rates will provide people more after-tax income that would be want to acquire more goods and services. This is a demand-side dispute to maintain a tax reduction as an expansionary fiscal incentive. Further, lowered tax rates could encourage saving and investment, which might increase the economy's productive capacity.

In other words, the economic process is essentially unaffected by what proportion of tax the rich pay. Growth is more likely to drive if lower-income earners receive a tax cuts.

G. Fiscal Policy

When the economy is in a recession, or growing slowly, people turn to the government to remedy it. The most recent and palpable example was when the COVID-19 pandemic ravaged the world resulting to a global health crisis and unprecedented economic contraction. Containment measures caused wise-spread business closures, lay-offs, healthcare system collapse, supply-chain disruption, and severe deterioration of public finances. In this scenario, what can the government do?

One of the tools at the government's disposal is fiscal policy. In our example, governments around the world introduced measures to mitigate adverse impacts of the pandemic, especially the output and employment gap, such as deferral of tax filing, tax exemptions for medical items, tax amnesty, direct cash transfers, income support, asset write-off for businesses, recovery loan schemes, license and fee waivers, grants to specific industries, and wage subsidies among others. These interventions belong in the scope of fiscal policy.

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Fiscal Policy and the Dynamics of Government Spending

a. What is Fiscal Policy?

As discussed in the earlier section, the economy experiences fluctuations called the booms and busts. At the boom phase, an economy's output grows exponentially at a rapid rate. This is accompanied by higher productivity, bullish stock markets, lower unemployment but rising prices. Meanwhile, bust phase is characterized by slower economic growth, and higher unemployment with abated price pressures. The government aims to achieve a sustainable balance between economic growth, health care system collapse, full employment, and price stability.

In times of extreme fluctuations, the government can utilize two tools to influence the economy and maintain its stability. One of the tools is monetary policy which we have already discussed in detail and the other one is fiscal policy.

Fiscal policy refers to the use of government expenditure and tax structure to influence aggregate demand and economic activity in a country. It includes government's decisions on the goods and services they purchase, the level of transfer payments[193] it doles out, and the tax it collects.

b. Why Does the Government Spend?

Economics' main ethos is that resources are limited and one must use them efficiently to produce value. This rationale is applicable to an individual decision-making to businesses, to government spending. When the government receives income from tax and other sources, it must decide not just how, when, and where would this be utilized, but also what are the objectives upon its use. Government spending covers a range of services provided by the national, regional, and local governments. Ultimately, the government spends based on three broad objectives:

1) *Provide for the Public Good/Welfare*

The government plays an important role in providing public goods such as infrastructure, hospitals, vaccines, national defense, and security to its citizens. One distinction of a public good to a private good is that one person's use of it does not diminish the government spending is utilized to produce goods and services for redistribution of income and promotion of social welfare.

Advocates of government spending, mainly the Keynesians, claim that government should provide public goods that markets generally do not, such as military defense, public health care services, tax collection, and emergency services because the private sector have little incentive to provide these as people tend to use them without contributing to their payment (insufficient profit).

2) *Market Failure*

[193] Transfer payments refers to the provision of money by the government to individuals without goods or services in return. Welfare payments and government subsidies for individuals and businesses are few of the examples.

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As discussed in the previous section, under perfect conditions, market equilibrium is attained. It is the setting where supply and demand are in balance and neither buyers nor sellers have the reason for price to change, ceteris paribus.

However, in real life, markets are rarely perfect and certain factors hinder this equilibrium resulting to market failure. Market failure refers to the inefficient allocation of resources in the market. In other words, this occurs when demand does is not equal to the goods or services supplied. Commonly cited market failures include:

a) Existence of market power (Monopoly) – Occurs when a specific firm holds control over the market and has the ability set higher prices. This can lead to lower production levels and diminished consumer welfare through higher prices and lack of options
b) Information asymmetry – Occurs when there is a lack of and/or disparate information in the market for consumers to make informed choices
c) Externalities (Spill overs) - Occur when goods and services generate a benefit (positive externality) or cost (negative externality) to a third party
d) Public Goods - Goods which are non-rival and non-excludable, and benefit all members of society, which tend to be over-consumed and under-produced without intervention

These market failures provide the case for government intervention in order to improve social welfare and general economic fairness. Examples of government intervention include enacting legislation, and issuing tradable permits and property rights.

3) Economic Growth

For years, the relationship of government spending and economic growth has been widely debated. While Classical and Neoclassical economists question its impact to the economy, Keynesians argue that government spending has positive effects on the economy.

Despite these different perspectives, government spending in countries is still increasing remarkably. The ethos is that an increase in government spending would create a multiplier effect driving increases in the other components of the economy and eventually in the total output. As the government injects more money in the system through their spending, demand for goods and services are expected to increase succeeded by increase in production which will eventually lead to economic growth.

c. What are the Sources of Government Funds?

One of the most famous artifacts in the British Museum is the Rosetta Stone. Discovered in 1799, the Rosetta Stone is a slab of stone featuring a document written in Egyptian hieroglyphics from 196 B.C. Aside from hieroglyphs, the document is also written in Demotic (Egyptian used by ordinary people), and Ancient Greek. The scholars were astounded, the stone held the key to the decipherment of the long-forgotten Egyptian hieroglyphics.

Upon translation of the document using Ancient Greek as reference, scholars discovered that the Rosetta Stone is actually a tax decree. In an attempt to dissuade the ongoing civil war at that time Pharaoh Ptolemy V imposed tax reforms to placate powerful groups such

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as the temple priests. The Rosetta Stone is one of our earliest examples of organized taxation. It stands as a monument to the importance and inevitable role of taxes in societies millennia ago until today.

As U.S. President Benjamin Franklin famously said, "In this world, nothing is certain except death and taxes".

In the next section, we will discuss the various sources of government which include taxes among others.

1) *Tax Revenue*

By far, the largest and most important source of income for the government is through taxation. It has existed since the earliest forms of recorded government in history: from ancient Egypt; to the Roman age with their taxes on inheritance, property and consumer goods; to Medieval Europe where the earlier version of income tax originated. In Asia, Chinese Dynasties were also recorded to impose organized taxation through methodical census of the population. In the time of the Mongol Empire, the largest contiguous land empire in history, people has a fixed system of taxation and paid their taxes to the central government rather than to individual collectors.

Today, taxes are generally defined as compulsory payments made by individuals and businesses to the government as mandated by law. Taxes can be categorized into two: Direct and Indirect taxes. Direct taxes are levied on income and activities conducted by an individual or organization, and are directly paid by the concerned subject. This includes income tax, corporate tax, donor's tax, inheritance tax, and property tax among others. Meanwhile, indirect taxes are levied on product or services before it reaches the taxpayer. Typically, it is imposed on manufacturers and retailers who pass it on to the consumer. Some examples of indirect taxes are excise tax, value-added tax, and tariffs. In the Philippines, major tax collecting agencies include the Bureau of Internal Revenue and the Bureau of Customs.

2) *Borrowing*

While tax revenues remain the primary source of funds of the government, it is rare for a government to rely solely on taxes for its expenditures. Borrowing is another source of funds from the government. Government debt is also referred to as public debt. In reality it does not differ much from private debt aside from the fact that it is an obligation of government rather than of private individuals or firms.

a) Domestic

Domestic debt are financial liabilities of the government secured from the domestic market such as loans, and debt securities. Governments may issue securities such as bonds, notes, and bills, which require repayment of the principal with interest at designated times. Government securities are considered low-risk investments as the repayments are guaranteed by the national government.

b) International

On the other hand, international borrowings are funds obtained from lenders outside the country including multinational and foreign institutions, foreign

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government, and foreign private firms. It is also referred to as external debt. Example of international lenders include the International Monetary Fund, World Bank, Asian Development Bank, and foreign commercial banks.

3) *Proprietary Income*

While the government source funds from the taxes mandatorily paid by the citizens, it also obtains revenue from the various services it provides. These are the receipts from the government's exercise of its proprietary functions. Some examples include dividends and profits received from government-owned and controlled companies, revenue from power and railways, and rents.

d. Limitations of Government Spending

The Keynesian model views government spending as a tool to boost aggregate demand and output, and stimulate economic growth. It provides justification for government spending, even deficit spending financed by borrowing, with the assumption that it can reverse recessions through various spending programs. While highly-regarded and utilized, the concept it not without limitations.

One limitation of government spending is the accurate identification where the money should be spent on. In theory, government should spend on value-adding projects that will offset the productivity lost due to taxes and stimulate the economy but in reality, the information that allows the government to know where goods and services can be most productively employed are not readily available. It takes time, effort, and resources to research and plan value-adding projects. Historically, government resources are underutilized or used in poorly planned projects.

Another limitation of government spending is the inefficient and political process surrounding it. Rather than using government resources where they can generate additional value to support economic growth, politicians instead allocate the resources to favored groups. This misallocation of money through rent-seeking[194] hinders the objective of government spending which is to provide public goods and stimulate economic growth.

Lastly, another limitation of government spending is that it can lead to crowding-out. This happens when private investment declines due to high interest rate driven by government borrowing. While the government aims to boost the nation's economy through debt-financed spending on public goods and services, the resulting higher interest rates may lead to lower investment and even less income in the economy.

The debate about whether government spending has positive or negative impact in the economy is likely to occupy economists and policymakers years to come. Aside from short-term effects, it is also important to evaluate the impact of government spending to long-term economic growth.

Fiscal Policy and Its Basic Components

A nation's economy is an interrelated and complex system of production, consumption, and trade of goods and services. It is heavily reliant on the economic decisions of households and private firms. For example, the decision of households to increase the consumption after receiving higher

[194] Rent-seeking was firstly coined by British 19th-century economist David Ricardo. The theory is officially developed by Gordon Tullock and popularized by Anne Krueger in her paper The Political Economy of the Rent-Seeking Society (1974).

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income leads to higher aggregate demand, profit, employment, and investment. The synthesis of which supports economic growth. Another example is the decision of private firms to invest on capital assets that generate higher profits and boost the economy in the long-run. The only caveat is, their impact relies on their aggregate decision, individual household or firm has negligible impact in the overall economy.

Aside from households and private firms, the government's decisions have a significant impact in the economy. In a way, the government is both a consumer and producer. It is a consumer when it purchases supplies for its offices, procures materials for road development, and acquire services of a consultant for example. Meanwhile, it is also a producer when it produces goods and services that the private sector does not make or render such as public parks and libraries, road maintenance, police enforcement, and emergency services. The economic decisions surrounding this dual facet of the government greatly influence the economy.

a. What are the tools used by the government?

Fiscal policy involves the government's decision making in order to manage the economy through various tools in the pursuit of macroeconomic stability.

1) Taxes

When setting the fiscal policy, the government can change the level and composition of taxation. As discussed earlier, tax is the compulsory contribution of citizens levied by the government. By increasing or decreasing taxes it imposes, the government can affect the disposable income of households. If taxes are raised, disposable income decreases which can lead to lower total demand in the economy and slower economic growth if not offset by higher government spending. Alternately, if taxes are lowered, disposable income and total demand. This then drives output higher which creates jobs and alleviates unemployment, ultimately resulting to an increase in GDP.

2) Spending

Government spending is also one of the fiscal policy tools the government can utilize. It takes form in two types: (1) Current spending which are short-term expenditures such as raw materials and wages, and (2) Capital spending which are long-term expenditures such as infrastructure (roads, equipment, and bridges).

Government spending also include subsidies which are forms of financial aid provided to the public with the goal of promoting economic and social policy.

While both tools eventually lead to the same economic outcome, the government is free to choose whether to employ just one or both depending on the situation and target.

b. Impact on the Economy

Ever since the onset of the COVID-19 pandemic, the topic of fiscal policy gets thrown around in newspapers, radios, news reports, even social media. From subsidy programs, to unemployment benefits, to emergency loans, and even tax adjustments, governments worldwide introduced diverse sets of interventions to keep their respective economies afloat and support the recovery initiatives.

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But, while we have already defined and set up the parameters of fiscal policy, it is important to understand how it works in the real world in order to know how it actually affect and influence the economy

1) Expansionary Fiscal Policy

Whenever we experience economic hardships, we tend cut our spending and save for the future. For some, that would mean skipping the pricey morning iced-coffees, for some that would be commuting instead of driving to work, and for some that would be cancelling that gym membership they rarely use. We do all of these and more to increase our savings and minimize risk from the economic changes and insecure future.

It is human nature after all to flee for safety and security (including economic security) in tough times. But while it makes sense on an individual level, thrifting on a macroeconomic level in times of recession is unwise according to Keynesian model.

Keynesian economics proposes that the correct response to a recession are increased spending and reduced savings. This theory, which traces its root from Keynes' Paradox of Thrift, points out that if everyone cuts their expenditure to increase savings on a recession, aggregate demand will dwindle and ultimately lead to economic contraction. If left unchecked, this would leave the country poorer due to the decreases in aggregate consumption, savings, and income.

This principle is the backbone of the expansionary fiscal policy which involves deliberately increasing government expenditure and/or reducing direct and indirect taxes to stimulate aggregate demand, output, and employment. It is used in response to economic downturns and recessions.

To finance its larger spending and offset their tax revenue reduction, the government typically borrows money during an expansionary fiscal policy. This in turn drives interest rates up, becoming more attractive than foreign rates. Automatically, there will be higher demand for domestic investments from foreign investors which would boost demand for the local currency, increasing the value of the local currency (also known as appreciation). When this happens, the local currency becomes more expensive versus other foreign currencies making domestic goods and services more expensive relative to foreign goods and services. This tend to decrease the level of exports and increase imports, ultimately resulting in trade deficit[195].

Through the tools used in expansionary fiscal policy, the government is essentially providing people and businesses with more money to spend and invest. In theory, this will lead to increased output and accelerated price increases (inflation). Aside from boosting government spending, expansionary fiscal policy tools also include tax cuts, increase in transfer payments, and rebates.

One limitation of expansionary fiscal policy is that government spending relies on its income (tax and proprietary revenue) and borrowing. An increase in expenditure leads to budget deficit, increasing the need for borrowing. When used correctly and efficiently, government debt can help boost economic growth however if left unchecked, the debt may become a burden. In time, government income may be used to repay debts more than to the generation of public goods and services. Another limitation of expansionary

[195] For further analysis on the fiscal policy, you may read Olivier Blanchard's *Macroeconomics,5th Edition (2008)* *and N. Gregory Mankiw's Principle of Economics, 7th Edition (2015)*

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fiscal policy is that it provides an avenue for rent-seeking in the government. Politicians may find ways to control the spending for other reasons not related to function of the policy. Lastly, extreme caution as to the supply of money in the economy should be implemented to prevent rapid inflation which may hurt the economy.

2) Contractionary Fiscal Policy

Fiscal policy could also be utilized in order to manage an overheating economy. In as much as we do not want a declining economy, we also avoid the overheating of an economy. This happens when an economy is growing at an unsustainable rate leading to accelerated inflation. To put simply, overheating occurs when the productive capacity reaches its limits and cannot meet all of the demand from individuals, businesses, and government. Eventually this would lead to accelerated inflation. As mentioned before inflation is not inherently bad but rapid and continued price increases could develop into the wage-price spiral. This is the phenomenon when higher prices result to higher wages which drive firms to further raise prices creating a theoretical spiral. This becomes a major dilemma as the higher prices diminishes the country's goods and services' competitiveness which can result to lower trade, lower income, and higher unemployment. Overheating can also result to full employment levels (zero unemployment) which poses a problem for the public and private sectors. At first, full employment may sound positive but employers would then have difficulty in finding workers which may hinder businesses' productivity and growth and in turn, adversely affect the economy. Most governments aim to maintain a natural level of unemployment to ensure that there is a balance between workers and employers.

To address these kind of overheating issues, the government can utilize contractionary fiscal policy.

Contractionary fiscal policy is characterized by a reduction in government spending, increase in taxes or a combination of both to reduce aggregate demand to tame down inflationary pressures. It is also used to pace economic growth at a steady rate to prevent overheating followed by recession (boom-bust cycle).

When governments enact contractionary fiscal policy, it can also reduce the national debt and budget deficit resulting in lower interest rates and a depreciation in the domestic currency, and contraction in trade deficit, and a slower inflation rate. Basically, an inverse of the impacts of an expansionary fiscal policy.

One limitation of contractionary fiscal policy is that its strategies are unpopular to the masses. People don't like being imposed higher taxes nor do they appreciate decreases in subsidies, welfare programs, and public services following reduction in government spending. Because of this politician are extremely hesitant to implement contractionary policies even if they are needed to stabilize the economy. Another limitation is that it takes a long time for businesses to gear up again after a slowdown of production following the reduction in aggregate demand. People laid-off due to the lower demand for labor may take a long time to be employed again even after the policy has been lifted. The slowdown in economic activity may lead to long-term impacts if left unchecked by the government.

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Table 21 Expansionary and Contractionary Fiscal Policy

Expansionary Fiscal Policy	Contractionary Fiscal Policy
↑ Government spending and/or ↓ Taxes	↓ Government spending and/or ↑ Taxes
↑ Aggregate demand	↓ Aggregate demand
↑ National output	↓ National output
↑ Inflation (Accelerated)	↓ Inflation (Slower)
↑ Interest Rates	↓ Interest Rates
↑ Trade Deficit	↓ Trade Deficit

H. Monetary and Fiscal Policy

Monetary and fiscal policies are two closely linked macroeconomic tools of the government. While managed by two different authorities, the policies are often used in combination thereby affecting each other. A nation's fiscal policy has an influence on the effectiveness of its monetary policy and vice versa, which at the end has implications on their macroeconomic impacts.

Since fiscal and monetary policies employ different strategies to ensure economic growth and stability, it is imperative for the government to pursue a balanced and advantageous policy mix through coordination of the various implementing agencies. This will minimize the possibility of inconsistency and friction between the two policies and their respective methodologies.

1. Similarities and differences of each kind of policy

Monetary policy and fiscal policy are the two main tools to influence the economy, ensuring a positive and steady economic growth combined with stable and low inflation. Fiscal policy and monetary policy significantly diverges in terms of their effect on interest rates. In monetary policy, the central bank lowers interest rates to stimulate the economy and increases them to cool down the economy. Meanwhile, in fiscal policy, the expansionary approach leads to increases in interest rates while the contractionary approach leads to lower interest rates.

Another difference is the management of these policies. Fiscal policy is overseen by the government while monetary policy is managed by the central bank.

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Table 22 Fiscal vs. Monetary Policy

Fiscal Policy	Monetary Policy
Macroeconomic tools used to manage the economy during recession and overheating	
Tax, government spending	Interest rate, money supply
Managed by the Government	Managed by the Central Bank
High political influence	Typically independent, low political influence
No specific target	Inflation targeting

While the methods of these policies are different, their main end goal are generally the same: stimulate the economy in times of recession and tame the economy when it is overheating.

Both fiscal and monetary policies play major roles in a nation's macroeconomy. Each has their own advantages and limitations depending on the situation at hand and the objectives. The decision making on what policy to adopt or how to balance them together requires detailed research and analysis from the government and the central bank.

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Part III. Financial Economics

LEARNING OUTCOMES

- Define money, banking, and financial markets and explain their roles and importance to the economy.
- Understand the function of each type of markets in the financial system.
- Determine who the players are in the financial system and their respective roles.
- Appreciate the importance of the stock market.
- Understand the behavior of interest rates, its risk and term structure.
- Identify the problems in the market that can be addressed by regulation and how these problems manifest in the capital market.

A. Introduction

This section discusses Financial Economics - a branch of economics that examines the utilization of resources in markets during which decisions are made under uncertainty. It employs theory to gauge how time, risk, opportunity costs, and knowledge can create incentives for a specific decision.

Financial System

A financial system consists of institutional segments and markets that communicate to mobilize funds for investment and provide facilities, including payment systems, to finance the economic project.[196] In other words, the economic system allows net savers to lend funds to net spenders. In addition, it also assists to connect risk-averse entities hedgers to risk-loving individuals (speculators).

Households are normally the lenders or savers, but firms, public companies and non-residents can also extend credits using their excess funds. Non-financial companies and the government are typically considered as the ultimate borrowers, but in some instances, households and non-residents also borrow funds for their acquisitions.

Funds flow from lenders to borrowers in two forms: direct and indirect. In direct financing, debtors (issuers) borrow funds directly from investors (lenders) by selling them financial instruments, also called securities that claim the borrower's future income or assets.

In indirect financing, financial institutions facilitate the transfer of funds between borrowers and lenders by borrowing from the lenders and then giving the funds to the final borrowers. Such financial institutes are called intermediaries. (see below diagram)

One of the critical features of a well-functioning economic system is that it fosters an allocation of capital that's most beneficial to the economic process. The last two centuries' material development and technological breakthroughs wouldn't be possible without the economic system. Thus, it should be noted that the financial system is linked strongly to the economic system.

[196] As defined by *Organisation for Economic Co-Operation and Development* (Glossary of terms).

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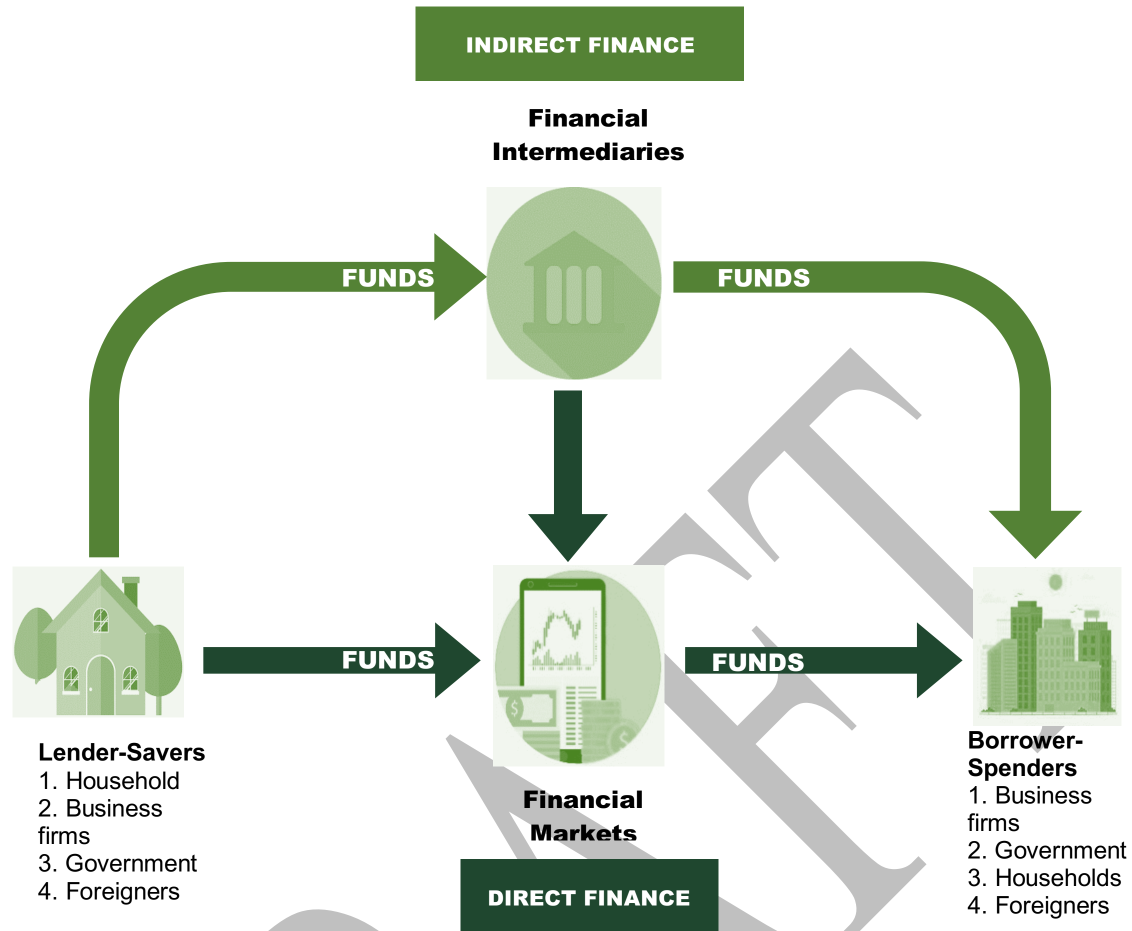

Figure 20 Direct and Indirect Finance

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Before diving deep into how economics is related to the financial arena, an understanding or a review of the basics of financial markets is necessary.

The financial system is composed of these five essential components:

1. ***Financial Institutions***

A financial institution is an intermediary between individuals and/or firms and, therefore, the capital. Its role within the system is primarily to intermediate between people who provide funds and people that require funds and typically involves transforming and managing risk.

2. ***Financial Services***

Financial services consist of services provided by financial institutions, which assist in obtaining the needed funds and ensure that they are efficiently disposed of. They help with borrowing, selling and buying securities, lending and investing, making and allowing payments and settlements, and taking care of risk vulnerabilities in financial markets.

3. Financial Instruments

A financial instrument arises from an agreement/contract. This provides a financial asset of an entity and subsequently financial debt or equity instrument of another firm. The details of financial instruments will be mainly discussed in a later part of this section.

4. Money

Money is a concept which everyone is familiar with but which is difficult to define in exact terms. The definitions of money vary by country but generally include a minimum of a measure for little money and one for broad money.

Narrow Money (M1) consists of circulated currencies (banknotes and coins) and peso deposits subject to see of the medium of exchange. The peso deposits subject to check or transferable deposits comprise managers' and cashiers' checks as deposits automatically shifted from savings to demand deposits except for demand deposits by the National Government and other depository companies' holdings of checks and other cash items.

M2 consists of M1 and other deposits as parts of broad money like savings and time deposits. Savings deposits are interest-bearing securities that are withdrawable upon displaying appropriately accomplished withdrawal slips and similar passbooks or utilizing negotiable orders of withdrawal. Time deposits are interest-bearing securities with particular maturity dates and are evidenced by certificates distributed by the bank. In defining broad money, the focus is on the characteristics of money as a medium of exchange and a store of value.

M3 includes M2, plus large-denomination interest-earning time deposits and term repurchase agreements sold by banks typically for longer than overnight.

Basic Functions of Money[197]

Money is known as having four essential roles, working as a:

1. Medium of exchange or the means for settling a liability, acquiring goods, services, and financial or nonfinancial assets without resorting to barter;
2. Store of value or purchasing power or a means of holding wealth;
3. Unit of account or atypical for denominating the prices of goods and services and consequently the importance of monetary and nonfinancial assets, thereby giving a means for comparisons of values and preparation of economic accounts; and
4. Standard of deferred payment or a means of relating current and future values in financial contracts.

5. Financial Markets

Lastly, financial markets provide a forum within which financial claims can be traded under established rules of conduct and can facilitate the management and transformation of risk.

Financial markets take several distinct forms and work in diverse ways. But all of them, whether highly organized or informal, serve the following same essential functions.

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[197] As discussed by the *International Monetary Fund*

Price discovery. Unlike goods and services whose prices are defined by the law of supply and demand, prices of securities are managed by financial markets. They provide price discovery based upon the prices at which individuals are willing to buy and sell them.

Investment. They provide an opportunity to earn a return on the funds that are not needed immediately.

Raising capital. Companies demand funds to operate and to develop. Most of the time, firms with good ideas do not have enough savings or cash required to fund their ideas. Without savings or some other form of external finance, companies cannot complete their projects. Financial instruments issued in said financial markets make these ideas possible.

Commercial transactions. Financial markets provide the grease that causes numerous commercial activities feasible.

Risk management. Some financial instruments such as derivatives contracts can protect against many types of risk. They also facilitate the markets to attach a price to risk, enabling firms and individuals to buy and sell risks until they take only those that they want to retain.

Financial markets may be broken down into various components based on the traded asset and the length of financing offered: the money market, the capital market, the derivatives market, and the foreign exchange market. More of this will be presented in the following part.

Financial Instruments

This section will briefly discuss financial instruments traded in the market discussed on those mentioned above.

A financial instrument is a contract that provides the financial asset of one entity and a financial liability or equity instrument of another entity.

A financial asset is an asset that provides a contractual right to obtain money or another financial asset from another entity or trade a financial asset or liability with another entity or a contract that may be completed in the entity's equity instruments. On the contrary, a financial liability may be a contractual obligation to transfer funds or other financial assets or trade financial assets or financial liabilities with another, or a contract completed within the entity's equity instruments.

For example, an entity builds finance by distributing equity shares. The entity that subscribes to the shares features a financial asset – an investment – while the issuer of the shares raised finance has to account for an equity instrument – equity share capital. A different example is when an entity builds finance by distributing bonds. The entity that received the bonds – i.e. lends the money – has a financial asset (an investment) while the issuer of the bonds – i.e., the borrower who has raised the finance – has got to account for the bonds a financial liability.

There are several kinds of financial instruments. Various instruments are custom agreements that the participants tailor to their individual needs. However, numerous financial instruments are based on regulated contracts with predetermined features. By nature, financial instruments are essentially classified into the following categories:

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1. Equity Instruments

Any instrument distributed by an entity that provides a contractual right to the net assets of the company (ownership rights) to the instrument owner is known as an equity instrument. They are a way to fund operations. The common types of equity instruments are common stock and preferred stock.

Common stock is that the most typical sort of stock that companies issue. It allows shareholders to participate in the company's earnings through dividends and/or capital appreciation. Ordinary shares stockholders usually are granted voting rights, with the number of votes immediately associated with the number of shares held. Of course, the company's board of directors has the decision whether or not to pay dividends and what proportion is paid. A company's dividend can vary with profits, affected by the economic, market, and political situations. Dividends are typically not warranted and will be changed or eliminated.

Common stock has the potential for savings through capital gains. The income and capital amount of stocks shift with fluctuations in market conditions. Shares, when traded, could also be worth more or but their original cost. Shareholders aren't guaranteed to receive dividend repayments. Investors should examine their toleration for investment risk before investing in common shares.

Preferred stock is usually considered less volatile than common shares but typically has fewer earnings potential. Preferred stockholders usually do not have voting powers, as common stockholders do, but they have a more extraordinary claim to the company's assets.

Holders of preferred stocks receive dividends before ordinary holders, and these dividend repayments tend to be more expensive. Shareholders of preferred stock take fixed, regular dividend payments for a particular period, unlike the variable dividend fees sometimes extended to common stockholders. Of course, it's essential to recognize that fixed dividends depend on the company's capacity to repay as agreed. If a corporation announces liquidation, holders of preferred stocks are paid first before common stockholders. Unlike preferred shares, though, common shares can return higher yields over time through capital growth. Investments seeking to realize more elevated rates of return also involve a better degree of risk.

2. Debt Instruments

Any instrument issued by an entity to boost funds while assuming the contractual obligation to repay the funds raised alongside the other costs agreed under the contractual terms (such as finance cost) is known as a debt instrument. It includes all types of fixed income securities, promising the investor that they will receive specific cash flows at particular times in the future.

An entity issuing a certificate of indebtedness will record a financial liability in its books of account. In contrast, an entity investing in debt instruments will record a financial asset in its books of account.

The bond market is significant for economic activity because it's the market where interest rates are determined. Interest rates are substantial personally because they guide our decisions to save lots of and finance major purchases like houses, cars, and appliances.

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3. Derivatives

A derivative may be a contract between two or more parties that derives its value from underlying financial assets or some agreed market indices. It derives its value from changes within the values of underlying assets or indices agreed within the derivative contract. Derivatives are utilized in hedging to attenuate the risks related to future fair value changes and future income changes of assets and liabilities. They are also used to earn speculation gains by trading in derivatives.

Most derivatives are traded on the OTC market. However, a number of the contracts, including options and futures, are traded on specialized exchanges.

Types of Derivatives

a. Forwards and Futures

Financial contracts obligate the contracts' buyers to urge an asset at a pre-agreed price on a specified future date. Both forwards and futures are essentially equivalent.

However, forwards are more flexible contracts because the parties can customize the underlying commodity because of the commodity's quantity and, therefore, the date of the transaction. On the opposite hand, futures are standardized contracts that are traded on the exchanges.

b. Options

Options provide the customer of the contracts the formal requirement to get or sell the underlying asset at a predetermined price. Based on the chosen type, the customer can choose the maturity (European options) or on any date before the maturity (American options).

c. Swaps

Swaps are derivative contracts that enable the transfer of money flows between two parties. The swaps typically include the deal of a fixed cash flow for a floating cash flow.

In general, derivatives significantly affect modernized finance because they supply various benefits to the monetary markets. Because the value of the derivatives is related to the underlying assets worth, the contracts are typically utilized for hedging uncertainties. For instance, an investor may acquire a derivative contract whose cost changes the other way to the value of an asset the investor holds. In this approach, earnings within the derivative contract may compensate for losses within the underlying asset. Another benefit of those instruments is that they're frequently wont to determine the worth of the underlying asset. For example, the spot rates of the futures can function as an approximation of a commodity price. They are also considered to increase the efficiency of financial markets. By utilizing derivative contracts, one can replicate the payoff of the assets. Therefore, the values of the underlying asset and thus the affiliated derivative tends to be in balance to avoid arbitrage possibilities.

However, despite derivatives' benefits, the financial instruments accompany some significant drawbacks despite the benefits that derivatives bring back the financial markets. The disadvantages ended in unfavorable results during the worldwide

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Financial Crisis of 2007-2008. The high volatility of derivatives endangers them to possibly massive losses. The complex design of the contracts makes the valuation extraordinarily difficult or maybe impossible. Thus, they bear a high inherent risk. Also, derivatives are widely considered an instrument of speculation. Due to derivatives' remarkably risky nature and unpredictable behavior, irrational speculation may cause huge losses.

d. Foreign Exchange

Foreign exchange may be a unique financial instrument where the trading of one currency to a different happen. It is an easy method of adjusting one currency for an additional. Forex market is taken into account most liquid market within the world.

Financial Intermediaries

As mentioned previously in the beginning of this section, funds can flow indirectly from lender-savers to borrower-spenders indirectly through financial intermediaries. A financial intermediary is an institution that stands between borrowers and lenders and facilitate transfer of funds from one to the other. To do this, financial intermediaries borrow funds from lenders, which they in turn use to provide loans to borrowers. This process of obtaining funds indirectly from financial intermediaries is called financial intermediation. And this is usually the primary route for the movement of funds from lenders to borrowers, especially for corporations, rather than through the securities market.

Types of Financial Intermediaries

1. Depositary Institutions

Intermediaries that accept funds in the form of deposits from lender-savers to provide loans to borrower-spenders are called depositary institutions. These institutions are comprised mostly of commercial banks, but also include 'thrift institutions' such as savings and loan associations, credit unions, and mutual savings banks.

2. Contractual Savings Institutions

Contractual savings institutions refer to financial intermediaries that secure funds on a contractual basis at periodic intervals. Such institutions include insurance companies and pension funds. Contractual savings institutions are able to predict the amount of payouts it has to provide to its lenders, as a result, they tend to be able to invest in longer-term securities such as stocks and corporate bonds.

3. Investment Intermediaries

Lastly, intermediaries that raise funds by issuing securities, such as commercial paper, shares, bonds, etc., are called investment intermediaries. This includes institutions such as mutual funds, finance companies, hedge funds, and investment banks.

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B. Function of Each Type of Market in the Financial System

Money Market

This market is called the "money market"[198] because the assets bought and sold here are short-term and liquid and can be easily converted into cash. It is also defined as a mechanism through which short-term funds are loaned and borrowed.

According to **Nadler and Shipman**, "A money market is a mechanical device through which short term funds are loaned and borrowed through which a large part of the financial transactions of a particular country or world is degraded. A money market is distinct from but supplementary to the commercial banking system."

Money markets provide savers a mechanism for safe, liquid, short-term investments, while offering borrowers access to low-cost funds. Businesses and governments particularly benefit from this market as it helps in meeting their working capital requirements. For example, business entities borrow short-term loans available in the market to fulfill daily business needs such as uninterrupted electricity, timely wage payments, etc.

The tenure of investments ranges from a day to a year, usually not more than 365 days. Since investments with longer terms earn better, the assets traded here have low risks and gains. Thus, money markets differ from capital markets where long-term securities trade and rates, risks, and returns are high. (Further discussion on the capital market is found in the following section)

Functions of Money Market

The money market performs several functions. Following are some of the means it can influence an economy.

1. As mentioned above, the money market provides short-term funds to public and private entities needing such financing for their working capital requirements and to fund business growth. By making funds available to various participants in the market, this market promotes the economy's economic growth. It helps the development of commerce, industry, and trade within and outside the country.

   On the other hand, it also allows banks and other institutions to use their surplus funds to earn profit for a short period.

2. A well-developed money market assists in the successful implementation of the monetary policies of the central bank. The central bank may control the supply of money and curtail inflation/deflation using the money market. To tackle deflation, it purchases bonds and securities. As a consequence, more cash is deposited into the economy.

   The nominal interest rates can be referred to as the cost of borrowed funds. In an inflation setting, the central bank purchases back bonds and securities. As an effect, it diminishes the supply of money in the economy, shifting up the nominal interest rates. Alternatively, when the money supply rises, nominal interest rates drop.

3. Interest rates on money market instruments work as reference rates for pricing every other debt instrument in the financial market.

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[198] As such, this market provides a means for lenders and borrowers to satisfy their short-term financial needs according to *International Monetary Fund*

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4. The money market leads to equilibrium among the demand and supply of short-term funds. It allocates saving into investment channels. It provides a platform to wholesale as well as retail investors for investing or borrowing funds. In this way, it also helps in the rational allocation of resources or monetary equilibrium.

5. By facilitating the transfer of funds from one sector to another, the money market helps in economic mobility – that is, mobility in the stream of funds that is required for the growth of business and industry in an economy.

Capital Market

Capital markets refer to financial markets for long-term financial products and services where governments and companies can raise financing and investors can purchase and sell securities. Although these products may have similarities with money market instruments, the main difference lies in their maturity. Funding is provided for one or more years on a capital market, while money markets offer short-term financing.

These markets connect people and institutions that want or need funds with those that have capital. For firms, there are several reasons why they would like to build wealth. It typically supports a startup business, an ongoing operation, an expansion, or a strategic acquisition. As you might have imagined, those who give borrowers capital anticipate profit from their financing efforts.

Funds are built up by issuing capital market instruments like stocks and bonds. These instruments have a greater risk than money market instruments. Yet, at the same time, these instruments create higher profits.

Functions of Capital Market

The capital market plays a vital part in the development of an economy. The essential functions and significance of the markets are discussed below:

1. **Capital Raising**

   Building capital is an essential function of the capital market. Funds are needed by entities, whether businesses or government institutions. They are used to run the operations of entities. An efficient market creates convenient access to capital. If a company requires funds through equity, it can issue shares on the stock exchange. Examples of stock exchanges include the PSE (Philippine Stock Exchange), NYSE (New York Stock Exchange), and LSE (London Stock Exchange). In addition, capital markets guarantee the availability of funds by continuously providing long-term investment avenues for investors.

   Without markets for stocks and bonds, company owners would have fewer options to bring their plans to fruition or grow their firms. They would have to conserve up sufficient cash to re-invest. Companies can obtain the needed financial capital to establish and grow successful companies with a healthy capital market. They can also develop existing institutions to generate new jobs and strengthen the economy.

2. **Economic Growth**

   Capital Markets play a crucial role in economic development. It reflects the general condition of the economy. Capital markets help allocate resources from the people who have surplus

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capital to the people who need money. It mobilizes savings from individuals, banks, financial institutions, real estate, etc., thus diverting from unproductive channels to productive areas.

An improvement in capital goods increases the efficiency of labor. In other words, it assists in the optimum utilization of scarce resources. Superior and technologically advanced capital goods increase overall productivity. This increased productivity enhances economic growth.

Developed and extensive capital markets can play a crucial role in financing economic growth and affecting financial stability and transmission of monetary policy. As economies grow and investment projects become more complicated, efficient resource allocation and risk-sharing are aided by the information aggregation project and several financial claims produced by capital markets.[199]

3. Investment

Capital markets allow those who have the capital to invest it. In return, they have ownership of a bond or equity. Capital markets promote investing by providing facilities and provisions to investors in different financial instruments such as bonds, common shares, and preference shares, depending on the investor's risk appetite. They encourage a massive range of ownership of productive assets.

4. Risk Management

Risk management is a necessary function of the capital market. The capital market supports investors to reduce the risk of losses in other financial instruments and commodities through diversification. To spread out risk, investors can buy bonds, preference shares, and debentures simultaneously with common stock and other commodities. In addition to diversification, the capital market helps distributing risk by allocating investors with a high-risk appetite to riskier investments and those who are risk-averse to less risky instruments. Risk tolerant investors purchase stocks while risk-averse investors purchase bonds.

Capital markets primarily feature two types of securities – equity securities and debt securities. Both are investments that provide investors with different returns and risks and provide users with capital with various obligations.

Derivatives Market

The derivatives market belongs to the financial market for derivative securities. In the field of monetary economics, a derivative security is generally referred to as a financial contract whose worth is determined from the amount of an underlying asset or simply underlying. Many financial assets have been utilized as underlying, including equities or equity index, fixed-income instruments, foreign currencies, commodities, credit events, and other derivative securities.[200]

Derivatives differ from underlying rights or interests in that derivatives typically transfer a single risk—often called a market risk—while underlying rights or interests generally are bundles of risks. A bond, for example, is a bundle of interest rate, credit, and possibly currency risks, but a derivative instrument wrote on a bond typically transfers only one of the risks.

[199] Capital markets have executed an essential role in financing the recovery from the Great Financial Crisis (GFC), a hint of their "spare tyre" function in the financial system according *Bank for International Settlement* Publication
[200] Depending on the kinds of underlying, the values of the derivative contracts can be derived from the corresponding equity prices, interest rates, exchange rates, commodity prices, and the probabilities of certain credit events as discussed by *Bank for International Settlements.*

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Derivatives markets are now so big that they exert a significant impact on the overall economy. Many people now directly or indirectly earn or lose money from trading on derivatives and for them.

However, this market has come under attack in recent years with the accusation that they played a role in the financial crisis of 2007-2008. This event raised some critical questions concerning the regulations of derivatives trading and financial stability. With this, financial regulators are designing new rules to improve post-trade price transparency. There are also proposals in some jurisdictions to encourage the migration of trading in some actively OTC traded products to exchanges.

Functions of Derivatives Market

Despite the fear and criticism, the derivative markets perform several key functions:

1. **Risk management**

The primary economic role of most derivatives markets is the hedging function, also known as the risk-shifting or risk transference function. Derivatives enable market participants to hedge themselves from adverse fluctuations in exchange and interest rates, equity and commodity prices, and creditworthiness in the underlying in which they encounter a price risk. The ability to hedge allows them to shift undesired risk to others willing to bear that risk. The prices of derivatives are related to their underlying assets, as mentioned before. Thus, they can be used to increase or decrease the risk of owning the asset.

2. **Price discovery**

The derivatives market serves as an essential source of information about prices. Prices in an organized derivatives market reflect market participants' perception of the future and drive the underlying prices to the perceived expected level. The prices of derivatives converge with the costs of the underlying at the expiration of the derivative contract. Thus derivatives aid in the identification of future as well as current prices.

3. **Encourage investors and entrepreneurs**

A significant incidental benefit from derivatives trading is that it catalyzes new entrepreneurial activity. The derivatives have a history of drawing many intelligent, inventive, well-educated people with entrepreneurial attitudes. They usually stimulate others to devise new businesses, new products, and new work opportunities.

Foreign Exchange Market

The market for foreign exchange (commonly called the forex market) is where currencies are bought and sold. It is the market where exchange rates are defined. Exchange rates are the mechanisms by which world currencies are joined collectively in the global marketplace, presenting the price of an individual currency in terms of another.

The forex market is the world's biggest financial market, where trillions are exchanged every day. It is the most liquid among all the markets in the financial world. Given the global environment of the market, the majority of all foreign exchange transactions involve cross-border counterparties.

Functions of the Foreign Exchange Market

1. Conversion

The foreign exchange market's primary and most obvious function is to help to convert one currency into another - i.e., to perform shifts of purchasing power between two nations. In conducting the transfer function, the foreign exchange market makes payments globally by discharging debts in both directions simultaneously, similar to domestic clearings.

The market for foreign exchange determines the price of one country's currency related to another country's currency.

2. Managing Foreign Exchange Risk

Another role of the foreign exchange market is to hedge foreign exchange risks. Hedging means avoiding a foreign exchange risk; when the exchange rate changes, there may be a profit or loss to the party involved in a free exchange market. Under this situation, a person or a firm engages a significant exchange risk if vast amounts of net claims or net liabilities are met in foreign money.

The fluctuation of exchange rates in the foreign exchange market causes a need for hedging—the parties in the market hedge foreign exchange risk by participating in the forward market. One acquires a forward currency contract with a currency pair for a pre-defined value, rate, and date in the forward market. This is agreed upon at the point of dealing. The rate quoted on the forward market is termed a forward exchange rate.

3. Speculation

Another function of the forex market is speculation. Speculation is referred to as purchasing financial instruments to expect them to become more valuable or profitable shortly. Uncertain investors tend to reach conclusions based on technical investigation of market price movement rather than on the fundamental study of an asset. They also tend to be more aggressive market traders – constantly seeking to profit from short-term price fluctuations – instead of being "buy and hold" investors.

Speculators can buy foreign currency for future delivery if they think that the spot rate for a future date will be higher than the prevailing forward rate. This is popular with speculators because there are continuous fluctuations in the exchange rates between currencies, both intraday, and long-term. The currency market also contributes frequent trading opportunities due to the many different currency pairs open for trading.

The Primary and Secondary Markets

A Recap of Equity and Debt Securities

Equity securities are traded on the stock/equities market and are essentially ownership shares of a business or venture. When someone owns equity securities of a corporation, they essentially own some of that company and are qualified for any prospective earnings that the corporate takes in.

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On the other hand, debt securities are traded on the bond/debt market and are IOUs that are available bonds or notes. They essentially represent the borrowing of money which can be paid back at a later date with interest.

Interest is that the specified compensation that entices lenders to lend their money. The borrowers will take the cash today, use it to finance their operations, and pay back the money added to a prescribed interest rate later.

The said securities are often bought and sold on two markets: the first and secondary markets.

The Primary vs. Secondary Markets

The ***primary market*** issues new securities and sold for the primary time by a corporation. The businesses directly give the securities to investors. On the opposite hand, ***secondary market*** refers to the venue where securities transactions occur after the first or primary issuance of the securities.

To better understand and differentiate these two markets, a comparison is presented below.

Table 23 Primary and Secondary Market

Primary Market	Secondary Market
A significant component of the first market is that the IPO. It is how to issue new shares within the market.	It is an area where already issued or existing shares are traded.
The value obtained from the issuance of shares belongs to the corporate for their business development plans.	The amount invested by the customer of shares goes to the vendor, and hence the corporate doesn't receive anything.
The businesses issue securities to the investors.	Securities are traded between buyers and sellers, and stock exchanges expedite the trade.
The securities are all given at one price for all investors engaging in the offering.	Securities are exchanged at the market price.
The primary market doesn't give liquidity for the stock.	The secondary market gives liquidity to the stock.
Underwriters act as intermediaries.	Brokers act as intermediaries.
On the first market, security is often sold just one occasion.	On the secondary market, securities are often sold innumerable times.

Transactions within the capital market could even be classified consistent with where the securities are traded, i.e., exchange, over-the-counter (OTC), or the choice trading system (ATS).

Exchange

A marketplace where buyers and sellers meet together to exchange financial instruments. They started as physical places where trading took place, but the appearance of electronic trading has eliminated the necessity for transactions to be physical areas. It sets the institutional rules that govern trading and knowledge flows that trading.

It concentrates the information of bid and offer prices to all primary market participants, who can counter by selling or buying at one of the quotes or by responding with another quote.

Over-the-Counter (OTC) Market[201]

Contrary to trading on formal exchanges, OTC trading doesn't require exchanging only standardized items (e.g., precisely specified range of quantity and quality of products). Also, prices aren't continuously published to the general public. OTC contracts are bilateral, and every party could face credit risk concerns regarding its counterparty.

OTC trading raises total liquidity in financial markets, as businesses that can't trade on the formal exchanges gain capital through OTC markets. It allows greater flexibility to market participants by adjusting derivative contracts to suit their risk exposure better. However, OTC trading is endangered by numerous risks. One of the foremost significant is counterparty risk – the likelihood of the opposite party's default before the fulfillment or expiration. Moreover, the deficiency of transparency and weaker liquidity linked to formal exchanges can trigger destructive financial disasters.

Alternative Trading System (ATS)

An ATS refers to an institution, organization, person, or association of persons, or system that develops, operates, controls, or provide an electronic marketplace for bringing together:

a. The issuer of primary market securities of SEC-registered small, medium, growth, venture companies, and technology-based enterprises, and the investors who want to acquire those securities;
b. Primary market issuers of innovative registered securities of any SEC-registered enterprises and the buyers of those securities;
c. Secondary market traders of securities of SEC-registered small, medium, growth, venture companies, and technology-based enterprises;
d. Secondary market traders of innovative registered securities of any SEC-registered company;
e. Primary and secondary market traders of other securities may be authorized by the Commission.[202]

ATS has become essential to the present securities market, providing investors with enhancing flexibility, security, transparency, reduced trading costs, and competition to the established securities exchanges.

[201] According to *SEC MC No.14. s. 2*, the OTC market is formed by trading securities bilateral between parties outside of a trade or Alternative Trading System (ATS).
[202] In accordance to *SEC Rules on Alternative Trading System*

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C. Financial Markets

While the primary function of the financial market is to allocate capital – that is, mobilizing and channeling funds from those who have it to those who need it – it also allows people to trade financial assets with different patterns of cash flows over time. It also mitigates risks of uncertainty. However, uncertainty is a fact of life. This is accurate for financial markets, as evidenced by the various risks discussed in the earlier sections. Thus, economists and financial practitioners alike have extensively studied needs, individuals, and their behaviors to develop theories that explain how they respond in the face of uncertainty and attempt to predict future outcomes.

1. Theory of Rational Expectations

The theory of rational expectations proposes that the outcome of many economic phenomena partly depend on what people expect to happen[203]. The value of the Philippine Peso, for example, partly depends on what people expect the rate of appreciation/ depreciation will be. As a result, people will rush to accumulate Peso if they think it will gain value or rush to discard it if they expect to perform otherwise, thereby contributing to its rise or fall in value. The price of a stock or bond also comparably depends, to a certain degree, on what investors and potential investors believe it will be in the future.

In formulating these expectations, Muth's theory of rational expectations asserts that: (i) information is limited, and people use it efficiently, and (ii) people understand the structure of the economy and create their expectations based on this knowledge. This is the usual baseline assumption in many economic theories – that economic agents (individuals, firms, etc.) behave optimally and rationally.

Rational expectations are often believed as a school of thought in economics, i.e., it works under the assumption that economic agents are reasonable in their behavior and that people behave in ways to maximize their utility or profits. It would be better to regard it as a ubiquitous modeling technique used by economists and financial practitioners alike. However, one should take caution in applying the rational expectations theory, as once expectations are formed, reality becomes irrelevant. Thus, the actual outcome may be different from the model's conclusion. Another main critique of the rational expectations theory is that economic agents must have the financial knowledge and statistical skills to analyze all available information and assess the future equilibria of the economy – which, in practice, is not always true. Lastly, the assumption of rationality – that all decision-makers are sufficiently intelligent to use all available information to maximize their utility or profit – does not always hold in reality. People may make decisions based on emotions and other beliefs.

Nevertheless, the theory of rational expectations works well as it does not need to apply to all individuals in the economy. Instead, it asserts that, on average, expectations of the real economy are rational – some may over-predict, while others may under-predict. As such, the theory of reasonable expectations has become the cornerstone of many modern economic ideas – one of which will be discussed next.

[203] First introduced by John F. Muth in 1961.

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2. Efficient Market Hypothesis and Random Walk Behavior of Stock Prices

Efficient market hypothesis

While monetary economists were studying rational expectations, financial economists were in a parallel path looking into how expectations are formed in financial markets. Similarly, they conclude that the proponents of the reasonable expectations theory in that expectations in financial markets result from the optimal predictions using all available information. While this theory was given a different name – the efficient market hypothesis (EMH) – it is essentially applying rational expectations to prices of financial assets.

The EMH is attributed to two economists – Eugene Fama[204] and Paul A. Samuelson[205]." A market is said to be 'efficient' when market prices reflect all known market information. It is this assumption that underlies the efficient market hypothesis. Simply put, the EMH asserts that prices of financial assets (including stocks, bonds, and other investment products) fully reflect all the available information in the financial market.

The EMH can be further understood through the concept of arbitrage. Arbitrage can simultaneously purchase and sell a security or package of securities to profit from a price difference and practice market participants to take advantage of unexploited profit opportunities. Suppose the average return on a Jollibee Foods Corp. (JFC) common stock is 10% per annum, and its current price of PhP200 is lower than the optimal forecast of tomorrow's price of PhP200.27 so that the optimal estimates of the return of JFC is at 50% per annum which is greater than 10%. Based on rational expectations, market participants can predict that the average return of JFC will be unusually high – presenting an unexploited profit opportunity. With the knowledge that market participants can earn a high rate of return on JFC because the current return of 10% is less than the optimal forecast return of 50%. They will buy more of the stock, thereby driving up the current price of JFC relative to tomorrow's forecasted price, which in turn lowers the expected return of 50%. When the current price has risen sufficiently so that the expected rate of return equals the current rate of return – which satisfies the condition of EMH – the buying of shares of JFC will stop, and the unexploited profit opportunities will disappear.

Similar to rational expectations, one of the most enduring critiques of EMH is about the assumed rationality of the market participants since actual human behavior reveals biases that lead to less than optimal decision making. However, an essential factor of EMH reasoning is that not all market participants must be well informed about financial assets or have rational expectations for the market to be efficient. According to EMH, financial markets are structured so that many people can participate. And as long as their market participants keep an eye on unexploited profit opportunities, they will eliminate chances that appear, and the market will achieve efficiency.

Random-walk

In discussing the efficient market hypothesis, an important implication of this theory is that stock prices should approximately follow a random walk. The random walk concept describes the movement or changes in a variable (e.g., stock cost). Its future values cannot be predicted – i.e., provided the current value, its future value is as likely to rise as it is to fall. This can be easily explained using the previous example on JFC. If the price of the common stock of JFC is predicted to increase, then the EMH indicates that market

[204] Fama was the first to define an 'efficient' market in his work analyzing stock market prices published in 1965.
[205] Samuelson presented the first formal theoretical argument for efficient markets in 1965.

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participants would buy JFC and bid up its current price until the recent return of JFC equals its predicted return[206].

3. Behavioral Finance

The leading critics of rational expectations theory and the efficient market hypothesis are psychologists and experimental economists who assert that, in reality, market participants are often, if not always, irrational. According to them, people display specific behavioral biases which are persistent in human decision-making when faced with uncertainty. And these behavioral biases lead to less than optimal outcomes. Some examples of behavioral tendencies of humans include overconfidence, overreaction, under-reaction, loss/ risk aversion, herding, the miscalibration of probabilities, hyperbolic discounting, and regret.

Overreaction and under-reaction are common explanations for divergences from EMH. This occurs when market participants do not react in proportion to new market information. For example, when a stock experiences recent gains, some investors may overreact to this performance and buy up the stock, thereby pushing its price beyond its 'rational' or optimal value. Meanwhile, the rational investors will take up the other side of the trades and bring the value of the stock back to an equilibrium state.

Risk-aversion is another well-known facet of human behavior. Consider the following example. Suppose an investor is offered two different investment opportunities, A and B: A will provide the investor a guaranteed profit of PhP250,000; In contrast, B will show the investor a 25% chance of earning PhP1.2 million and a 75% chance of making PhP0. Accounting for probability, Investment B has an expected value of PhP300,000, which is higher than the payoff of Investment A. However, faced with an all-or-nothing outcome of Investment B, most people will prefer Investment A, which will provide a sure profit.

On the other hand, suppose the investor is faced with another investment decision X and Y: Investment X will yield a sure loss of PhP500,000, while Investment Y presents a 50% probability of a loss of PhP0 and a 50% probability of a loss of PhP1 million. In this case, Y is a riskier investment as the investor may lose a lot more than Investment X. However, when faced with a choice that involves losses; people tend to become 'risk-seeking and not risk-averse as when dealing with profits. This behavior of risk-aversion, when there is potential for gains and risk-seeking when there is potential for losses, can lead to bad financial decisions.

While behavioral finance is a relatively new subject, there are already a few studies that reveal people's behavioral biases when it comes to making market decisions, which in turn influences how markets behave. As such, there is a need to further study and understand behavioral anomalies and integrate them to the conventional knowledge of how markets work.

4. Investment and Its Determinants

Investment is a key component of the economy. A country's productivity is heavily influenced by the amount and quality of capital it has – and that capital was only available because certain investment decisions were made. Investment is also an important factor of an economy's long-run potential output as it adds to the country's national capital stock – that is, the net accumulation of capital goods by an economy. Increasing an economy's

[206] Hence, in an efficient market, future changes in stock prices should be unpredictable for all practical purposes (Mishkin, F.S., 2019)

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capital leads to increases in aggregate production, which in turn increases the demand for labor, and thus aggregate supply. In addition, as discussed in the earlier section, investment is a component of aggregate demand. Thus, changes in investment levels influences real GDP and prices in the short-term.

The following sections discusses key investment determinants that economists have identified.

a. Interest rate

The level of interest rates plays a key role in making investment decisions. Generally, interest rates have a negative relationship with investment – i.e. higher interest rates tend to result in lower investment levels, while lower interest rates lead to increased investment. This is because the prevailing interest rate determines how much an individual or company would have earned if he had purchased interest-bearing assets as opposed to capital goods.

For example, Company A is seeking to be more sustainable in its operations; hence, the management is considering the installation of solar energy system for its building. Suppose the total installation cost of a solar energy system for Company A would be PhP500,000 and that this system would reduce the Company's energy bills yearly by PhP50,000. For simplification purposes, this example will assume that Company A's yearly energy savings will remain the same and that its solar energy system will never require maintenance or repair. In this regard, Company A will only consider the PhP500,000 purchase and installation costs and the annual savings of PhP50,000.

Should Company A install the solar energy system, this will increase capital stock and be considered as an investment. The decision on whether Company A will invest in a solar energy system, however, will depend on the potential profits it could gain from alternative uses of the PhP500,000 it would need to purchase and install system.

Suppose Company A already has PhP500,000 available funds on hand and is considering investing this on either a solar energy system for its building or on a bond. Company A's investment decision will depend on the interest rate it could potentially earn from the bond. Investing in a solar energy system would essentially provide the company an interest income of PhP50,000 annually in the form of energy expense savings – or a 10% return per year. If the interest rate on the bond is higher than the return generated by the solar energy system – say 15% or PhP75,000 per year – then Company A will have enough interest income from the bond to cover the PhP50,000 energy expense and have PhP25,000 left over. In this case, investing in the bond is a better decision. Alternatively, if the interest rate on the bond is 8% – which is lower than the yearly savings of the solar energy system – then the solar energy system is a better investment.

The interest rate is also critical if Company A does not have funds on hand and would need to borrow to purchase and install a solar energy system. If the interest rate is below 10%, then it would make sense borrow funds and invest in the system. If the interest rate is above 10% however, it would be costly for the company.

Fundamentally, the interest rate represents the opportunity cost of using the funds to invest in capital stock instead of purchasing bonds. In the case of Company, A, the cost of spending PhP500,000 to purchase and install a solar energy system is the forgone interest income if it had purchased a bond instead.

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As such, higher interest rates warrant less purchases of capital goods and thus leads lower investment levels; while lower interest rates support a greater number of potential investment in capital goods. The figure below illustrates the demand curve for investment at each level of interest rate, with all other things held constant.

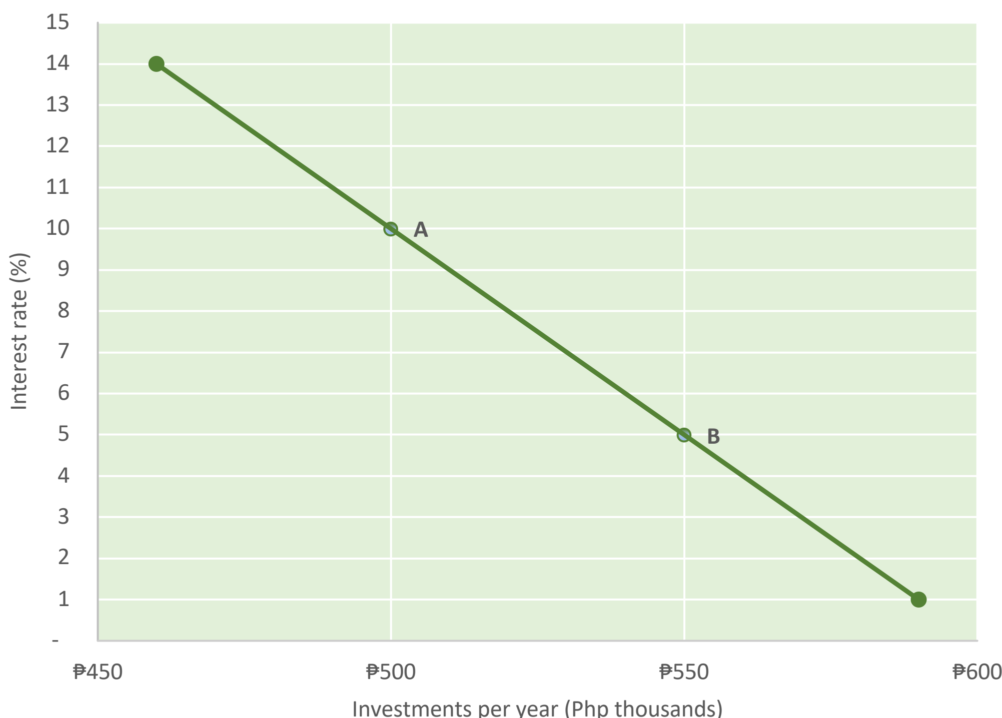

Figure 21 Interest Rate Movement

b. Expectations

Expectations about the future also affect how individuals and firms make investment decisions. If a company expects its sales to increase, it will likely invest to raise its current capital stock and increase its future production capacity. Likewise, expectations of reduced future profitability will result in decreased investment levels.

c. Economic activity

The degree of economic activity also influences investment. To produce goods and services, companies need capital. Therefore, increasing the level of production of companies will tend to increase the demand for capital, and thus investment.

Increased production can have a multiplier effect on boosting investment. With the initial rise in aggregate demand for capital, household incomes will also increase; which in turn, increases consumption. This increase in consumption further adds to the increase in aggregate demand. If this rise in demand also stimulates companies to further increase their production (and thus, investment), the multiplier effect becomes even stronger.

d. Stock of capital

The current stock of capital can influence the level of investment in two different ways. On one hand, majority of investments made are to replace existing capital that have already depreciated; thus, the greater the stock of capital, the greater the amount of investment needed to replace them. On the other hand, however, higher level of capital stock can lead to reduced investment. This is because individuals and firms make investments to adjust the stock of capital to a certain level. If the current stock of capital is higher, then the amount of investment needed to reach the desired level of capital is lower.

e. Capacity utilization

How much of the current stock of capital being used – or the capacity utilization rate – also affects investment levels. The capacity utilization rate of capital is generally below 100% as capital, such as plants and equipment, require downtime for repair and maintenance. If utilization rate of capital is high (or near 100%), this may be an indication for companies to increase investment to keep up with their production plans. Alternatively, if capital is idle and capacity utilization rate is low, firms are less likely to increase investment.

f. Cost of capital goods

As with any other goods, the cost of capital can shift its demand curve to left or right, with all other things held constant. If the cost of the capital good – for example the cost of putting up a new office building – increases, then demand for investment is likely to fall and its demand curve will shift to the left. On the other hand, if the cost capital goods decrease – suppose the price of construction materials fall – then demand for investment is expected to increase; thus shifting the demand curve to the right.

g. Technological Change

Technological changes or advancement can also affect investment positively. More often than not, new technology requires new capital – for example, new computers and technological infrastructure. Thus, developments in technology can significantly boost investment.

h. Public Policy

Government intervention through policy also has a significant effect on capital demand and investment. These policies intend to influence the cost of capital for companies to stimulate investment. Examples of these policies include accelerated depreciation, investment tax credit, capital gains tax rate (where assets held for a minimum specified period can be taxed at a different rate than other income).

5. The Stock Market as an Economic Indicator

The relationship between the stock market and economic growth has been well studied. Theoretical discussions have proposed that stock markets encourage economic growth as it allows capital to earn a higher rate of return. In turn, growth supports the development of

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costly financial infrastructures[207]. Moreover, in addition to facilitating efficient capital allocation, stock markets also promote entrepreneurship, entrepreneurial development, and the adoption of new technologies[208]. While the additional role of monitoring delegated to financial intermediaries fosters diversification within the intermediary, leading to minimization of costs of information monitoring[209].

Empirically, evidence has been found that the value to stock market trading relative to GDP is positively correlated with economic growth[210]. In addition, it has also been suggested that a well-functioning stock market is important in promoting long-run growth, in that that financial markets facilitate efficient resource allocation, physical capital formation and faster economic growth[211].

However, it has also been argued that the role of stock markets in economic development has been greatly exaggerated. It was also put forward that while the level of stock market activity does affect change, it is weak and does not provide significant incremental explanatory power[212].

Further some studies showed that although banks and stock markets may be able to encourage growth in the economy, the contribution of stock market development is significantly less than that of the banking system[213]. Moreover, it was implied that the stock market's volatility instead has real adverse effects on growth.

Still, more evidence regarding the impact of stock markets on growth emerged during the past few years. A more recent study by Mohtadi and Agarwal (2007) found that several indicators of stock market performance are significantly and positively related to economic growth directly and indirectly through encouraging private investment behavior. Moreover, results also suggest a long-run relationship between economic growth and stock market development. In an even more recent paper by Fufa and Kim (2018) determine that the correlation between financial development and economic growth becomes more pronounced when more homogenous groups of economies are considered. Their study suggests that for high-income countries, stock market liquidity has a strong positive impact on growth. In contrast, for middle-income countries, the significance of stock market liquidity on economic growth is marginal. Further, Fufa and Kim (2018) propose that with more homogenous income groups, their results imply that the financial development-growth nexus depends on the level of the economies' economic development.

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[207] As proposed by Greenwood and Javanovic in their 1990 paper entitled *Financial Development, Growth, and the Distribution of Income.*
[208] Suggested by Greenwood and Smith in 1997 in their study, Financial markets in development, and the development of financial markets.
[209] This view was contributed by Diamond in his paper on *Financial Intermediation and Delegated Monitoring* published in 1984.
[210] Using data from 39 countries for the period of 1980 to 1988, Atje and Javanovic (1993) identified the channels through which the stock market can affect economic growth – i.e. availability of information, diversification of risks, market liquidity, and corporate governance – and concludes that stock markets indeed have a long-term relationship with economic growth; in another study, Levine and Zervos (1996) built on this research by using stock market indexes as a measure of overall stock market development in a cross-country regression.
[211] In a study by Levine and Zervos in 1998 using cross-sectional data from 47 countries over the period of 1976-1993, it was found that even after controlling for economic and political factors, stock market liquidity and banking development both are positively correlated with economic growth, capital accumulation, and productivity improvements.
[212] In a 1997 study, Harris employed a model that uses current investment values, rather than lag values, estimates that suggested no hard evidence that stock market development support growth.
[213] Based on the results the study by Arestis et al. in 2001, utilizing time series methods from five developed economies.

D. Interest Rates and Time-Value of Money

Interest rates are one of the closely monitored economic variables. Movements in the interest rates are reported daily as it directly affects everyday lives and the economy. The rate of market interests influences personal and investment decisions, whether to consume goods or save, buy a car, or buy bonds. Interest rates also affect business and household spending, such as keeping their funds or investing in new equipment.

As such, it is essential to understand how the overall level of nominal interest rates – or simply interest rates – is determined and how it behaves relative to other economic factors.

1. Asset demand determinants

Understanding how interest rates behave is done by applying the law of supply and demand on bond markets and markets for money. Therefore, the initial step is to examine the factors that affect the quantity demanded of financial assets such as money and bonds and derive a demand curve for it.

a. Wealth, Expected Returns, Risk, Liquidity

In determining whether to purchase and hold an asset or which asset is preferred over the other, an individual must consider the following factors: (i) wealth, (ii) expected return, (iii) risk, and (iv) liquidity.

i. Wealth

Wealth is the total resources, including all assets, owned by the individual. When wealth is increased, more resources are available to the individual to purchase assets, so the quantity demanded increases[214].

ii. Expected Returns

The return on an asset evaluates how much an individual would gain from holding that asset. Therefore, the individual is influenced by the expected return they would get on that asset. For example, if the relative expected return of Asset A increases as against Asset B, then, holding everything else constant, Asset A becomes more desirable, and its quantity demanded increases[215].

iii. Risk

The degree of risk is also an essential factor in determining the demand of an asset. Consider two assets with the same expected return of 10%, Asset ABC and Asset XYZ. However, Asset XYZ returns 15% half the time and 5% the other half, while Asset ABC has a fixed return of 10%. In this case, Asset XYZ has an uncertainty associated with its returns and, therefore, more significant risk than Asset ABC. A risk-averse

[214] Thus, holding everything else constant, an increase in wealth raises the quantity demanded of an asset (Mishkin, F.S., 2019)
[215] Therefore, an increase in an asset's expected return relative to that of an alternative asset, holding everything else unchanged, raises the quantity of an asset (Mishkin, F.S., 2019)

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individual will prefer Asset ABC, whose return is a "sure thing" over Asset XYZ despite the two assets having the same expected return[216].

iv. Liquidity

Lastly, liquidity describes how quickly an asset can be converted into cash flows at low costs. An asset is liquid if the market where it is traded in has depth and breadth – that is, it has many buyers and sellers. A house, for example, is not a very liquid asset since it would be difficult to find a buyer quickly unless it would be sold for a much lower price. In addition, there are also substantial costs associated with selling a house (e.g., real estate broker's commission, transfer tax, etc.). In contrast, a T-bill is a very liquid asset that can quickly be sold in the exchange[217].

b. Theory of Portfolio Choice

The theory of portfolio choice combines all the factors affecting asset demand discussed in the previous section. This theory explains how much of an asset an individual would want in their portfolio. The idea of portfolio choice states that holding everything else constant:

1. Demand for an asset is directly related to wealth.
2. Demand for an asset is positively associated with the asset's expected return relative to alternative assets.
3. Demand for an asset is negatively associated with the risk of its returns relative to alternative assets.
4. Demand for an asset is directly related to its liquidity relative to alternative assets.

The theory is summarized in the following table:

Table 24 Illustration on Theory of Portfolio Choice

Variable	Change in Variable	Change in Quantity Demanded
Wealth	↑	↑
Expected return relative to alternative assets	↑	↑
Risk relative to alternative assets	↑	↓
Liquidity relative to alternative assets	↑	↑

2. Bond Market Supply and Demand

This approach of analyzing movements in the interest rates involves looking into the supply and demand of bonds and how prices of bonds are determined. Therefore, the initial step in this analysis is to obtain a demand curve for bonds, which will show the relationship

[216] As most individuals are risk-averse, particularly when it comes to financial decisions, holding everything else constant, if an asset's risk increases relative to alternative assets, its quantity demanded will decrease (Mishkin, F.S., 2019)

[217] Therefore, the more liquid an asset is relative to alternative assets, holding everything else unchanged, the more advantageous it is and the greater the quantity demanded (Mishkin, F.S., 2019)

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between quantity demanded and the price when all other economic variables are held constant.

Demand Curve

Consider a one-year discount bond with PhP 100,000 face value, which makes no coupon payments. If there is one year holding period, then the return on the bond is known, and it is equal to the interest rate as measured by the yield to maturity. The expected return of the bond, therefore, is represented by the following equation:

$$i = R^e = \frac{F - P}{P}$$

where i is the interest rate/yield to maturity
R^e is the expected return
F is the discount bond's face value
P is the initial purchase price

The equation above shows that the value of the interest rate corresponds to the bond price. For example, if the bond sells for PhP 95,000, the interest rate and expected return are 5%. At this interest rate level and corresponding price, assume that the quantity demanded is PhP 100 million – which is illustrated in Figure ___ as point A. Following the above equation, at the price of PhP90,000, the bond will have a return of 11%. With this higher expected return on the bond, the theory of portfolio choice predicts that the quantity demanded for this bond will be greater, with all other variables held constant. In Figure __, point B shows the quantity demanded for the bond with an 11% expected return is PhP200 million. Using the same logic, the figure also shows that a bond with a price of PhP85,000 or a 17.6% expected return will have an even greater quantity demanded at PhP300 million (point C). Continuing with this reasoning, lower bond prices of PhP80,000 (25% expected return) and PhP75,000 (33.3% expected return) will have even higher amounts of quantity demanded (points D and E in Figure ___). Connecting these points, A to E, will result in the demand for bonds BD. As with typical demand curves, BD slopes downwards, which denotes that, with all other variables held constant, at lower bond prices, quantity demanded of bonds is greater.

Supply Curve

To complete the picture of the supply and demand for bonds, the same assumption of holding all other economic variables aside from interest rate and bond price is used in the analysis.

Using the same bond example in the demand curve analysis, suppose the bond price is at PhP75,000 (or 33.3% interest rate), and the quantity supplied at this level is PhP100 million. If the bond price is increased to PhP80,000, interest rate is lower at 25%. At this reduced level of interest rate, it would be less costly for companies to borrow funds through issuing bonds, and would therefore be more willing to borrow through the bonds market; thereby increasing the quantity of bonds supplied to PhP200 million (point G). Further increasing the bond price to PhP85,000 would lower the interest rate even more at 17.6%. At this level, more companies would be more willing to issue bonds – resulting in increased bond supply. Similarly, higher prices of PhP90,000 and PhP95,000 would correspond to even more lower interest rates of 11% and 5%, respectively; and thus significantly larger quantity of bonds would be supplied (points H and I). As was done for the demand curve, connecting these points F to I will result in the supply curve BS. BS, as with usual supply curves, slopes

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upwards – indicating that, with all other variables held constant, at higher bond prices, quantity of bonds supplied is larger.

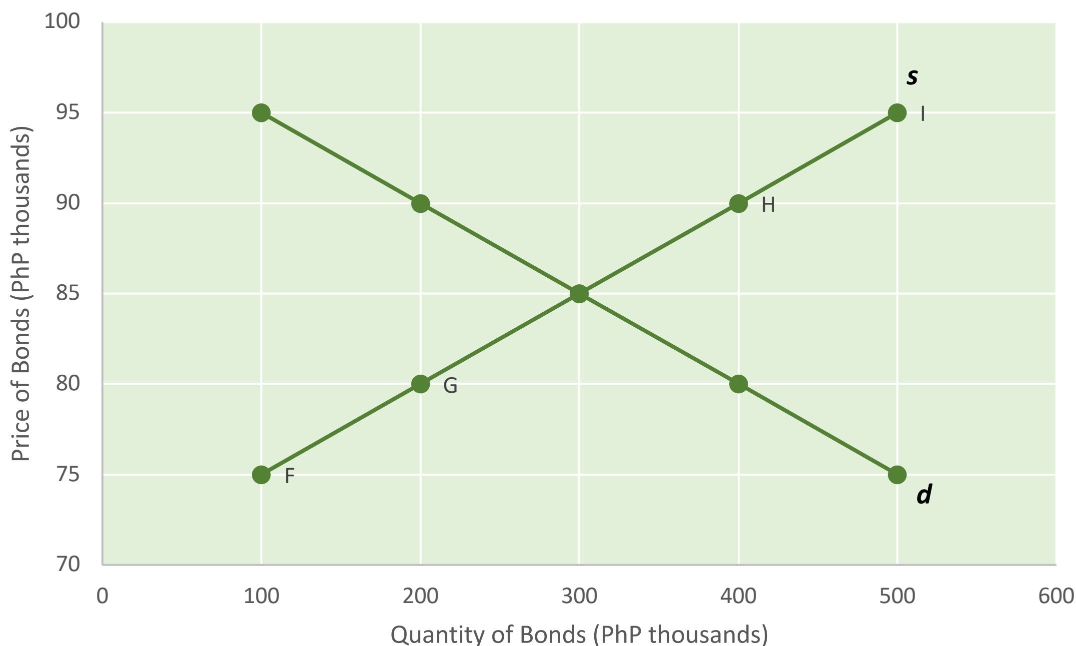

Figure 22 Bond Market Supply and Demand Curve

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a. Factors That Shift Demand Curve

Following the theory of portfolio choice, the framework for determining which factors affect the demand curve for bonds can be developed.

1. **Wealth**: *In a growing income and wealth business cycle expansion, the bond's demand rises, and the demand curve shifts to the right*[218].
2. **Bond's expected return relative to alternative assets:** An increase in expected return on alternative assets lowers the demand for bonds and shifts the demand curve to the left[219].
3. **Bond's risk relative to alternative assets**: *A bond's risk increase affects the bond's demand to decrease and its demand curve to move to the left*[220].

[218] Applying the same reasoning, when income and wealth are falling in a recessional economy, the bond's demand falls, and the demand curve shifts to the left (Mishkin, F.S., 2019)

[219] Alternatively, a decrease in expected return on alternative assets increases the demand for bonds and shifts the demand curve to the right (Mishkin, F.S., 2019)

[220] Alternatively, a risk increase of alternative assets causes the demand for bonds to rise and the demand curve to shift to the right (Mishkin, F.S., 2019)

4. **Liquidity of bonds relative to alternative assets**: *Increased bond liquidity results in increased demand and the demand curve moves to the right*[221]

Figure 23 Factors Affecting Demand Shift

b. Factors That Shift Supply Curve

Among the factors that affect the supply curve for bonds include:

1. Expected profitability of investment opportunities
2. Expected inflation
3. Government budget deficits

The following section will discuss each factor in detail.

i. Expected Profitability of Investment Opportunities

The expected profitability of investment opportunities affects the supply of bonds. Firms would be more willing to borrow to finance plants and equipment when there are plenty of options for these investments to be profitable. When the economy is

[221] Similarly, increased liquidity of alternative assets lowers the demand for bonds and shifts the demand curve to the left (Mishkin, F.S., 2019)

growing – in a business cycle expansion, the number of promising investment opportunities increases, and the quantity of bonds supplied at any given bond price also increases[222].

ii. Expected Inflation

In financing, the actual cost of borrowing is closely tied with the real interest rate, which is equal to the nominal interest rate minus the expected inflation rate. For each level of interest rate and corresponding bond price, an increase in expected inflation causes the real cost of borrowing to fall, which increases the quantity supplied of bonds[223].

iii. Government Budget Deficits

The activities of the government influence the supply of bonds in several ways. The Philippine Bureau of Treasury (BTr) issues bonds with financing government deficits due to gaps between the government's revenues and expenditures. When deficiencies are significant, the BTr sells more bonds, which increases the supply of bonds at each price[224].

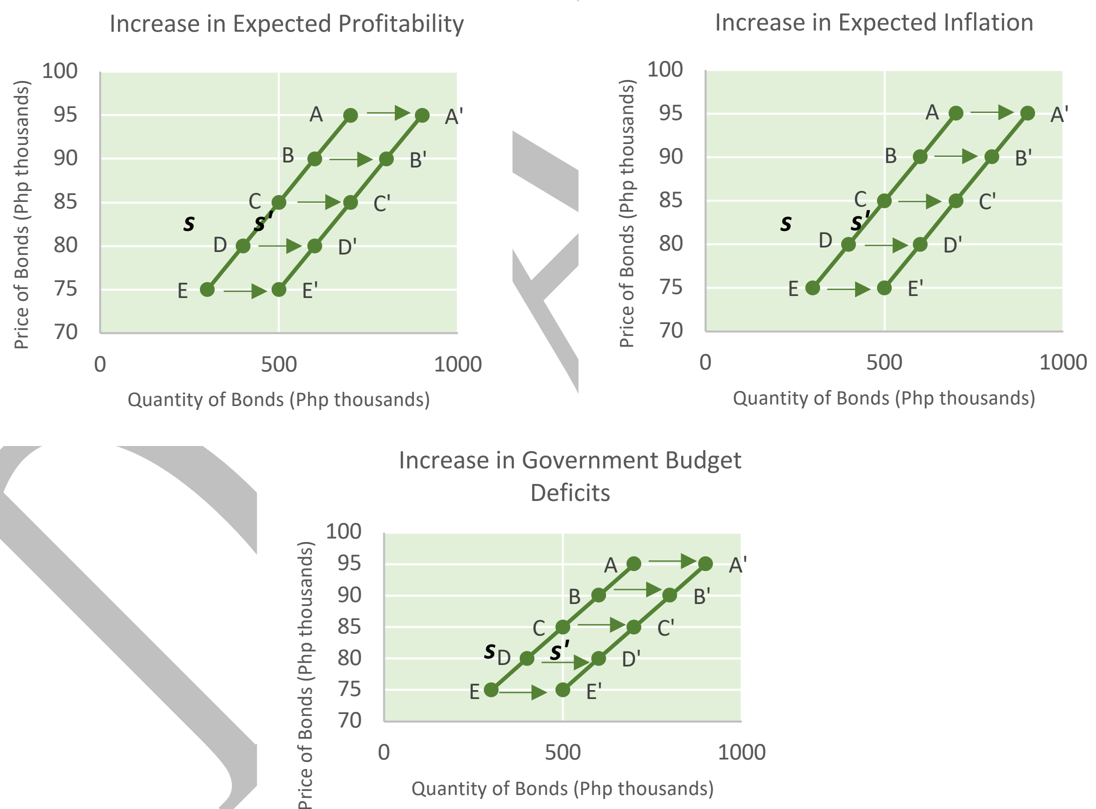

Figure 24 Factors Affecting Supply Shift

[222] Therefore, in a business cycle expansion, the bond's supply increases, and the supply curve shifts to the right. Likewise, when far fewer profitable investment opportunities are expected in a recession, the bond's supply falls, and the supply curve's direction moves to the left (Mishkin, F.S., 2019)
[223] Hence, an increase in expected inflation causes the supply of bonds to grow and the supply curve to shift to the right, and a decrease in expected inflation causes the supply of bonds to decrease and the supply curve to turn to the left (Mishkin, F.S., 2019)
[224] Thus, more government deficits enhance the bond's supply and move the supply curve to the right. On the other hand, government surpluses reduce the supply of bonds and change the supply curve to the left (Mishkin, F.S., 2019)

3. Default-Free Bonds and Risk Premiums

The behavior analysis of interest rates in the previous section focused on just one interest rate. However, there are vast numbers of bonds in fundamental markets where interest rates can differ from one bond to another. This section, therefore, will look into the relationships of various interest rates and examine why they differ from one another.

Interest rates of bonds (and other debt instruments) may vary due to their differences in default risk, liquidity, and taxation despite having the same maturity. Collectively, these factors are known as the risk structure of interest rates. On the other hand, the correlation among interest rates on bonds with different terms to maturity is called the term structure of interest rates.

Default Risk

One characteristic of a bond that determines its interest rate is its risk of default. Default occurs when the issuer of a bond fails to make interest payments or pay off the bond's face value within the specified period for one reason or another. A corporate bond issuer who has suffered significant losses is more likely to suspend coupon payments on its outstanding bonds, thereby increasing the company's default risk. In contrast, treasury bonds that the government issues are usually considered default-free bonds – treasury bonds carry no default risk since the government can always increase taxes or print money to pay off its obligations.

Risk Premiums

The difference, or the spread, between interest rates of bonds with default risk and interest rates of default-free bonds such as treasury bonds, both with the same term to maturity, is known as the risk premium. Risk premiums indicate how much investors must earn in exchange for their willingness to hold a risky bond. Based on supply and demand analysis of the bond market, a bond with a default risk always has a positive risk premium; and a higher default risk entails a more significant risk premium on the bond.

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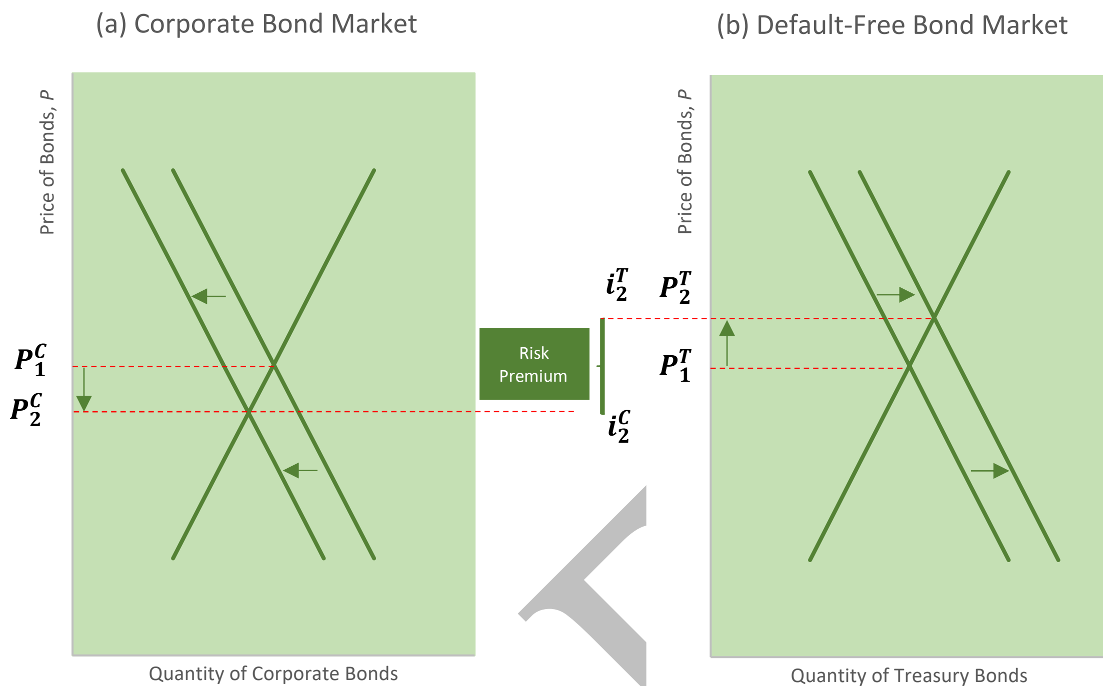

Figure 25 Corporate and Default-Free Bond Market

a. Credit Rating

Considering the importance of default risk to determining risk premiums, investors must know whether a corporation is likely to default on its bonds. As such, some companies make it their business to assess a corporation's ability to pay off its obligations – these companies are called credit rating agencies. Credit rating agencies assign ratings on bonds based on their quality regarding a corporation's probability of default. Bonds issued by corporations with relatively low risk of default are called investment-grade securities and have a Baa (or BBB) rating and above. Whereas bonds rated below Baa (or BBB) have higher default risk – these bonds have been dubbed as speculative-grade or junk bonds. In addition, since speculative-grade or junk bonds always carry higher interest rates than investment-grade securities, these bonds are also called high-yield bonds.

Liquidity

Another attribute that influences the interest of a bond is its liquidity. As discussed previously, a liquid asset can be quickly converted to cash with low transaction costs; thus, the more liquid an asset, the higher its demand. Unlike treasury bonds that are easy to sell and can be sold quickly, corporate bonds are not liquid. There are fewer bonds issued by anyone corporation that can be traded. Hence it could be costlier to sell these bonds since it would not be easy to find buyers quickly.

Using supply and demand analysis, if a bond's liquidity decreases relative to other assets, say a treasury bond, so will the demand for it – thus, shifting its demand curve to the left. In comparison, a treasury bond becomes relatively more liquid than a corporate bond, which increases its demand and goes its demand curve to the right. A leftward shift in the demand curve of a less liquid bond results in a decrease in its price and an

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increase in its interest rate, while a rightward change of the demand curve of a more liquid bond causes its price to increase and its interest rate to fall.

4. Yield Curve

Another factor that influences a bond's interest rate is its term to maturity – bonds with similar characteristics in terms of risk and liquidity may have different interest rates because their maturity dates are not the same.

A line that plots the interest rates – or yields – of bonds with the same attributes but different terms to maturity is called a yield curve. A yield curve depicts the term structure of interest rates for specific bonds such as government bonds.

A yield curve is when bond yields (interest rates) have equal credit quality but differing maturity dates.

A plot of the bond's yield with differing terms to maturity but the same risk, liquidity, and tax considerations are called a yield curve. It describes the interest rate's term structure for particular types of bonds, such as government bonds.

The figure below shows an example of a yield curve which is comprised of bonds with varying terms to maturity – from three months to 30 years.

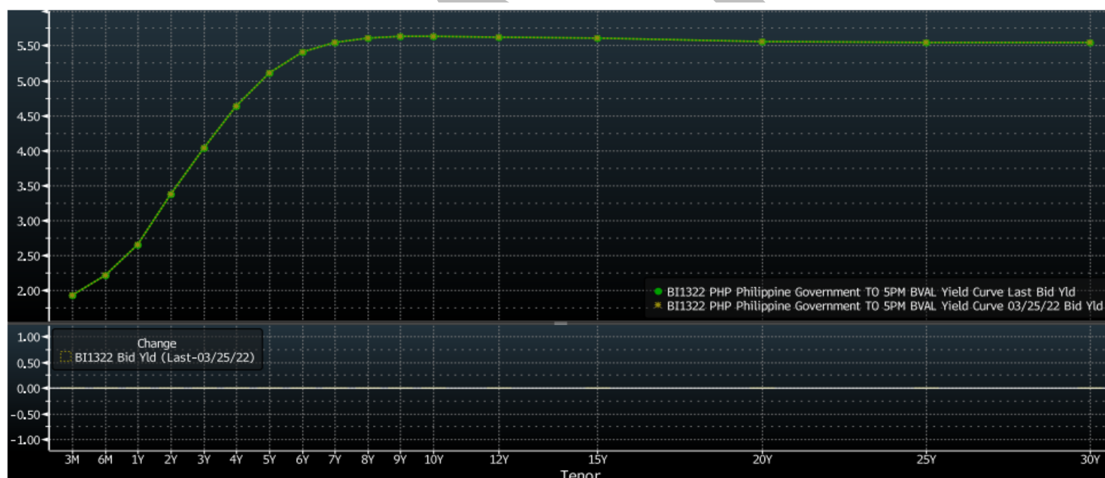

Figure 26 Philippine Government Yield Curve as of 25 March 2022; BVAL

Typically, yield curves are upward-sloping; however, they could also be flat or downward-sloping (also known as an inverted yield curve). When the yield curve is upward-sloping, long-term interest rates are higher than short-term interest rates – this is when the market expects the economy to grow at an expected rate. Long-term bonds are seen as riskier compared to short-term bonds due to the uncertainty of the future. When the yield curve is flat, short- and long-term interest rates are relatively the same – this type of yield curve may indicate that the economy is at a transition stage, preceding either an economic pick-up or recession. Lastly, a downward-sloping or inverted yield curve – wherein long-term interest rates are lower than short-term interest rates – occurs when the market expects the economy to slow down and inflation rates to decline in the future.

Sometimes, the market may see a steep yield curve when long-term when yields are rising at a faster rate than short-term yields. Historically, this is an indication of an expansionary economic trend.

Liquidity Premium Theory

The long-term bond's interest rate will equal an average of short-term interest rates anticipated to occur over the long-term bond's life plus a liquidity premium (also referred to as a term premium) that responds to supply and demand conditions for that bond.

While several theories endeavor to explain the term structure of interest rates, this section will focus on the most widely accepted theory – namely, the liquidity premium theory[225].

The critical assumption of this theory is that bonds with different maturities are substitutes; that is, the expected return of one bond influences the expected return of another bond with a different maturity. However, the theory allows for investors to have a preference over two bonds with different maturities. In this case, bonds with different maturities are assumed to substitute each other, but not perfect substitutes. And since bonds with shorter maturities tend to carry less interest-rate risk, investors usually prefer shorter-term bonds. Thus, for investors to be willing to hold longer-term bonds, a positive liquidity premium must be offered.

E. Financial Market Regulation

The financial market is one of the most scrutinized and heavily regulated sectors in an economy. The government imposes regulation on the financial system usually for two main reasons: (1) to increase transparency and available information to investors, and (2) to ensure a healthy financial market.

This section will look at some of the financial market issues that have led to the current regulatory environment.

1. Problems in the Market that Can be Addressed by Regulation

In the general context, governments intervene in the regular operation of markets to address inefficiencies. In an optimally efficient market, resources are allocated ideally to those in need and in the amounts they need. However, rarely is that true in reality. Actual markets are inefficient where some people may have too many resources while others do not have enough. Market inefficiencies – or market failures – can take many different forms. The government, therefore, tries to tackle these problems through regulation.

Below are some of the most common market failures that governments try to combat, including those pervasive in financial markets.

[225] The long-term bond's interest rate will equal an average of short-term interest rates anticipated to occur over the long-term bond's life plus a liquidity premium (also referred to as a term premium) that responds to supply and demand conditions for that bond (Mishkin, F.S., 2019)

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a. Public Good

In economics, a public good is non-excludable and non-rivalrous products or services. A product or service is non-excludable if one cannot exclude individuals from enjoying its benefits when that product or service is provided. On the other hand, a non-rivalrous good is nondepletable – that is, an individual's enjoyment of the product or service does not diminish its supply available to others.

Clean air, for example, is a public good – there is no way to exclude an individual from consuming – or breathing in – air, and its use by one person does not deplete (for all practical purposes) its supply for others. Another commonly cited example is national defense since it is assumed that a nation-state cannot simply protect only some of its population from foreign aggression and exclude others. The national protection it provides to one individual does not diminish the protection provided to other residents.

Similarly, a public "bad" is defined as an undesirable product or service that is non-excludable and non-rivalrous. Polluted air is an example of a public bad because clean air is a public good.

Considering its nature, the market typically undersupplies public goods – and in the case of public bad, it oversupplies it. As such, commonly suggested solutions to this market failure involve government intervention, taxes, and subsidies.

b. Tragedy of the Commons

The commons' tragedy is a concept that highlights the conflict between individual rationality and that of the collective[226]. When the number of animals grazing on the field is below the capacity, the ranchers may feed their animals without limitations. A profit-maximizing rancher, however, will seek to increase his number of animals. The rancher, in this case, is thinking logically but not collectively – adding livestock grazing on the field benefits the rancher alone, while costs are shared. If all ranchers believe the same way, ultimately, the tragedy is that no rancher will be able to use the field for grazing due to overconsumption. For the world's limited natural resources, this kind of scenario has severe consequences.

Therefore, it is recognized that one of the primary roles of the government is to establish regulations that manage these shared resources. While this may be relatively straightforward for the resources within a country's jurisdiction, it becomes a bit more complicated when the resources are shared among different nations. At the international level, problems arise when a joint authority does not bind countries, and any restrictions imposed on them are viewed as a threat to their sovereignty. However, with increasing global dilemmas that cut across borders – such as climate change – managing the commons on a supranational level has become imperative.

c. Externalities

Externalities are "side effects" of consumption, production, and investment decisions of individuals, households, and firms, directly affecting people not involved in the transactions. An externality can both impose costs or benefits to people who are not reflected in the prices charged for its provision.

[226] This concept was popularized by American ecologist Garrett Hardin who illustrated the tragedy of the commons through the analogy of ranchers grazing their livestock on a common field (Hardin, G., 1968)

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Sometimes, these side-effects are insignificant; however, when the side effect is substantial, it could lead to problems. As such, externalities are among the main motivations why governments intervene in the market.

A typical example of a negative externality – an externality that entails costs to the economy – is pollution. Before environmental regulations were put in place, a polluter makes decisions based only on the direct costs of production and profit opportunities and does not consider the indirect costs to the environment caused by its polluting activities. The indirect costs to the economy may include reduced quality of life and increased costs for healthcare. Since the polluter does not assume these costs, the prices of its products do not carry the additional costs generated by it. But in actuality, the total costs – which includes social costs – of production are more significant than the private costs.

On the other hand, an externality can be positive and benefit the rest of the economy. Effects of research and development (R&D) activities is a positive externality example. A company pays a lot for R&D, typically to improve its products or come out with innovations. However, since research adds to the general body of knowledge, it produces a positive externality enjoyed by people beyond the company. In addition, the costs of R&D do not include the benefits received by other individuals outside of its own company. In this case, private returns are minor than social benefits.

When private and social returns and costs differ, the market outcome may not be efficient. To promote the welfare of individuals in an economy, social returns must be maximized while social expenses minimized. This means that externalities must be "internalized." All costs and benefits of the consumption of goods and services must be taken into account and reflected in the price. Otherwise, market inefficiencies will lead to an underproduction of goods and services with positive externalities, overproduction of goods, and assistance with negative externalities.

Overproduction and underproduction signify a market inefficiency or a market failure. Market inefficiency or market failure is an outcome that the government attempts to address by establishing institutional frameworks that allow parties affected by externalities to negotiate – such as the filing of patents. The government may also impose a Pigouvian tax or a tax on a market activity that produces a negative externality or an additional cost borne by individuals not directly involved in the action.

d. *Asymmetric Information: Adverse Selection and Moral Hazard*

Asymmetric information is an essential concept in financial markets. This transpires when one party in a transaction has incomplete or insufficient knowledge about the other party, making it impossible for the first party to make accurate decisions about it. For example, a corporate issuer of a bond usually has better information about the potential returns and risks associated with its company. Asymmetric information's presence gives rise to problems of adverse selection and moral hazard.

A moral hazard is the problem created by a lack of information after a transaction has occurred. In financial markets, moral hazard is the risk (hazard) that an issuer or borrower will engage in unwise (immoral) activities from the investor's point of view as it would increase the probability of default. Since moral hazard makes it less likely for investors to get back their investment, investors may decide that they would instead not lend their money.

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On the other hand, adverse selection is a problem created by asymmetric information before the transaction has been entered into. The adverse selection comes about when potential issuers or borrowers who are most likely to make undesirable (negative) decisions – or the bad credit risks – are the ones who actively seek out investments and therefore are most likely to be selected by investors. Similarly, adverse selection decreases an investor's willingness to invest because it makes it more likely that investments will be offered lousy credit risks despite reasonable credit risks in the market.

e. Price Transparency

1. The Lemon Problem

The lemons problem is one example of how asymmetric information and adverse selection interfere with the market's efficiency[227].

In the used-car market, potential buyers have limited knowledge on how to assess the quality of a used car – that is, they do not know whether a used car is of good quality and will run well, or whether it is a lemon which will incessantly give them problems. Because of this, a potential buyer will pay a price which reflects the average quality of used cars in the market, which is between the high value of a good car and the low value of a lemon.

On the other hand, the seller or owner of the used car knows more about the quality of the vehicle they are selling – whether or not it's a lemon. If the car is a lemon and therefore has a lower value than average, then the seller would be more than happy to sell it at the price that the potential buyer is willing to pay, which is between the price of a good car and the price of a lemon and thus higher than the actual value of their used car. Alternatively, suppose a seller has a good-quality vehicle. In that case, they know that the car is undervalued at the price the buyer is willing to pay and thus would be less likely to sell at that price due to this adverse selection problem in the market.

The market will be saturated with lemons and not having enough good cars in the adverse selection problem result. With the low average quality of cars in the used cars market, fewer people would be willing to buy used vehicles resulting in low sales. In this scenario, the used cars market is unable to function correctly, it at all.

Lemons in the Stock and Bond Markets

Unsurprisingly, the lemons problem can also be seen in the securities markets – that is, the market for debt and equity.

A potential investor wanting to invest in common stock would not accurately distinguish between the good companies with low risk and high expected profits and bad companies with high risk and low expected profits. In this case, the potential investor would limit their willingness to pay at a price that reflects the average quality of companies in the market. This price is between the value of good companies and the value of bad companies. Suppose the owners of good companies have more information than potential investors. In that case, they know that their securities are undervalued for the price the potential investor is willing to pay and hence would not want to sell. The only

[227] In a famous article by George Akerlof, he outlined this through his description of the "lemons problem" – called such since it is similar to the problem created by bad cars or "lemons" in the used cars market (Akerlof, G., 1970)

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companies that would be willing to sell securities to the potential investor would be the owners of bad companies whose value is less than the price of the potential investor. Aware of this problem, the potential investor would instead not invest in holding securities of a bad company. Similar to the outcome in the used-cars market, this market for securities will not work well because only a few companies would sell securities to raise funds.

Similarly, if the potential investor considers purchasing a debt instrument in the bond market, they would only be willing to buy a bond with interest high enough to compensate for the average market default risk of the good and bad companies in the bond market. Owners of good firms would not be willing to sell bonds since they would be paying higher interest than they should and so would be less likely to borrow funds through the bond market. Only the bad companies with high default risk would be selling bonds in the market. Knowledgeable investors will not be eager to buy bonds of bad companies and will probably refrain from participating in the bonds market. With few bonds in the market, this would not be a good source of financing for companies.

The lemons problem prevents the securities market from being an efficient and effective channel of directing funds from savers to borrowers.

f. Price Stability

Price stability has been increasingly viewed as the most important goal of monetary policy. Defined as low and stable inflation, price stability is desirable as a rising price level – or inflation – creates uncertainty in the economy, which may impede economic growth.

When the overall prices fluctuate, it isn't easy to interpret the data conveyed by the prices of goods and services in the market. This makes it complicated for consumers, businesses, and governments alike to make decisions, thus leading to a less efficient financial system.

Further, the general public is hostile to inflation, but a growing number of studies suggest that inflation leads to lower economic growth. Hyperinflation is an extreme example of volatile prices in Argentina, Brazil, Russia, and Zimbabwe and has proved to be very harmful to their economies.

Unstable prices also make it challenging to make plans for the future. For example, it would be more complicated to decide how much to save to provide for a child's education expenses in an inflationary environment.

Therefore, the government and its central bank must implement the right monetary policy. An expansionary monetary policy will lead to high inflation, which will decrease economic efficiency and hamper economic growth. However, a monetary policy that is too tight can result in economic recessions wherein output falls, and unemployment increases. A contractionary monetary policy can also lead to deflation. Price levels plummet – similar to what occurred in the United States during the Great Depression – and cause instability and worsening of financial crises.

g. Financial or Economic Crisis

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1. Asset Price Bubbles

Every so often, economies have to experience asset-price bubbles, which are significant increases in asset prices – or bubbles – that deviate from fundamental values and inevitably burst resoundingly. A prime example of how damaging and expensive these bubbles are in the 2007-2008 Global Financial Crisis. When the housing market bubble eventually burst, it brought down the American financial system. It dragged other economies with it, leading to an economic downturn and an increase in unemployment rates.

To better understand how central banks respond to asset-price bubbles, it is suitable first to determine its type. There are two general types of asset price bubbles: the first is driven by credit, while the other is driven by purely optimistic expectations or "irrational exuberance."

Credit-driven Bubbles

Credit-driven bubbles can emerge when there are credit booms. Credit can be easily obtained during such times and used to purchase particular assets, increasing their prices. With the rise in asset values, lending for these assets also grows since either the value of the collateral increases, which makes it easier to borrow or the capital of financial institutions is increased, which provides them greater capacity to lend. In turn, increased lending for these assets will further drive up the demand for them, thus raising their prices even more. This market reaction, where a credit boom drives up asset prices higher and higher, creates a feedback loop that spawns a bubble where assets prices rise well above their fundamental values.

These bubbles are hazardous since once the bubble bursts and prices fall back down, the collapse in asset prices reverses the feedback loop – loans go into default. Lenders reduce their credit supply, leading to a decline in asset demand and a further decrease in prices.

Expectation-driven Bubbles

Bubbles driven purely by irrational exuberance but not connected with any credit boom pose less risk to the financial system. The late 1990s' dot-com bubble was not fueled by credit. Instead, it was caused by excessive speculation of internet-related companies during a period of massive growth and adoption of the internet. The busting of the dot-com bubble was not followed by a significant deterioration in the balance sheets of financial institutions and thus did not negatively impact the economy.

These bubbles, driven solely by optimistic expectations, are therefore less dangerous than credit-driven bubbles.

2. Forms of Regulation that Can Address this Problem

a. Disclosures and Reporting

The disclosure relates to creating relevant information about some companies promptly available to the general public in business terms. Relevant information refers to any piece of information – which may include facts, figures, dates, procedures, innovations, etc. – that can potentially affect an investor's decision, including even negative information about the company.

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Disclosures and reports are tools that enhance the availability of information and reduce information asymmetry. Disclosures and reporting improve transparency and market efficiency, but it also helps avoid financial and economic crises. Therefore, it is essential that government bodies such as the central bank and securities regulator strictly regulate disclosure rules.

b. Capitalization Requirements and Prudential Standards

Broadly construed, prudential regulation involves the government – particularly the central bank – supervising and monitoring the banking system to ensure its safety and soundness.

Typically, the government provides some form of safety net for the banking system to prevent public panic and bank runs if an adverse shock hits the economy. However, the government must also put regulations to limit the potential moral hazard and adverse selection that these safety nets can create. Otherwise, there will be strong incentives for banks to take on excessive risks, and the government's safety net will cause more harm than good to the economy and might even promote banking crises.

Regulations that are established to reduce the banking system's risk-taking activities and monitor the banks' compliance to these regulations fall under the prudential supervision role of the central bank. Prudential supervision ensures that the banks do not take on excessive risks – and this is especially important, particularly in emerging countries as recent years have shown where inadequate prudential regulation and supervision has been one of the critical triggers that led to currency and financial crises.

Prudential regulation and supervision include:
a. Restrictions on asset holdings and activities.
b. Separation of the banking and other financial service industries such as securities, insurance, or real estate.
c. Restrictions on the competition.
d. Capital requirements.
e. Risk-based deposit insurance premiums.
f. Disclosure requirements.
g. Bank chartering.
h. Bank examination.
i. A supervisory versus a regulatory approach.

c. Enforcement Action

The most important aspect of regulation is that it provides the basis for punitive action – or enforcement – when individuals or firms perform harmful or fraudulent activities. Regulation also provides investors some degree of protection, compensation, and basis for class action against illegal players.

Forms of enforcement action may include: warning letters (that do not carry any penalty or sanctions unless compliance is not met within a specified period), civil penalty, criminal penalty, license suspension, and license revocation.

The existence of these penalties and sanctions are to induce regulated entities to comply with the rules set by regulatory bodies, and to provide a deterrence for harmful and fraudulent actions.

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Topic 3: Risk Management (RM)

Capital market professionals in the performance of their duties, encounter different risks in the conduct of their respective duties as compliance officers, associated persons, and salesmen (equities securities, fixed income, mutual funds, timeshares salesman). Organizations face risk in almost all aspects of their business activity. This is the reason why it is important for capital market professionals to have a broad understanding of what risk is, how to think about risk and understand the basic framework of risk management.

Brokers/ dealers, in the course of buying and selling securities either for his or her own account in the ordinary course of business or for the account of others need to be able to appreciate the risks in buying and selling securities to understand their own or their respective clients' risk profile.

The associated persons, in their exercise of their supervisory authority over brokers/ dealers, need to understand risks to get a big picture overview and perspective of the risk implications of business decisions taken.

Compliance Officers, in their duty of providing independent oversight and check over the business activities of brokers/dealers, should be familiar with the risk consequences of their respective business activities.

The salesman, in the course of the performance of their duty to buy and sell securities need to understand the risk of the securities they are selling and the suitability and appropriateness of these securities to be sold to their respective clients especially in their performance of the level of care they are expected to exercise for their clients.

This section is not a comprehensive discussion of risk management. The main objective of this session is to give the capital market professionals a helicopter's overview of risk management.

A simple working definition of risk is provided by ISO 31000, which is an open, principles-based system for organizations.

Learning Objectives

At the end of this section, the capital market professional is expected to be able to:

1. Define risk as effect, uncertainty and impact on objectives
2. Identify the different types and categories of risk
3. Identify the causes and impact of the different types of risk
4. Define risk management
5. Discuss the importance and objectives of risk management
6. Describe the risk management process
7. Identify the different activities or processes in risk management
8. Cite relevant rules on risk management
9. Apply risk management thought process in a structured framework

Throughout this section, we will discuss different cases relevant to Asia and Philippines to help capital markets professionals concretize and apply their understanding of risks.

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Part I. Definition of Risk

A simple working definition of risk is provided by ISO 31000, which is an open, principles-based system for organizations. Risk is defined as: ***"Effect of uncertainty on objectives"***

This simple definition provides profound insights on how to define risk in a structured manner.

A. Risk as effect
B. Risk as uncertainty
C. Risk as impact on objectives

A. Risk as Effect

Effect is "deviation from expected – positive or negative". This means that we consider not only negative surprises (i.e. losses) as risk but also positive surprises (i.e. unexpected gains). An important insight from this definition is that the direction of the outcome is not as important as the degree of deviation from the expected.

What then is the expected? Expected is the predictable or stable value. To understand the concept of the expected, it will be helpful to discuss a simple experiment.

In Practice: Understanding the Concept of the Expected

Suppose you are playing a simple dice experiment where the outcome can be a number between 1,2,3,4,5 and 6.

Can you predict the next outcome? The answer is no. In a fair dice game, the outcome is random. Therefore, it is not predictable.

Now, suppose you perform a large number of dice experiments and get the average of each of the rolls of that dice experiment. The outcome would be at around 3.5.

What is this amount? This is simply the average of the outcomes (i.e. [1+2+3+4+5+6]/6). In the long run, everything goes back to the average. The average, therefore, is the expected value. This is why mean reversion is a powerful concept in finance: in the long run, everything goes back to the average.

The illustration above shows why we commonly use average or expected value as a reference point for risk. Risk is seen as the distance away from the predictable value or expected value.

One of the most popular measures of risk used in finance is standard deviation or volatility. Standard deviation is a statistical measure that measures the spread or deviation away from the average. The farther you are from the predictable variable (expected value or average), the higher the standard deviation or risk.

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This is why we often associate risk with volatility (i.e. interchange the use of two words to describe risk).

Given this, then, we can view risk in terms of its magnitude (i.e. the amount of impact or damage of an adverse consequence)?

In Practice: Which is Riskier?

To concretize your understanding of risk, evaluate which of the following cash outflows are riskier:

Cashflow 1: Outflow of PHP 10,000,000
Cashflow 2: Outflow of PHP 1,000,000

Is cashflow 1 riskier than cashflow 2 because it is 10 times larger than cashflow 2?

What if we provide more context on the nature of these two cashflows.

Cashflow 1 is the present value of the cash outflow from your food expenditures over your lifetime.

Cashflow 2 is the amount of money you will lose today from theft or fraud.

PHP 10 million **PHP 1 million**

Given this context, it is clear that cashflow 2 is riskier than cashflow 1. Why?

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B. Risk as Uncertainty

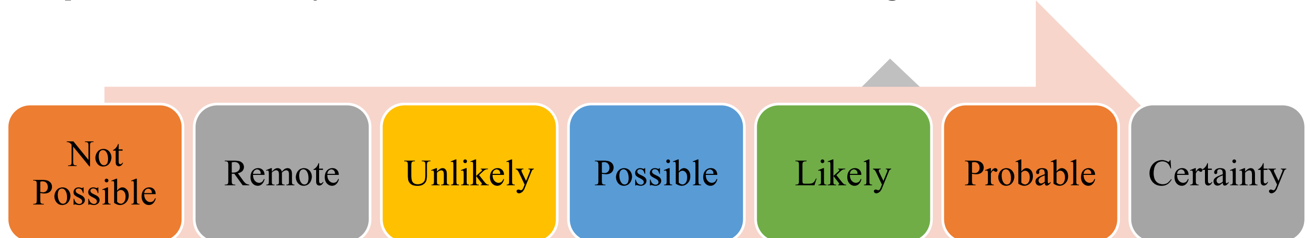
Risk is uncertainty. Uncertainty is defined as the "state, even partial, of deficiency information related to, understanding or knowledge of an event, its consequence or likelihood".

This uncertainty exists in two dimensions:
1. Likelihood that the adverse event will happen
2. Consequence or impact of the adverse event

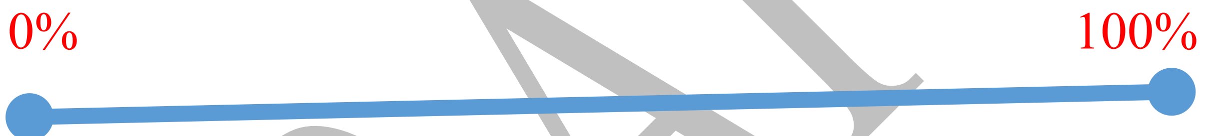
1. Likelihood

Likelihood refers to the "*chance of something happening*". The higher the likelihood that the adverse event will happen, the higher the level of risk is. The lower the likelihood the adverse event will happen, the lower the level of risk is.

Likelihood can be described qualitatively which could range from not possible to likely to probable to certainty. Below is the continuum of the different range of likelihood.



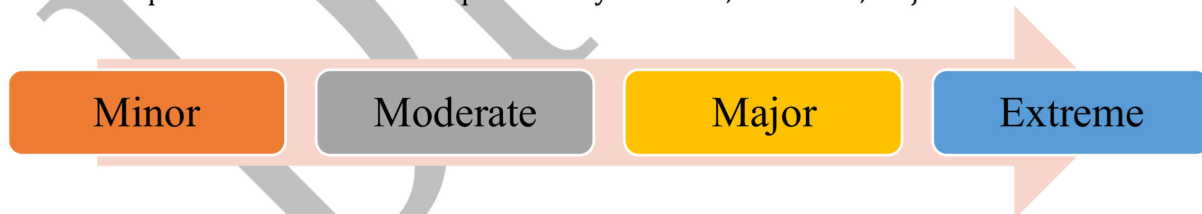
Likelihood can also be described quantitatively. This is referred to as probability. Probability of risk ranges from 0% to 100%. 0% indicates an event that is not likely to happen. 100% indicates an event that is virtually certain to happen. The higher the probability is, the higher the level of risk.



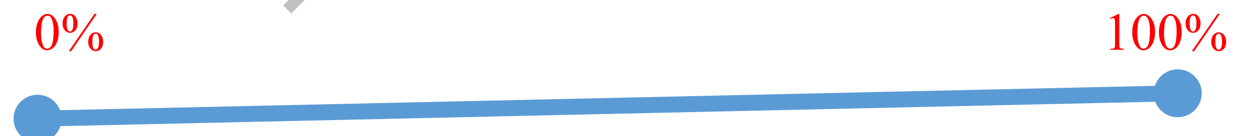
2. Consequence

Consequence refers to the "*outcome of a risk event*". While the focus of most is on negative consequence of a risk event, the consequence could either be positive or negative.

Consequence can be described qualitatively as minor, moderate, major or extreme.



Consequence can also be described quantitatively with losses ranging from 0% (no loss) to 100% (full loss). Consequence is also referred to as severity of the risk event.



Risk = Consequence x Likelihood

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These two factors, when considered in tandem, provide a helpful and holistic view of risk. Risk is consequence multiplied by likelihood.

If either the consequence or the likelihood is zero (i.e. no likelihood of occurrence or no impact), then risk is zero.

In determining which risk to prioritize, both factors must be considered. A risk matrix is a table combining likelihood and consequence to summarize the overall level of risk.

Risk = Consequence x Likelihood

			Consequence		
			Low	Medium	High
	Likelihood	Low	Low	Low to Medium	Medium to High
		Medium	Low to Medium	Medium	Medium to High
		High	Medium to High	Medium to High	High

In Practice: Understanding the Concept of Uncertainty

To understand the dimensions of uncertainty, it would be helpful to apply this concept in practice.

Suppose an investor invested in a fixed income security. The fixed income security promises repayment of both interest and principal.

Interest represents compensation for the time value of money and for credit risk the investor is taking on the borrower or issuer of the fixed income security.

Credit risk is the risk that the borrower will not be able to repay the obligations as they come due. An investor in a fixed income security, therefore, is exposed to the ability and willingness of the borrower to repay its obligations as they come due.

C. Risk as Impact on Objectives

Risk would mean different things in different situations. There is no single, objective and universal application of risk. Risk is usually context-specific. Risk depends on individual or institutional-specific objectives.

1. Individuals

Most market practitioners would conclude that equities are riskier than bonds. However, this is not always the case. For instance, if the security is sold to a young professional, single and with no family, investing in a fixed income security may be a riskier proposition than investing in equity security if the objective is to preserve purchasing power over a 20 to 30-year period.

On the other hand, if the security is sold to a retiree who is investing his retirement money and will likely depend on the retirement money to sustain his cost of living, then equity securities may be too risky given that equities are generally more volatile than bonds. Bonds may be the more appropriate investment alternative considering that they are fixed income securities with a return of principal and certainty of interest income (assuming no default).

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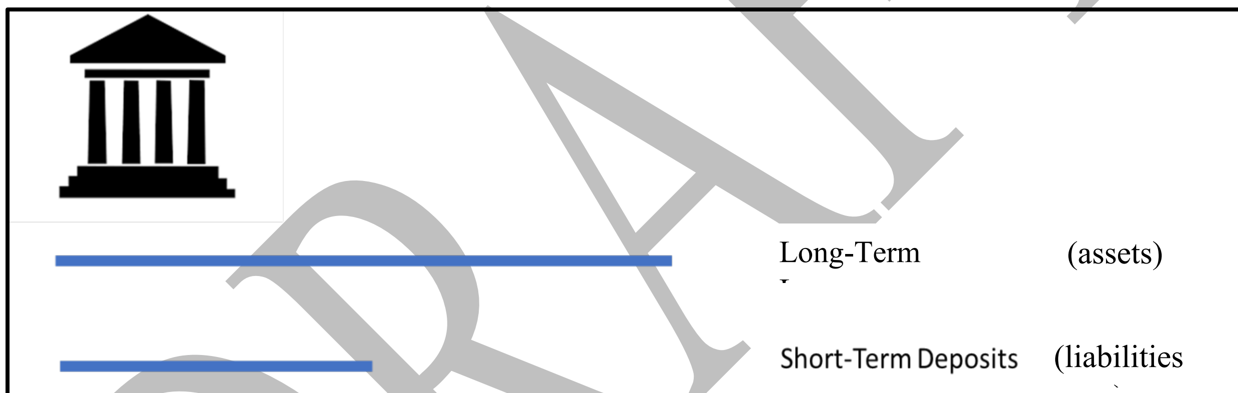
2. Institutions

Investing in equity securities may or may not be a risky proposition for corporations depending on the specific context. For example, a real estate company is in the business of buying, developing and selling properties. Investing in equity securities is not part of the ordinary course of their business unless these equity securities are acquired for a strategic purpose. Real estate companies may need their excess cash to fund their working capital requirements and investing in equity securities endangers their ability to repay their short-term obligations.

Financial institutions (especially qualified institutional investors) that are in the business of buying and selling securities would typically invest in fixed income securities. But which is riskier: short-term securities or longer-term securities? It is easy to conclude that short-term fixed income securities are less risky than long-term securities. However, looking at the unique context and objective of the client will give us a clearer understanding on the risks involved.

For a bank with short-term liabilities (from deposits), investing in shorter-term securities would be a less risky proposition. This is because investing in longer-term security would further widen the gap in the maturity between the bank's source of funds (short-term deposits) with their use of funds (longer-term assets: loans to clients – home loan, corporate loan/ business loan). This is known as maturity mismatch.



On the other hand, for insurance companies, the situation is different. The source of funds of insurance are premiums received from policyholders. The premiums received should be invested upon receipt (also known as insurance floats) with the expectation that at some time in the future if the insurance risk event happens, the value of the investment should be sufficient to cover the payouts under the insurance contract.

Investing in a short-term fixed income security may be riskier than investing in a long-term fixed income security. This is because as the investments mature earlier than the liability, the proceeds will have to be reinvested in new short-term securities. However, this new short-term securities may offer yields, which are less than the yield offered by the long-term security that was previously offered. This is also known as reinvestment risk.

[228]

The illustrations above show that the investors' profile and objectives determine whether the investments are risky or not. While it is generally true that short-term securities are less risky than long-term securities, in some instances, they would be a riskier proposition.

3. Three Levels of Risk

There are three levels of risk[229] that organizations face. These are:

Known risks are risks that an organization are aware of and can identify and plan for.

An example of known risk is the possibility of employee fraud within the business organization. Given the prevalence of fraud and the negative consequences associated with it, there is a compelling argument that organisations should invest time and resources towards tackling fraud. Prevention and detection techniques include the introduction of policies, procedures and controls, and activities such as training and fraud awareness to stop fraud from occurring, use

[228] Source of illustration: http://samuelsejjaaka.com/2020/03/24/blog/on-the-economic-mentality-of-the-fisherman-covid-19-and-scenario-planning-part-ii
[229] PricewaterhouseCoopers (PwC), in a document published in January 2012 entitled: "Black Swans Turn Grey"

of analytical and other procedures to highlight anomalies, and the introduction of reporting mechanisms that provide for communication of suspected fraudulent acts.

Developing risks are risks that an organization are aware of but the full extent and implications are not completely clear.[230]

Technological innovations come with inherent risks. There's no question that in recent years, financial markets have become more reliant on technology. They are more interconnected, and more interdependent. Banks now depend on a complex ecosystem of infrastructure – from cloud services, exchanges and platforms to valuation and data providers, and retail payment systems. All of this is now critical infrastructure but much of it is outside the banks' own control and beyond the regulator's scrutiny. As it is more integrated, this ecosystem creates more 'weak spots' for cyberattacks.

Black swan risks are risks that are unforeseen and hard to predict or avoid. It is a popular term in risk management to describe low probability but significantly high impact risk events that could threaten the ability of the organization to continue or operate as a going concern. It is used to describe events that are almost impossible to happen (low likelihood) but when it happens, it can cause severe damage (high impact).

Examples of black swan events are once in a lifetime crises like the 2008 global financial crisis and 1997/1998 Asian financial crisis.

The interval upon which black swan events occur are unpredictable. While we earlier mentioned that black swan events are rare in recent years, we are seeing black swan events occurring with surprisingly higher frequency (for example, market failures, negative interest rates, sovereign defaults, political instability, etc.)

In Practice: The Concept of Black Swan in Risk Management

In the old times there is a popular belief that *all swans are white.* This is a centuries-old belief. Black swan, therefore, is a statement of impossibility. In 1697, Dutch explorers found black swans in Western Australia. The implication is one observation could falsify centuries-old belief or certainty. Nassim Taleb published a bestselling book (must read for those interested in risk management) entitled Black Swan where he enumerated the essential characteristics of black swans: high-impact, hard to predict but rare events; difficult to quantify probability and psychological biases of people as the role of uncertainty.

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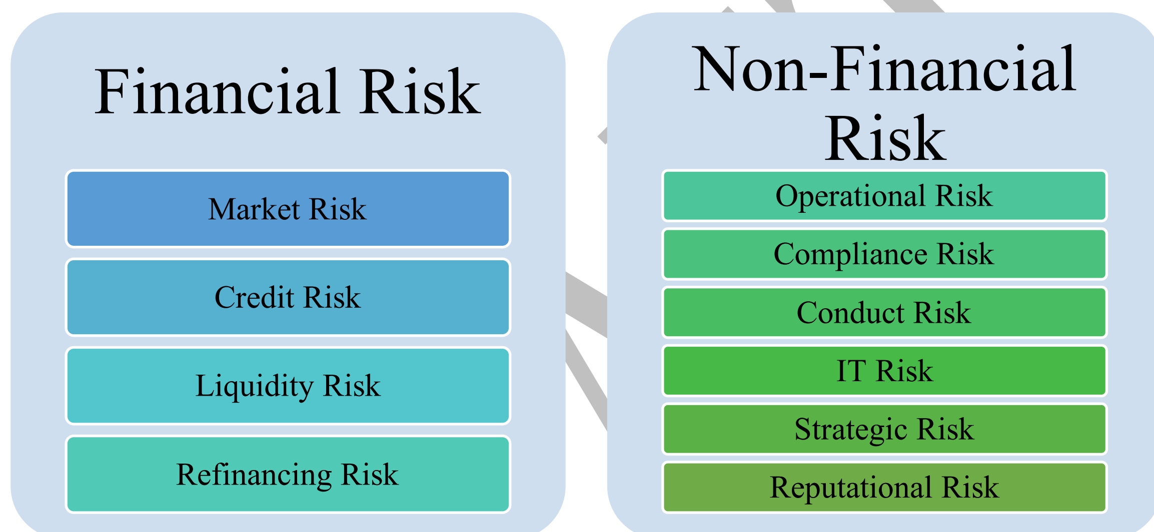
[230] Source: KPMG Emerging Risk and Evolving Responses

Sample Question
1. Black swan risks are risks that are: A. High probability, low impact B. Low probability, low impact C. High probability, high impact D. Low probability, high impact Answer: D

Part II. Typology of Risks

Risk can be broadly categorized into two different types: financial risk and non-financial risk.



A. Financial Risks

Financial risks are risks that are associated with financing and investments. These risks are associated with transactions that have a direct financial impact.

Examples of financial risks are:
1. Market risk
2. Credit risk
3. Liquidity risk
4. Refinancing risk

To understand the nature and sources of financial risks, it will be helpful to look at the balance sheet of a typical company.

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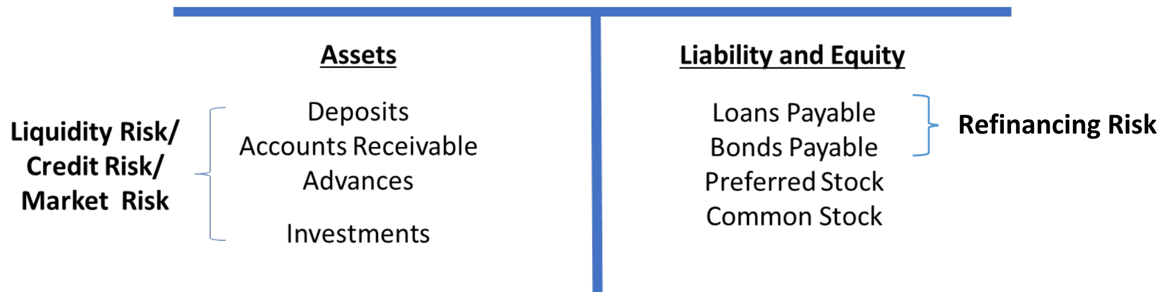

Financial risk arises from both sides of the balance sheet. On the left hand side of the balance sheet are the company's assets (cash, accounts receivables, properties, equipment and investments). On the right hand side of the balance sheet are the company's sources of funds:

a. Funds that come from sources with contractual obligations to repay (Liabilities: accounts payable, loans payable, bonds payable); and
b. Funds that come from owners or sources with discretionary payments (Equity: common stock).

1. Market Risk

Market risk is the risk that the investment will not be as profitable as the investor expected because of fluctuations in the market. It involves the risk that prices or rates will significantly change due to economic forces.

Market risk can be categorized into: interest rate risk, foreign exchange risk, equity price risk and commodity price risk.

JG Summit Reports PHP 694-million loss for 2008 JG Summit, the investment holding firm of the family of tycoon John Gokongwei, incurred a net loss of PHP 694 million last year, a reversal of the PHP 8.61 billion net profit reported in 2007. The mark-to-market losses were brought about by the combined effects of the following factors: lower market value of its financial assets and fuel hedges volatility of global financial and commodity markets, and the lower value of the peso. Source: Philippine Star, 17 April 2009

a. Interest Rate Risk

Interest rate risk is the exposure of a company's earnings and financial condition to fluctuation or adverse movements in interest rates.

How does this affect companies or individuals? Companies and individuals borrow regularly from banks or financial institutions or via the capital markets. As interest rates increase, their respective cost of borrowing also increases. This is also known as cash flow interest rate risk.

How does this affect investors? Investors invest in securities that carry a fixed interest. For example, if bonds are purchased and market interest rates subsequently rise, the price of bonds that carry fixed interest rate will decline to entice future buyers of the bond as the

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fixed interest carried by the bond is now lower compared to market interest rates. This is also known as fair value interest rate risk.

b. Foreign Exchange Risk

Foreign exchange risk is the exposure of a company's earnings and financial condition to movements in exchange rate.

In this age of globalization, even a domestically oriented company (or investor) could be exposed to exchange rate risk directly or indirectly.

A company could have foreign currency denominated sales (e.g., to international customers) or foreign currency denominated payables (e.g., from importation of raw materials). These are also known as transactional foreign exchange risk exposure.

A company with ownership of overseas subsidiaries also faces revaluation risk from changes in the reported domestic accounting results of foreign operations due to changes in foreign exchange rates.

In Practice
Falling Peso Hits Debt Laden Philippine Companies

The Philippine Peso is among Asia's worst performers in 2018. San Miguel Corp, SM Investments Corp and Ayala Corp are some of the leading groups with dollar-denominated obligations who need to refinance or repay in the next five years. The most at risk from the peso slump are construction and transportation companies, whose revenues are in Peso but they make large investments in dollars.

Source: Gulf News, 31 October 2018

c. Equity Price Risk

Equity price risk is the exposure of a company's earnings and financial conditions to adverse movements in equity prices. It is the risk that arises from security price volatility.

d. Commodity Price Risk

Commodity price risk is the exposure of a company's earnings and financial condition to fluctuations in commodity prices.

Commodity price risk exposure usually arises from commodity price-linked revenues (e.g., oil sold by oil companies) or commodity price-linked expenses (e.g., oil purchased by energy producer/generation companies).

2. Credit Risk

Credit risk is the risk that the borrower will fail to meet its obligations as they come due. This is largely dependent on the ability and willingness of the borrower to pay their obligations as they come due.

Credit risk can also be viewed as the potential loss to investors due to the inability of the issuer of a security to repay all or part of its interest or principal due. The greater the credit risk on an

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investment, the higher the yield investors demand to compensate for it. For example, when a corporate bond has its credit rating lowered the tendency is that the bond's price will also decline and a higher yield or return will be demanded by the investors. This is due to the investors' perception that such investment is riskier than those corporate bonds with higher credit ratings.

Credit risk can be understood in two main dimensions:

a. **Probability of default**. Probability of default is the likelihood that the borrower will not be able to repay their obligations as it comes due. It is dependent on the characteristics of the borrower or counterparty. The higher the probability of default, the higher the credit risk of the borrower.
b. **Loss given default**. Loss given default is the amount of loss that will be incurred if the borrower defaults. It can be measured as 100% minus the recovery rate, which is the amount that a creditor can claim from the borrower or counterparty in the event of default.

Hanjin Default Threatens Banks' Credit Ratings

Credit ratings of five Philippine banks are in danger after they were exposed to the biggest default in Philippine corporate history as it could mean higher credit costs and reduction in profit according to Moody's.

Source: Philippine Star, 15 January 2019

Under the Risk Based Capital Adequacy (RBCA) Rules of the SEC,[231] Credit Risk requirements include requirements for Counterparty Risk, Settlement Risk and Large Exposure Risk.

- **Counterparty Risk** is the risk of a counterparty defaulting on its obligation to a broker dealer. As defined in the RBCA Rules, a counterparty means any person or entity with or for whom a Broker Dealer carries on, or intends to carry on, any dealings in securities or another asset which could be either another executing Broker Dealer or a client.

- **Settlement Risk** is the risk that one or more parties will fail to deliver a security or its value in cash as per agreement or at settlement date. In principle, settlement risk is simply the chance that a buyer or seller fails to keep their end of a deal. On the other hand, Pre-settlement Risk is the possibility that one party in a contract will fail to meet its obligations under the contract, resulting in default before the settlement date.

- **Large Exposure Risk** is a risk to which a Broker Dealer is exposed whether by way of: (a) a proportionally large amount of exposure to particular counterparty; (b) a proportionally large exposure to a single issuer of debt; or (c) a proportionally large exposure to a single equity security or single issuer group.

3. Liquidity Risk/Refinancing Risk

Liquidity risk is the risk arising from the inability of the company to pay its obligation as they come due. Liquidity describes the ability of the company to convert its assets to cash to meet short-term obligations.

[231] SEC Memorandum Circular No. 16, Series of 2004

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In case of cash requirements to fund day-to-day working capital requirements, the company may sell its assets to generate more cash. Certain assets may be easily convertible to cash (for example, short-term investments). Some assets, however, are not easily convertible to cash (for example, long-term properties).

Liquidity risk arises from two factors:

a. Inability to sell or liquidate assets to meet obligations
b. Inability to obtain adequate funding through new borrowings

An alternative to selling or liquidating assets for cash is to replace existing funding to repay existing maturing obligations. Refinancing risk is the inability of the company to replace existing funding to repay existing maturing obligations.

For example, if a loans payable is due to be repaid, to continue to exist as a going concern either of the following should happen:

a. The company should refinance the maturing obligation; or
b. The company could sell assets to finance the repayment of the maturing obligation. This case shows the interaction between the liability side of the balance sheet and the asset side of the balance sheet. The company could mitigate the refinancing risk by drawing on the liquidity of its assets (i.e. liquidity risk).

Hanjin Philippines Shipbuilding Bankruptcy

Hanjin Philippines - the biggest investor in the Subic Bay Freeport Zone filed for bankruptcy on 8 Jan 2019. The company has become financially distressed due to its heavy debt. With revenues falling behind, it cannot support its operations anymore under the burden of heavy debt.

Source: Philippine Star, 16 January 2019

B. Non-Financial Risks

Non-financial risks are risks that do not have a direct financial impact.

Examples of non-financial risks are:
1. Operational risk
2. Legal and Compliance risk
3. Strategic risk
4. Reputational risk

Non-financial risks do not usually get the necessary attention as much as financial risks do. This could be because non-financial risks are harder to quantify than financial risks. They are seen as "soft" risks with no direct financial consequences. However, in some cases, non-financial risks can even have a greater impact than financial risks.

1. Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

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a. Causes of operational risk

1) **People risk** is the risk that people do not follow the organization's procedures, practices and/or rules. It is the risk that people deviate from expected behaviors.

   There are two types of people risks:
   a) **Non-deliberate deviations**: these are deviations from expected behaviors or set of rules that are not intended (e.g., operational losses from human errors)
   b) **Deliberate deviations**: these are deviations from expected behaviors or set of rules intended to result in personal or financial gain (e.g., fraud committed by employees)

> **PHP 900 Million Fraud Rocks One of the Largest Banks**
>
> The bank has been hit by internal fraud that a senior official perpetrated causing it to lose at least PHP 900 million. The senior official funnelled disbursed loans into fictitious accounts created in the name of a legitimate client. The funds in the fake account, controlled by the rogue officer, were then siphoned off electronically to other accounts in other financial institutions and into the pockets of the suspect.

2) **Process risk** is the risk arising from a faulty overall design and application of business processes.

   There are three types of process risks:
   a) ***Model risk***. This is the risk of incurring consequences, including financial losses, as a result of making decisions based on models that are incorrect or misused. Model risk happens due to fundamental errors that result in inaccurate output or due to incorrect and inappropriate application due to misunderstanding on limitations and assumptions (e.g., unrealistic revenue forecast).
   b) ***Transaction risk***. This is the risk that occurs due to failure in execution of transactions.
   c) ***Operational control risk***. This risk arises from the failure of established controls to work as intended.

   Examples: inadequate segregation of duties, absence of internal controls, erroneous legal documentation

3) **Systems risk** is the risk of failure arising from deficiencies in a company's infrastructure and information technology systems. Risks associated with information technology systems are identified with deficiency or inadequacy in software quality, IT security, interruption of day-to-day operations and outsourcing.

   Examples: IT system breakdown resulting in losses for the institution, power outage, data breaches due to poor security parameters that are prone to cyberattacks and hacking

4) **External events risk** is the risk associated with events outside the company's control.

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Examples: natural calamities or disasters, wars, terrorism, global pandemic, climate change

Toyota Halts Production in Japan After Deadly Quake

Toyota Motor Corp. is stopping most of its auto production in Japan as a result of a deadly earthquake in northern Japan.

Due to the interruption in its supply chain there, Japan's largest automaker will idle factories beginning Saturday, the company said.

Toyota will halt planned production at its Kyushu, Tahara and Toyota Auto Body plants. Those factories make Lexus vehicles and the Toyota Land Cruiser, among others, some of which are bound for the U.S. markets.

Spokeswoman Akiko Kita said, starting on Monday, the shutdown will affect all Toyota and Lexus lines in Japan, except for two Daihatsu plants that also manufacture Toyota-brand vehicles.

Toyota has 18 plants that produce vehicles in Japan.

Source: Automotive News, September 07, 2018

b. Operational Risk Events

Operational risk can also be classified according to events.

Risk Events	Description	Examples
Internal Fraud	Internal fraud is an operational risk event that arises due to acts intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity/ discrimination events, which involves at least one internal party.	• Unauthorized activity • Theft or fraud
External Fraud	External fraud is an operational risk event that arises due to acts intended to defraud, misappropriate property or circumvent the law, which involves a third party	• Theft and fraud • Systems security • data breach
Employment Practices and Worker Safety	Operational risk events that arise from human resource related policies, such as employment practices and workplace safety.	• These arises from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/ discrimination events.

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Risk Events	Description	Examples
Clients, Products and Business Practices	These arise from intentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature or design of a product	• Suitability, disclosure or fiduciary • Defects in the nature or design of a product
Damage to physical assets	These arise from loss or damage to physical assets due to natural disasters or other events.	• Natural disaster losses • Property losses from external sources, i.e, war, riot, terrorism, etc.
Business disruption and system failures	These arise from the disruption of business or system failures	• Hardware, software, telecommunication and utility outages or disruptions • data breaches due to poor security parameters, cyberattacks and hacking
Execution, delivery and process management	These arise from failures in transaction processing, process management and relations with trade counterparties and vendors	• Transaction capture, execution and maintenance • Monitoring and reporting • Customer intake and documentation • Customer/client account management • Trade counterparties • Vendors and supplies

2. Legal and Compliance Risk

Legal risk is the possibility that lawsuits, adverse judgments or faulty contracts can disrupt or adversely affect the operations or conditions of the organization. It can also refer to the exposure to fines, penalties or punitive damages resulting from the supervisory actions as well as private settlements.

Compliance risk is the risk of legal or regulatory sanctions, material financial loss, or loss to reputation that an organization may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organizational standards, code of conduct applicable to its activities and internet policies.

Philippine Regulatory Agency penalized Ride-hailing Companies

A Philippine Regulatory Agency penalized millions of pesos on two (2) ride-hailing companies for violating the Agency's order to keep operations separate until the merger of both was approved.

3. Strategic Risk

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Strategic risk is the risk of loss in earnings, capital or reputation arising from changes in the business environment, adverse strategic decisions, and improper implementation of decisions or lack of responsiveness to an industry, political, economic or technological changes.

Strategic risk arises from failure to properly formulate or implement strategies leading to significant damage to an organization's financial position, reputation, competitiveness or business development prospects.

Risks of Business Obsolescence

From the late 1990s to the early 2000s, Nokia was the world's leading supplier of mobile phones that used GSM (Global System for Mobile Communications) or digital technology, which was superior to the cumbersome analog system. So profitable were Nokia's operations then that in 2000 it accounted for 4 percent of the gross domestic product of Finland (its home base), 70 percent of Helsinki's stock exchange market capital and 14 percent of corporate tax revenues.

Sadly, Finland's multinational pride has joined the ranks of technology companies that once held sway in their business fields but failed to maintain that position because the competition came up with better products or innovative substitutes. The decline of once dominant tech companies may be attributed primarily to their failure to foresee the preferences and tastes of their target market.

While they were probably enjoying the perks and privileges of being on top of their game, their competitors (or disruptors as they are now called) quietly engaged in R&D activities that made their products obsolete or less useful. To paraphrase a popular business adage, the competition was able to produce a better mouse trap. By the time these companies woke up and saw their inventory piling up unsold, newbies had made substantial inroads in their market. The oldies' catch-up efforts were either too late or too little. It's textbook management lesson that business cannot stand still. It has to be on its toes to maintain or expand its market share and keep the competition at bay with new or better products and services.

Source: Inquirer.Net, February 4, 2020

4. Reputational Risk

Reputational risk is the risk that may arise from negative publicity regarding an institution's business practices. Whether true or not, such reputational risk can cause a reduction in customer base, costly litigations or revenue decline. In fact, a global survey conducted by Deloitte in 2013 on more than 300 companies around the world concluded that reputational risk is the biggest concern by respondents.

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Part III: Definition and Objectives of Risk Management

Risk Management is crucial to an effective corporate governance process and the achievement of a company's value creation objectives. Thus, it is very important that every company has sound and effective risk management policies and procedures in place. To be effective, the concern and tone for risk management must start at the top. While the overall responsibility of risk management rests primarily with the Board of Directors, it is the responsibility of senior management to assist the Board in ensuring that the risk management procedures are implemented and maintained in accordance with the policies set by the Board. Also, senior management has to ensure that these policies are embedded in the culture of the organization. Moreover, to keep these policies in line with significant changes in the internal and external environment, the Board should review these policies regularly and make appropriate changes as necessary.

Further, to effectively manage risks, companies may establish Board Risk Oversight Committees (BROC) to assist the Board in its oversight function and appoint a Chief Risk Officer (CRO). The CRO shall be responsible for spearheading the entire risk management process and communicating the top risks and the status of implementation of risk management strategies and action plans to the BROC.

With an integrated approach, the Board and top management will be in a confident position to make well-informed decisions, having taken into consideration risks related to significant business activities, plans and opportunities.

Definition of Risk Management

Risk management is defined by ISO 31000 as:
"*Coordinated activities to direct and control an organization with regard to risk*"

A. Coordinated

Risk management is too important to be left to one person, one unit or even one department. Risk management is everyone's responsibility. As one saying goes: "*everyone in an organization is a risk manager"*.

This is why a popular approach to ensure that this concept is implemented is to institute a three lines of defense model. This model aims to remind everyone that each department or unit has a role to play in risk management.

Three Lines of Defense Model		
First Line: Business Lines/ Operation	Second Line: Risk Management and Compliance	Third Line: Internal Audit

The first line of defense is the business unit. It has the primary ownership, responsibility and accountability of risk. They originate risk for the organization and are therefore, in the best position to manage risk.

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The second line of defense is risk management and compliance. They are expected to exercise oversight and control on the first line of defense. They are also responsible for developing and implementing the risk management framework.

The third line of defense is internal audit, which reviews the effectiveness of internal control and risk management practices of both the first and second line of defense.

B. Activities

Risk management can be viewed as a set of activities that includes:

1. Communication and consultation
2. Establishing the context
3. Identifying risk
4. Analyzing risk
5. Evaluating risk
6. Treating risk
7. Monitoring and reviewing risk

These activities are discussed in more detail in the next section.

C. Direct and Control

Contrary to popular belief, the objective of risk management is not to avoid risk. Instead, the objective of risk management is to direct and control risk. Risk management aims to make risks more manageable and acceptable in line with the capacity of the individual or the organization.

An important matter here has to be cleared: risk management is not risk elimination. It involves transforming risk into a form that can be accepted by management.

In Practice: Risk Mitigation/ Transformation Not Elimination

In buying insurance (for example, life insurance), the policyholder does not eliminate risk. Instead, mortality risk is mitigated by ensuring some payout will be made to a policyholder's beneficiaries if the policyholder dies. This, however, transforms the policyholder's risk from mortality risk into credit risk (i.e. ability of the insurance company to fulfil its obligation if the insurable event risk happens).

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Objectives of Risk Management

1. Increase the likelihood of achieving business objectives

Risk introduces uncertainty to the attainment of business objectives. Risk management aims to increase the likelihood of the organization reaching its business objectives by designing and executing strategies that will manage risks.

Risk management provides the framework and structure that will allow the organization to mitigate or transform the impact of those risks.

2. Encourage proactive management of risks

Establishing a formal and structured risk management framework and process encourages proactive management of risk. The absence of a formal risk management framework puts risk at the lowest level of priority (i.e. managing risk in a passive and reactive manner). The lack of formal process to manage risk makes the organization vulnerable to unwanted risk exposure and weakens the ability of the organization to respond to risks.

3. Compliance with laws and regulations

While not the primary concern of risk management, having a strong risk culture and a strong risk management process and framework increases the chance of compliance with relevant rules and regulations.

Failure to comply with laws and regulations is an important risk exposure that would ordinarily be captured in the organization's risk management practices. Thus, having a strong risk management framework and process reduces the likelihood or instances of violation of laws and regulations.

4. Efficient allocation of resources

Many risk events are associated with an organization's obsessive focus on attaining short-term objectives (for example, short-term profitability) at the expense of long-term objectives.

As an example, traders in an organization are compensated based on short-term performance results may take undue risk that would be against the long-term interest of the organization and its clients in exchange for short-term rewards (e.g., bonuses or commissions).

Risk management will help the organization align the short-term interest of each of its individual performer with its long-term objectives.

A way to do this is to embed risk management considerations in performance measurements. How an organization rewards or allocates capital says a lot about the values of the organization more than the official value statement or organizational credo.

5. Enhance competitive advantage

Risk management is increasingly being seen as a source of significant competitive advantage. History has shown that organizations that withstood unforeseen crises are organizations with strong and sound risk management.

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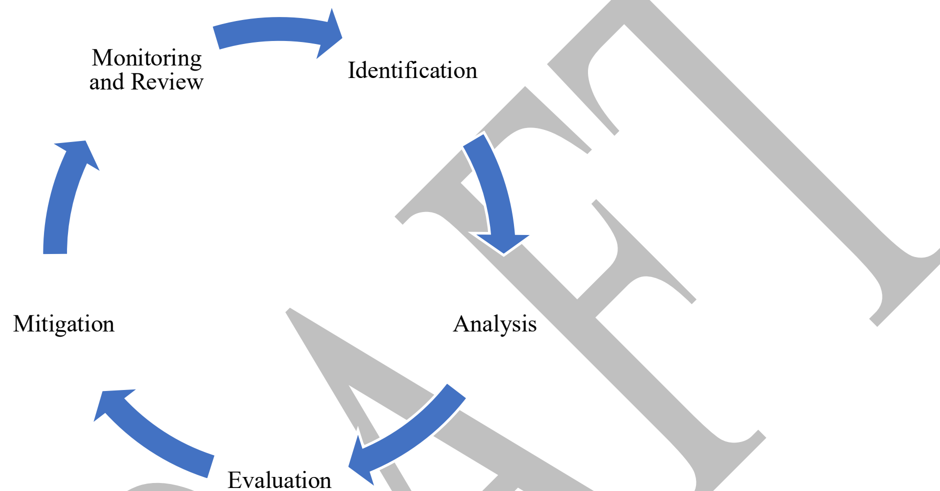
On the other hand, organizations which view risk management as a cost center and merely comply with the minimum requirements have been proven to be vulnerable in times of crisis.

Part IV: Risk Management Process

This section discusses the different activities in risk management which a capital markets professional can use in thinking about risks. The risk management process is a structured process of identifying, analyzing, evaluating, mitigating and monitoring risk. As shown in the illustration below, this process is iterative and not linear.



A. Risk Identification

Risk identification is the process of finding, recognizing and describing risks. It involves the identification of sources of risks, events and causes of risks and the consequences of risk.

	Definition	Example
Risk source	Risk source is an element which alone or in combination has the intrinsic potential to give rise to risk	For credit risk, the risk source would be loans and advances to customers and other subsidiaries.
Risk event and cause	Risk event is an occurrence or change of a particular set of circumstances. The event can be one or more occurrences, and can have several causes.	Some examples of risk events are: Bankruptcy Failure to pay Debt restructuring Repudiation/ moratorium Obligation acceleration
Consequences	Risk consequence is the outcome of an event affecting objectives. The event can lead to a range of consequences, which can be certain or uncertain and can	Credit risk could have consequence or not. It could be possible that a credit risk event happens but there will be no consequence (for example, the value of the collateral is sufficient to cover the credit risk exposure).

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	Definition	Example
	have positive or negative impact on the objectives.	An event with no consequence can also be referred to as a 'near miss', 'incident', 'near hit' or 'close call'

B. Risk Analysis

Risk analysis is the process of understanding the nature of risk and determining the level of the risk. Risk analysis involves the consideration of:

1. Causes and sources of risk
2. Positive and negative consequences of risk
3. Likelihood that the risk event happens
4. Factors that can affect the consequences and likelihood

When quantifying risk, three factors are typically analyzed and quantified in detail:

1. **Likelihood**. This is the chance that the risk event happens. For example, in credit risk, an assessment is made on the probability of default. The probability of default is the likelihood that the borrower will fail to fulfill its obligations as it comes due. This depends on the credit risk characteristics of the borrower.

2. **Consequence**. This is the potential gain or loss if the risk event happens. For example, in credit risk, an assessment is made on the loss given default. Loss given default is the amount of loss that the borrower will incur net of the recoveries from underlying collateral. This factor is instrument specific and depends on the availability of mitigants such as collateral.

3. **Exposure**. This is the total amount of potential loss or gain at the time the risk event occurs disregarding potential recoveries from collateral or other securities. Certain exposures are easier to quantify than others. For example, credit risk exposures from loans and advances can be determined as the amount of principal and accrued interest on the date of default. However, some exposures are harder to quantify. For example, exposures from losses from catastrophe are hard to quantify.

In Practice: Scenario Analysis

There are two types of analysis on future risks and uncertainties:

- Ex-post analysis

Ex-post is a Latin word for "after the fact". Ex-post analysis of risk involves collection of data on historical losses (e.g., operational loss events). One key advantage of ex-post analysis is that it provides important insight on what went wrong in the past. The intention of this analysis is to learn from past mistakes to avoid repeating them. One common error in making this type of analysis is that it is improperly extrapolating lessons from the past to future events. In a dynamically changing risk environment, this limits the ability to think about future risks that may not necessarily have occurred in the past (for example, once-in-a generation financial crisis).

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- Ex-ante analysis

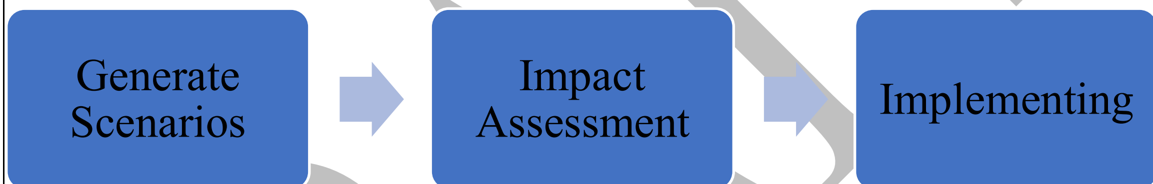
Ex-ante is a Latin phrase that means "before the event". Ex-ante analysis involves the use of flexible methodologies to think about hypothetical events. Scenario analysis is an ex-ante approach to analyzing risk and gives flexibility to think about risks in a world of uncertainties.

A scenario analysis is an underrated but powerful tool for risk management. Royal Dutch Shell, a global company with centuries of experience in navigating complex economic and political environments, is known to have pioneered the use of scenario analysis not only in risk management but also in business and strategic planning.

Scenario is simply defined as: "a story that describes a possible future. It identifies some significant events, the main actors and their motivations and it conveys how the world functions".

A scenario analysis involves identification of key risks on the organization's business and adopts a forward looking view on these risks.

Scenario analysis involves the following process:



Generating Scenarios
In generating scenarios, there are generally three approaches:
- Bottom-up
- Top-down
- Consensus workshop

Bottom-up approach involves each department coming up with its own scenarios through comprehensive and detailed analysis of risk losses. The main issue with this approach is whether each individual department would have a complete and full picture of the risk that the entire organization is facing. Further, quality of scenarios generated may be compromised as different departments could have different understanding and perception of risks. Certain risks may not be covered by a bottom-up approach simply because each department would not have a full integrated appreciation of risks.

Top-down approach involves the generation of key scenarios from senior management. The main downside of this approach is that the scenario analysis may not cover risks that senior management may be unaware of.

To overcome the limitations of a purely bottom-up and top-down approach is the consensus workshop approach. The workshop approach intends to generate wide levels of participation and agreement among different stakeholders. Stakeholders are represented in these discussions to come up with a consensus view on the scenario analysis program.

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After different stakeholders discuss each scenario, they then go through the process of Impact Assessment to come up with their educated opinions on frequency/likelihood and severity/consequences of such risk events in the scenarios generated. Through this exercise, the stakeholders form a picture of the overall impact of the risks predicted in the scenarios on the entire organization and even to their own line departments. In this process, it is vital to identify the relevant metrics or statistics by which to measure the impact in these predicted risks to ensure that such assessment will have a meaningful effect on the organization.

Armed with the analysis developed from the previous steps, the organization finally embarks on the Implementing phase where plans, protocols or measures to mitigate the impact of the risks are crafted and implemented in case the predicted scenarios come true. Through this exercise, the organization is not caught unprepared in case a predicted scenario finally occurs and will be better prepared to navigate through the crisis.

C. Risk Evaluation

Risk evaluation is the process of comparing the results of risk analysis with predetermined risk criteria to determine whether risk and/or its magnitude are acceptable or tolerable.

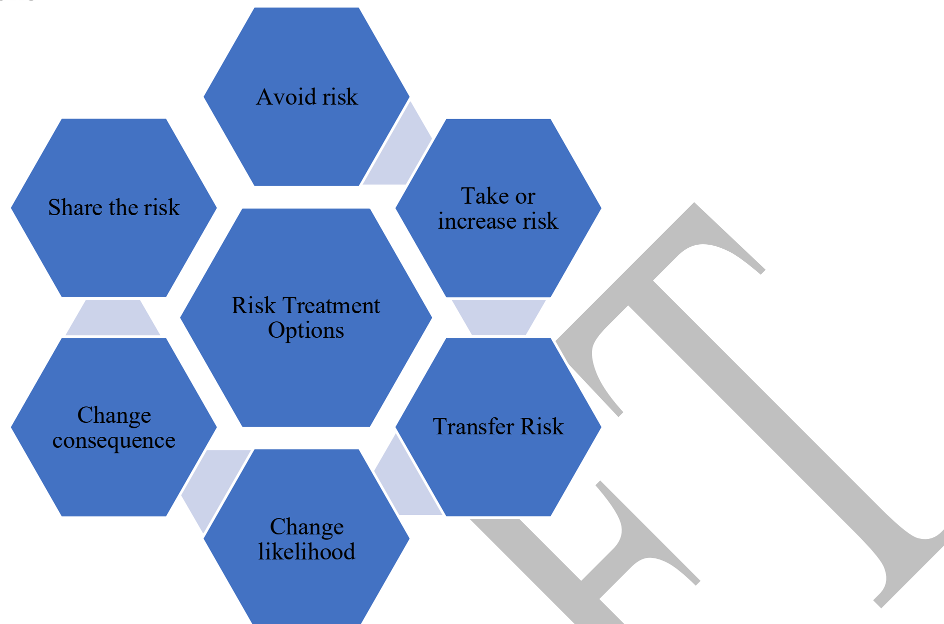
The risk criteria are based on an organization's risk appetite and tolerance. Risk appetite is the aggregate level and types of risk an organization is willing to assume within its risk capacity to achieve its strategic objectives and business plan. It includes qualitative statements as well as quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate. Risk tolerance, on the other hand, refers to the level of risk an organization can bear after the application of risk treatment mitigation strategies.

The purpose of risk evaluation is to assist management in making decisions based on the outcome of the risk analysis. The decisions may be any of the following:

For example, a bank has determined that it can take a default rate of 30% on2 its loan portfolio to be able to continue operations. However, after it implemented the use of credit scoring for new loans, it predicts a lowering of the default rate to 15% of its loan portfolio. It can be concluded that the risk appetite of the bank was originally 30% but after implementing its risk mitigation/treatment strategy of adopting credit scoring, its risk tolerance is now at 15% default rate.

D. Risk Mitigation/Treatment

Risk treatment involves selecting one or more options for modifying risks and implementing those options.



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1. Avoid Risk

One of the risk treatment options is to avoid risk by deciding not to pursue or continue with the activity that generates risk.

Billionaire and Legendary Investor Get Rid of All His Airline Stocks Due to the Global Pandemic

The billionaire business tycoon has sold at a loss his entire portfolio of U.S. airline stocks presumably to avoid further losses and risks directly associated with the aviation industry. This is also presumably because he thinks it will take ages for the aviation industry to return to profitability.

[232]

[232] Source: https://www.bing.com/images/search?view=detailV2&ccid=lSbvReK%2b&id=0634F962B8E87E339DC51297B33CE867DBE84354&thid=OIP.lSbvReK-hoVgWW_ieVULfAHaEo&mediaurl=https%3a%2f%2fwww.pointsnerd.ca%2fwp-content%2fuploads%2f2016%2f06%2fairplane-

Speaking at the company's annual meeting, the business tycoon, said that "the world has changed" for the aviation industry due to the global pandemic. He also revealed that he made the wrong decision in investing billions of dollars in the aviation industry. The coronavirus pandemic has led to airline stocks becoming deeply impacted by the near collapse of the U.S.' aviation industry as countries across the world remain in lockdown. U.S. airlines have cut hundreds of thousands of flights and parked their planes as the demand for US travel falls by around 95%. There is currently no clear timetable for when travel will return to pre-crisis levels. He said the industry was "grappling with what the long-term demand for its services might be in an age in which social distancing will be important and in which business travel, for example, might be different".[233]

2. Take or Increase Risk

Another option is to take or increase risk in order to pursue a business opportunity. This option is only taken if the company is confidence that it has the ability, expertise and willingness to tolerate and manage the residual risk arising from the business opportunity that generates the specific risk.

Jollibee acquires US firm Coffee Bean & Tea Leaf for $350M

MANILA, Philippines – Homegrown fast-food giant Jollibee Foods Corporation (JFC) has bagged its biggest multinational acquisition to date with a US$350-million deal to take over American specialty coffee and tea brand The Coffee Bean & Tea Leaf (CBTL).

The total consideration for this acquisition is $350 million on a debt-free basis but Jollibee's net investment is estimated at $100 million, the company disclosed to the Philippine Stock Exchange on Wednesday.

Its investment of $100 million represents 80 percent of the equity of the holding company that will acquire 100 percent of CBTL. The balance of $250 million will be made as advances to the new holding company.

Shares of JFC – the most actively traded company at the stock market on Wednesday - declined by 7.99 percent on concerns that the CBTL acquisition will constrain its earnings moving forward.
CBTL, which is based in Los Angeles, California, will be consolidated into JFC's financial statements immediately upon acquisition.

CBTL, which is based in Los Angeles, California, will be consolidated into JFC's financial statements immediately upon acquisition.

"The acquisition of The Coffee Bean & Tea Leaf® brand will be JFC's largest and most multinational so far with business presence in 27 countries," Jollibee chairman Tony Tan Caktiong said.

takeoff.jpeg&exph=1200&expw=1920&q=plane+take+off&simid=608023186860344914&ck=D81DFE088BB40A58CEB62F9CE6007DAE&selectedIndex=0&ajaxhist=0

[233] Source: New York (CNN Business), May 3, 2020

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> "This will add 14 percent to its global system-wide sales, 26 percent to its total store network, will bring international business' contribution to 36 percent of worldwide sales and will bring JFC closer to its vision to be one of the top five restaurant companies in the world in terms of market capitalization," said Caktiong.
>
> Source: https://business.inquirer.net/275315/jollibee-acquires-coffee-bean-and-tea-leaf-for-350m#ixzz6PVicYOaL

3. Transfer the Risk

Risk transfer is a strategy that involves the contractual shifting of risk from one party to another. An example of this strategy is the sale of an asset, which is the source of the risk to another entity.

4. Change likelihood

Another approach to treat risk is to reduce the chance or likelihood of a risk event from happening. This can be done through investments in preventive control to keep risk events from occurring.

Examples of Preventive Controls	Impact of Likelihood
Training on policies and procedures[234]	Lower likelihood of a risk event occurring as personnel are more aware of the policies and procedures.
Segregation of duties[235]	Lower likelihood of a risk event occurring due to more effective checks and balances.
Strict access authorizations[236]	Lower likelihood of a risk event occurring as unauthorized access may be less likely to happen.

The purpose of the adoption of the Risk Based Capital Adequacy (RBCA) Rules of the SEC is to protect the firms, investors, and its clients. It establishes minimum regulatory capital requirements for broker dealer in securities. RBCA refers to the requirement to maintain sufficient liquid assets to cover the total risk exposure of the company.[237] It is an approach to treat risk from the likelihood of happening as it ensures that companies have enough capital to cover its exposure to risks and that they are liquid enough to promptly settle obligations to clients.

5. Change Consequence

Change consequence refers to a risk treatment strategy where the consequence of risk is modified. Note that the difference between this and the other risk treatment is that this treatment applies only after the risk occurs (i.e. this does not seek to prevent or lower the chance of risk happening).

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[234] SRC Rule 30.2.7 Internal or Accredited Training Program
[235] SRC Rule 34.11 Segregation of Functions (Chinese Walls)
[236] SRC Rule 34.10 Segregation and Limitation of Functions of Members, Brokers and Dealers
[237] Memorandum Circular No. 16, s. 2004

There are many ways to change consequence such as:

- Changing the amount of loss if a risk event happen (for example, by requiring collateral in a lending transaction).
- Changing the party who will bear the consequence of risk (for example, by requiring guarantee).

Another example is the Securities Investor Protection Fund, Inc. (SIPF) which is comparable to the Philippine Deposit Insurance Corp. The SIPF administer the funds of its members so that it can be used in the event of failure of business or judicial insolvency as a result of fraud.

6. Share the risk

Risk sharing is a risk treatment option where the consequence of risk is distributed among several participants.

For example, instead of embarking on a risky business venture by itself, a company can tie up with other joint venture partners to spread out the risk of loss.

E. Risk Monitoring and Review

Risk monitoring is the process of checking, supervising, critically observing or determining the status of the risk in order to enable change from the required or expected performance level.

Risk review is the process of determining the suitability, adequacy and effectiveness of the risk management process.

Risk management is an iterative process. It is, therefore, important to continually monitor how risks are evolving (or not evolving) and check if the risk management process in place is adequately addressing the change in risk.

Risk reporting is an important part of the risk monitoring and reviewing process. It involves documenting and communicating the results of the organization's risk assessment and treatment measures to both internal and external stakeholders.

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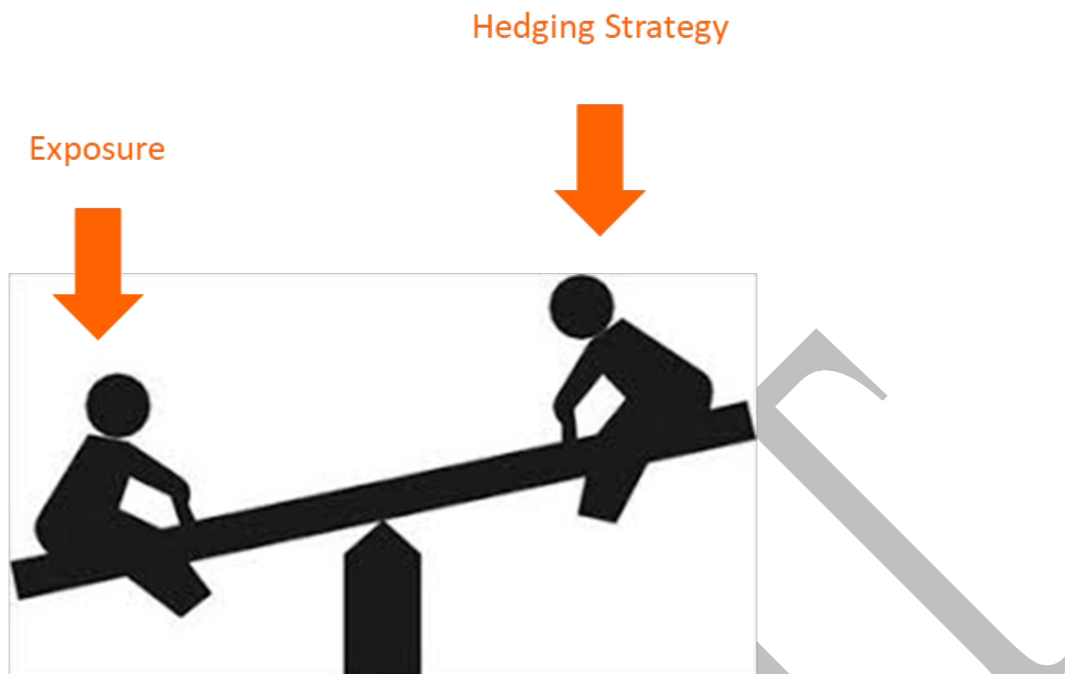
Part V: Hedging - Risk Management in Action

For this chapter, we will follow a simple case of a Philippine company with functional currency in Philippine Pesos who needs to buy foreign currency one year from now. The objective is to see how risk management thinking is applied in action.

A. What is hedging?

The first step in thinking about risk management is to understand the concept of hedging.

Hedging is a risk mitigation technique that involves the use of a strategy to offset or reduce an undesirable risk exposure.



The following are the components of a sound hedging strategy.

1. **Purpose**. The purpose of hedging is risk mitigation not elimination. It involves transformation of risk into something that an organization can withstand or accept.
2. **Elements**. Hedging involves an understanding of the exposure (hedged item) and the underlying hedging strategy (hedging instrument).
3. **Offset**. The most important element of hedging is the principle of offset. For a hedging strategy to be truly effective, it should offset the underlying exposure. Offset involves reduction of undesirable risk exposures.

B. Why hedge?

There are many reasons why a company needs to hedge and these reasons vary from one organization to another. The following are common reasons why a company hedges:

1. Avoid distress

A company typically hedges to avoid missed payments in interest and principal (i.e. manage cash flows). This is the most important reason why a company hedges.

2. Protect investments/ growth

Returns of certain investments are affected by factors that may be outside the company or the investor's control. Hedging would allow the company or the investor to minimize the influence of these uncontrollable factors that may be outside the circle of competence of the hedger.

3. Provide reliability/stability

Companies would prefer the certainty of a desired outcome and disfavor deviations from the same. By employing an appropriate hedging strategy, these deviations can be managed with minimal disruptions to the business operations.

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4. Strategic flexibility/maintain competitiveness

Hedging decisions could affect the company's ability to offer products and alter strategic decisions. Often, the ability to manage risk dictates an entity's competitiveness and confidence to pursue a business decision.

In Practice: McNuggets- A Risk Management Story

There is an interesting story about how risk management allowed McDonalds to offer one of their bestselling product – the McNuggets.

Prior to its full launch, McDonalds is facing difficulty in launching McNuggets as they are concerned about how the volatile price of chicken could affect their profit margins from this product. Chicken futures market at that time does not exist, therefore, there is no way McDonalds could hedge via the financial markets. McDonalds approached several chicken farmers/ producers but they refused as they do not want to lock-in long-term supply contracts with McDonalds in case the price of chicken rises steeply (i.e. cost of producing chicken goes up substantially). Offering McNuggets became a challenging proposition from McDonalds until a brilliant analyst (now a famous hedge fund manager came up with a hedging strategy for producers).

The hedge fund manager found out that the price of a chicken can be decomposed into:
Chick
Corn
Soyabean (main input for chicken feeds)

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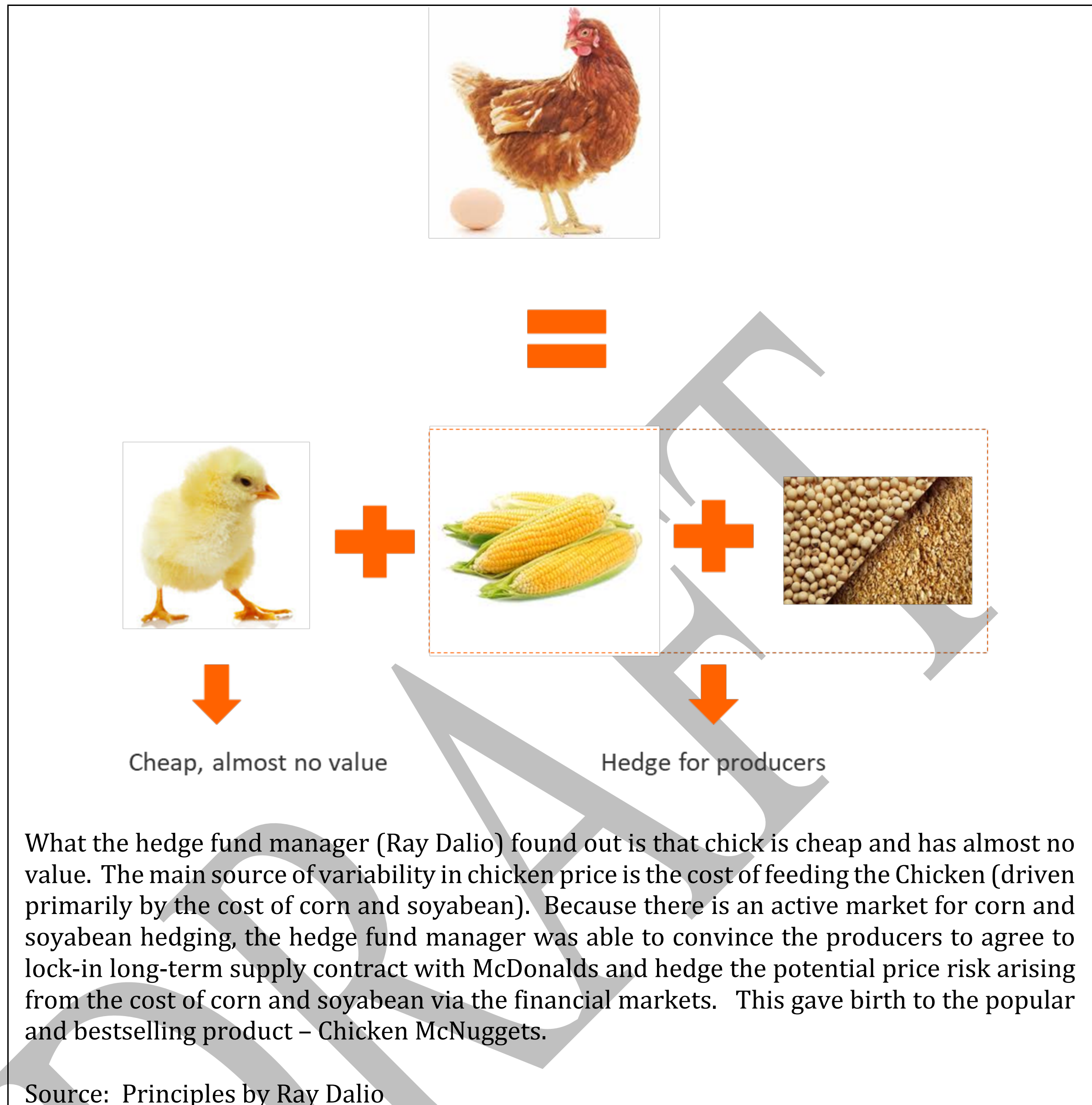

What the hedge fund manager (Ray Dalio) found out is that chick is cheap and has almost no value. The main source of variability in chicken price is the cost of feeding the Chicken (driven primarily by the cost of corn and soyabean). Because there is an active market for corn and soyabean hedging, the hedge fund manager was able to convince the producers to agree to lock-in long-term supply contract with McDonalds and hedge the potential price risk arising from the cost of corn and soyabean via the financial markets. This gave birth to the popular and bestselling product – Chicken McNuggets.

Source: Principles by Ray Dalio

C. What is the exposure?

The exposure can be an existing asset, liability or future cash inflows or outflows that the company would like to protect in terms of fair value or cash flow.

For example, a company's functional currency is in Philippine Pesos. This means that movements in exchange rate (i.e. Philippine pesos against U.S. dollars) could increase or decrease the local currency to be paid for loans denominated in U.S. dollars.

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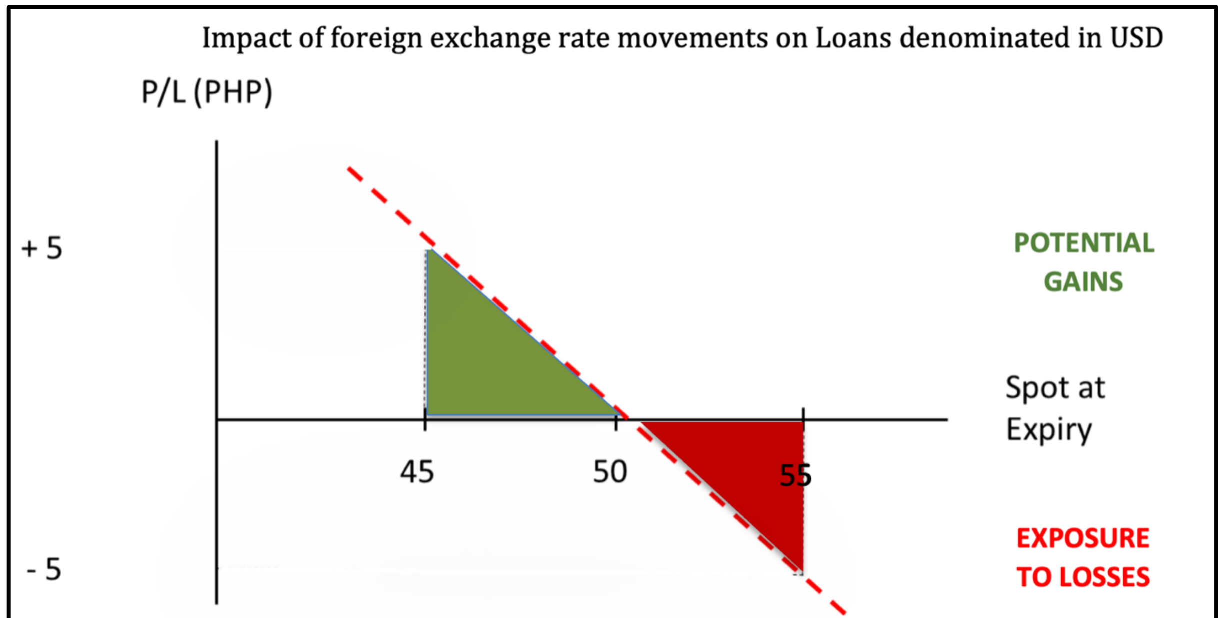
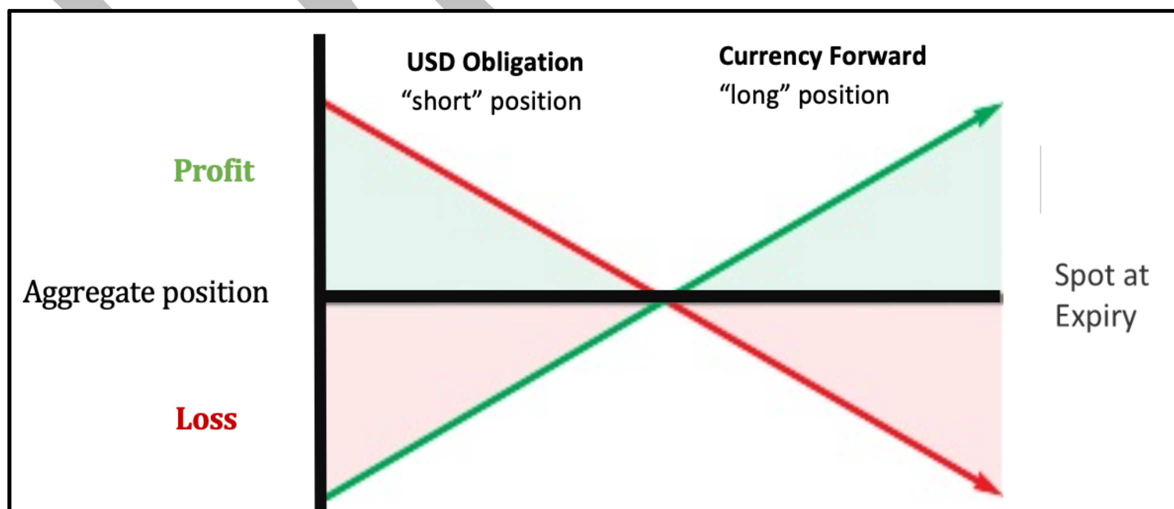


As can be seen above, assuming that the exchange rate between USD against PHP is initially at 50. If the exchange rate increases towards 55, the client is exposed to losses due to higher local currency equivalent of the USD obligation. On the other hand, if the exchange rate decreases towards 45, the client is exposed to potential gains due to lower local currency equivalent of the USD obligation.

D. What is the hedging strategy?

The hedging strategy should provide an offsetting impact to the exposure. As can be seen below, the simplest hedging strategy is to enter into lock-in contracts (i.e. forwards) that will allow the company to lock-in their obligation to buy U.S. dollars at a fixed rate.

Forward is a contract where the company can lock-in its obligation to buy an underlying asset (e.g., foreign currency) at a predetermined rate.



[238]

[238] Source: https://www.renesource.com/en/services/hedging-and-risk-management

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As the diagram above shows, if the company incurs losses on the exposure due to higher exchange rate, this is mitigated (or offset) by the gain from the hedging strategy.

On the other hand, if the company recognizes gains on the exposure due to lower exchange rate, this gain is offsetted by the losses from the hedging strategy.

This illustrates the simple concept of offset in hedging.

E. How to hedge?

There are two simple tools of hedging at the company's disposal. The forward hedging strategy discussed above is the simplest tool that gives the client protection from adverse movements in exchange rate. However, the company also gives up flexibility or participation (as can be seen in the lower exchange rate scenario discussed above).

PROTECTION **PARTICIPATION**

This is why the company may consider purchasing insurance, which gives the company the protection it needs, and the flexibility to walk away from the protection if circumstances are in the company's favor. An example would be a simple option contract.

In an option contract, the company has the right but not the obligation to buy an underlying asset (i.e., foreign currency) at a fixed price. This means that if the exchange rate moves against the company, the company may exercise the option to protect itself from the adverse consequences of such movements. However, if the exchange rate moves in favor of the company (in terms of the exposure), the company may allow the option to expire as it is now worthless given the benefit derived from the favorable movements in the exchange rate. For this flexibility, the company needs to pay an option premium.

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Securities and Exchange Commission
PHILIPPINES

MODULE 2

REGULATION

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SEC M2 Syllabus and BOK, as of 18 March 2024

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Topic 1: Fundamentals of Securities Regulation (FSR)

The Learning Objectives for this section are to share basic knowledge on the regulation of our securities market, the reasons for regulation, and the approaches and methods applied to pursue regulation.

After reading through this, the learners shall have an appreciation of the measures being taken to ensure that the securities markets function in an orderly manner, characterized by transparency, accountability, and fair dealing. The regulations, addressed to the securities themselves, the market, and the participants, provide a comprehensive regulatory environment which, even now, is constantly monitored and enhanced by both the government and the private sector.

Part I. Introduction to the Capital Market

A. Concept, Nature and Functions of Capital Markets

1. Capital Markets

Capital markets are venues where savings and investments are channeled between the suppliers or providers of funds who have capital and those who are users of funds or in need of capital.

Capital markets are used to buy or sell financial products such as equities and debt securities. Equities refer to stocks representing ownership shares in a company. Debt securities, such as bonds, are interest-bearing IOUs.

Capital markets are divided into two different categories: primary markets—where new equity stock and bond issues are sold to investors—and secondary markets, which trade existing securities. Capital markets are a crucial part of a functioning modern economy because they move money from the people who have it to those who need it for productive use. The most common capital markets are the stock market and the bond market.[1]

Stock Market

The **stock market** refers to the collection of markets and exchanges where regular activities of buying, selling, and issuance of shares of publicly-held companies take place. Such financial activities are conducted through institutionalized formal exchanges or over-the-counter (OTC) marketplaces, which operate under a defined set of regulations. There can be multiple stock trading venues in a country or a region that allow transactions in stocks and other forms of securities.

While both terms - stock market and stock exchange - are used interchangeably, the latter term is generally a subset of the former. If one says that she trades in the stock market, it means that she buys and sells shares/equities on one (or more) of the stock exchange(s) that are part of the overall stock market[2].

In the Philippines, there is only one stock exchange, the Philippine Stock Exchange.

[1] https://www.investopedia.com/terms/c/capitalmarkets.asp
[2] https://www.investopedia.com/terms/s/stockmarket.asp.

Bond Market

The **bond market**—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements. Publicly traded companies issue bonds when they need to finance business expansion projects or maintain ongoing operations.[3]

In the Philippines, the only exchange for fixed-income securities of bonds is the Philippine Dealing and Exchange Corporation (PDEx).

2. Exchanges versus Over-the-Counter Markets

An **exchange** is defined as an organized marketplace or facility that brings together buyers and sellers and executes trades or securities and/or commodities.[4] On the other hand, an **over-the-counter (OTC)** market is a decentralized market in which market participants trade stocks, commodities, currencies, or other instruments directly between two parties and without a central exchange or broker.[5]

3. Snapshot of the Philippine Capital Market

The size of the Philippine Capital Market can be seen from the value of transactions recorded by the two formal exchanges in the country. The Philippine Stock Exchange (PSE) for equities, and the Philippine Dealing & Exchange Corp. (PDEX) for fixed-income securities.

At PSE, the market capitalization of its listed stocks was PHP 15.89 Trillion as of the end of 2020. It was PHP 16.705 Trillion as of the end of 2019.[6]

Market Capitalization is calculated by multiplying the price of a stock by its total of outstanding shares. It shows the relative size of the company, how investors value it, and how they think its prospects are as an investment. Sometimes, analysts make differentiations by excluding locked-in shares in the computation, e.g., shares just kept by company executives or employees. Only the number of shares being traded by the general public (the float) is included, and this is called the free-float market cap.

Since the market value of stocks changes every trading day, the market capitalization also changes. But, it is the trend that is to be noted rather than the daily computations. For this reason, the Philippine Stock Exchange Composite Index, or the PSEi, is the trend indicator closely watched by analysts and investors. This PSEi is a carefully chosen composite market price indicator of 30 most-active traded PSE-listed stocks which are representative of the whole market.

At the PSE, there were 334 listed issues as of end-2020 vs. 326 as of end-2019. There were 271 Issuers/listed companies as of end-2020 vs. 268 as of end-2019.

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[3] https://www.investopedia.com/terms/b/bondmarket.asp#:~:text=The%20bond%20market%20broadly%20describes,improvements%20and%20pay%20down%20debts.
[4] Rule 3.1.10, 2015 SRC Implementing Rules and Regulations (IRR)
[5] https://www.investopedia.com/terms/o/over-the-countermarket.asp
[6] Source: https://www.pse.com.ph/resource/FY20_Infographics_fin.pdf.

With respect to PDEx, the statistics as of the end of 2020 are as follows:

1) Total outstanding amount of bonds/securities listed at PDEX was PHP 1,473.59 Billion
2) There were 207 outstanding corporate securities listed
3) There were 57 listed Corporate Issuers

For government securities (GS), as of the end of 2020, there were PHP 6,693.74 Billion outstanding.[7]

Government securities/government bonds have been always dominating the fixed-income securities market, representing 82% as against the 18% of corporate securities/corporate bonds, as of end 2020.

4. Capital Market Development Council (CMDC)

The CMDC is a public-private initiative with the objective of recommending policy and legislative reforms for the development of the Philippine capital market.[8] It is co-chaired by the DOF Secretary, the SEC Chairman, and the FINEX Foundation Chairman and has developed a Capital Market Development Blueprint for 2019-2023. This is the Third Blueprint collaboratively developed by all the institutional stakeholders, government and private sector alike.

B. Basis and Rationale for Regulation

It is the inherent and fundamental power of the State, acting through its Government, to promote the general welfare. This is referred to as the State's police power. When a business activity widely affects the interest of the public in the proper (or improper) and orderly (or disorderly) conduct of such activity, it becomes imbued with a public interest so much so that this requires the special oversight intervention of government to protect the public, to promote the general welfare, in the exercise of police power.

Sometimes, it is called being vested with the public interest and may refer to the activity or the entity that conducts the activity or the venue of such activity.

The Capital market is one such example that is imbued with public interest because, in this market, the public widely participates and involves a large value of financial transactions among institutions and individuals alike, executed in a quick, almost anonymous fashion. There is here a requirement of fair-dealing and trust that obligations are enforced. The very nature requires orderliness which demands the exercise of the police power of the State to regulate, for the protection of the public, especially investors.

As an example, if there were no regulations screening the offering of "securities investments" to the public, misleading information and misrepresentations could lead to fraudulent transactions. We see this now in the investment scams which continue to surface.

As another example, trading in the securities market can be manipulated to execute transactions that distort prices with the intent to mislead for unfair profit. Regulation helps to avoid these harmful transactions which bring disorder to the market.

[7] https://www.treasury.gov.ph.
[8] https://businessmirror.com.ph/2017/01/10/capital-market-development-council/.

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1. Declaration of State Policy on Securities Regulation

The basic policy on the regulation of securities and securities market is articulated in Section 2 of the Securities Regulation Code (SRC)

> *"Declaration of State Policy. – The State shall establish a socially conscious, free market that regulates itself, encourage the widest participation of ownership in enterprises, enhance the democratization of wealth, promote the development of the capital market, protect investors, ensure full and fair disclosure about securities, minimize if not totally eliminate insider trading and other fraudulent or manipulative devices and practices which create distortions in the free market."*

To achieve these ends, the Securities Regulation Code (SRC) was enacted. The Securities and Exchange Commission (SEC) is enforcer of the SRC. The Securities and Exchange Commission is a collegial body, composed of a Chairperson and four (4) Commissioners, appointed by the President for a term of seven (7) years each. The Chairperson is chief executive officer of the Commission.

2. Regulation by Government Authorities

As earlier said, the SEC is the principal regulator of the securities market, enforcer of the SRC and other related laws such as the Revised Corporation Code, Investment Company Act and the Financing Company Act, among others.

3. Self-Regulatory Organizations (SROs)

Self-Regulatory Organization or SRO means an organized Exchange, registered clearing agency, organization, or association registered as an SRO under Section 39 of the Code and which has been authorized by the Commission to: (1) enforce compliance with relevant provisions of the Code and rules and regulations adopted thereunder; (2) promulgate and enforce its own rules which have been approved by the Commission, by their members and/or participants, and ; (3) enforce fair, ethical and efficient practices in the securities and commodity futures industries including securities and commodities exchanges.[9]

The best examples of SROs are the Philippine Stock Exchange (PSE), Capital Markets and Integrity Corporation (CMIC), Philippine Dealing & Exchange Corp. (PDEX), Securities Clearing Corporation of the Philippines (SCCP), and the Philippine Depository and Trust Corp. (PDTC).

SROs promote and encourage a latitude of freedom to capital market institutions and professionals to maintain order in their own ranks, in the realization that internal self-discipline and peer discipline can be more effective to enforce good and fair conduct.

An SRO has rule-making powers.[10] As a self-regulator, an SRO has powers to Audit, enforce Compliance, conduct Surveillance and Investigations[11] plus the authority to discipline members[12]. SRO decisions are always appealable to the SEC.

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[9] Rule 3.1.22, 2015 SRC IRR.
[10] Rule 39.1.1.3 and 40.3, 2015 SRC IRR.
[11] Rule 30.1.1.5 to 7, 2015 SRC IRR.
[12] Rule 39.1.1.8, 2015 SRC IRR.

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Part II. The SEC as Regulator

A. Brief History of the SEC

The SEC was created on October 26, 1936 by the Commonwealth Act (CA) 83 also known as The Securities Act. Its establishment was prompted by the need to safeguard public interest in view of local stock market boom at the time. Its major functions included registration of securities, screening of applications for broker's or dealer's license and supervision of stock and bond brokers as well as the stock exchanges.

Subsequent laws were enacted to broaden the Commission's mandates, powers, and functions, notable among which are those mentioned below.

The SEC Reorganization Act or Presidential Decree (PD) 902-A in 1976, as amended, reorganized the Commission into a collegial body and was given additional powers and functions, including quasi-judicial powers over intra-corporate disputes as well as absolute jurisdiction, supervision, and control over all corporations, partnerships or associations, that are the grantees of primary franchise and/or a license or permit issued by the government to operate in the Philippines.

The Corporation Code of the Philippines, or the Batas Pambansa (BP) 68 in 1980, gave the SEC the mandate to register corporations, collect fees from registering corporations, and prescribe reportorial requirements. Likewise, it authorized the SEC to promulgate rules and regulations reasonably necessary to enable it to perform its duties particularly in the prevention of fraud and abuses on the part of the controlling stockholders, members, directors, and trustees or officers of corporations.

The enactment of the Revised Securities Act or BP 178 in 1982, which repealed CA 83 in its entirety, paved the way for the SEC to keep pace with new and more complex securities instruments, trading vehicles and strategies. The BP 178 provided, among others, for a more sophisticated disclosure mechanism of securities to be offered to investors.

Then, on 01 December 2000, the SEC was reorganized as mandated by Republic Act (R.A.) 8799, also known as the Securities Regulation Code (SRC), which legislation now gives greater focus on the agency's role in capital market development, fostering good governance, and enhancing investor protection. The law also transferred the jurisdiction to decide on intra-corporate disputes to regular courts.

B. Powers, Functions and Jurisdiction of the SEC

The SEC is the national government regulatory agency that is charged with supervision over the corporate sector, the capital market participants, the securities and investment instruments market, and the investing public.

Its main functions can generally be divided into three main categories:

1. Capital Market Development and Regulation
2. Company Registration and Monitoring
3. Enforcement

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The powers and functions of the SEC are enumerated in Sec. 5 of the Securities Regulation Code and include the following:

1. Exercise jurisdiction and supervision over all corporations, partnerships or associations granted primary franchises and/or licenses or permits issued by the Government;
2. Formulate policies and recommendations on issues concerning the securities market, advise Congress and other government agencies or all aspects of the securities markets and propose legislation and amendments thereto;
3. Approve, reject, suspend, revoke or require amendments to registration statements and registration and licensing applications;
4. Regulate, investigate or supervise the activities of persons to ensure compliance;
5. Supervise, monitor, suspend or take over the activities of exchanges, clearing agencies and other SROs;
6. Impose sanctions for the violation of laws and the rules, regulations and orders issued; &
7. Prepare, approve, amend or repeal rules, regulations and orders, and issue opinions and provide guidance on and supervise compliance with such rules, regulations and orders.

The Relevant Laws Enforced by the SEC

The SEC is the administrative agency that administers the Securities Regulation Code (SRC). Aside from the SRC, the SEC also implements, administers, and enforces other legislations and issuances either as lead or support agency, relevant among which are as follows:

1. Revised Corporation Code;
2. Investment Houses Law;
3. Investment Company Act:
4. Financing Company Act
5. Lending Company Regulation Act
6. Securitization Act of 2004
7. Special Purpose Vehicle Act of 2002
8. Access Devices Regulation Act of 1999
9. Real Estate Investment Trust Act of 2009
10. Personal Equity and Retirement Account Act of 2008
11. Retail Trade Liberalization Act of 2000
12. Foreign Investments Act of 1991
13. Omnibus Investments Code of 1987
14. Anti-Money Laundering Act of 2001
15. Credit Information System Act of 2008
16. P.D. 902-A

Specific laws and regulations governing capital market institutions and professionals regulated by the SEC are identified below:

Issuer/Capital Market Institutions/Professionals	Main Governing Laws and Rules
Broker Dealer, GSED, MFD, Exchanges, SROs, Transfer Agents, Clearing Houses, Securities Depositories, Registrar of QIBs, Operator of an ATS, Surety Companies, Credit Rating Agencies	SRC and its IRR
Associated Person/ Salesperson/ Fixed Income Market Salesmen	SRC and its IRR
Investment Houses & Underwriter of Securities	The Investment Houses Law/ Omnibus Rules and Regulations

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Investment Company Advisers-Fund Managers/ Mutual Fund Distributor (MFD)	Investment Company Act and its IRR
Certified Investment Solicitors (CISol)	Investment Company Act and its IRR

C. Capital Market Participants Over whom/which the SEC has Regulatory Oversight

These capital market participants may be grouped as:

1. Self-Regulatory Organizations
(SROs) such as:

a. The Philippine Stock Exchange (PSE)
b. The Philippine Dealing & Exchange Corp. (PDEx)
c. The Securities Clearing Corporation of the Philippines (SCCP)
d. The Philippine Depository and Trust Corp. (PDTC)
e. The Capital Markets Integrity Corporation (CMIC)

These will be described in more detail in the following sections.

2. Capital Market Institutions

a. Broker/Dealer in Securities who is authorized to act both as broker or dealer in transactions.
b. Broker in Securities who is authorized only as a Broker or agent for clients.
c. Dealer in Securities who is authorized as Dealer to transact for its own account.
d. Broker in Proprietary Shares, which is self-explanatory.
e. Voice Broker in Securities, which brings banks, institutional buyers, and sellers together for their securities transactions.
f. Underwriters, who are persons who guarantee on a firm commitment and/ or declared best efforts basis the distribution and sale of securities of any kind by another company.[13]
g. Government Securities Dealers, who are dealers accredited by the Bureau of Treasury to participate in the auctions for government securities issuance, and to trade in them.
h. Investment Company Fund Managers, who are duly appointed as such by investment companies organized and operating under the Investment Company Act.
i. Mutual Fund Distributors, who are accredited as such by duly organized mutual funds to sell or distribute their mutual fund shares.

3. Capital Market Professionals

These are identified in section 28 of the SRC as:

<u>Broker</u>- being a person employed in the business of buying and selling securities for the account of others.

<u>Dealer</u>- meaning any person who buys and sells securities for his/her own account in the ordinary course of business.

[13] Section 3.15, Securities Regulation Code (SRC).

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Salesman- a natural person employed as such as an agent, by a dealer, issuer or broker to buy and sell securities.

Associated Person of a Broker or Dealer who is employed full time by such Broker or Dealer whose responsibilities include internal control supervision of other employees, agents, salesmen, officers, directors, clerks and stockholders of such Broker or Dealer for compliance with the SRC and rules and regulations. *(Rules 28.1.5.2.2)*

Additionally, under Rule 1 (4) of the Implementing Rules and Regulations of the Investment Company Act:

Certified Investment Solicitor – a natural person of legal age duly licensed by the Commission and appointed by the Fund or the FM/MFD to solicit, sell or offer to sell the shares or units of an Investment Company to the public.

D. Objectives of Regulation

The objectives of regulation are embodied in the SRC's Declaration of State Policy, stated broadly and also with particularity, as follows:[14]

1. To establish a socially conscious, free market that regulates itself;
2. Encourage the widest participation of ownership in enterprises;
3. Enhance the democratization of wealth; and
4. Promotes the development of the capital market
5. To protect investors;
6. Ensure full and fair disclosure about securities; and
7. To minimize or totally eliminate insider trading and other fraudulent or manipulative devices and practices which create distortions in the free market.

In other words, regulations are intended to promote transparency and fair-dealing, deter illegal, fraudulent and manipulative practices, for the orderly functioning of the market.

With the growing number of corporations and other forms of associations that the SEC supervises and monitors, and given the evolving nature of transactions where the corporate vehicle is being used to defraud the investing public, as well as the ever-dynamic character of the capital market, SEC must progressively perform its critical role as the prudent registrar and supervisor of the corporate sector and the independent guardian of the capital market.

E. Methods of Regulation

The SEC adopts these methods of regulation, i.e., through

- Registration
- Disclosure
- Compliance
- Enforcement
- SROs

[14] Section 2, SRC.

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1. Through Registration

Registration encompasses registration of the product (securities), the market participants (salesman, brokers, AP) as well as the market (exchanges) and other intermediaries (clearing agency, depository, transfer agents).

We might think of the capital market as a wide field of opportunity to participate in buy and sell activities, to exchange items of economic value in the form of money and securities, and to gain benefits therefrom.

There must be some rules, explicit or implicit, to keep order in the functioning of these activities where multiple parties are involved, very often anonymous to each other.

To join this field of opportunity, there must be a Gatekeeper to assure that those who are allowed to participate are qualified and legitimate, and can be made accountable. The SEC is the Gatekeeper, and it does this through Registration requirements and procedures.

Registration before the SEC can either be primary or secondary.

A primary registration only grants juridical personality; hence, a general license to operate a business. A corporation with primary registration before the SEC does not automatically have the authority to engage in all types of business activities such as lending, selling of securities and investment contracts, and investment taking, among others.

A secondary registration, on the other hand, is a special grant to undertake and engage in special and particular business activities such as but not limited to brokerage or dealership of securities and public solicitation of investment funds.

As such, a corporation with only a primary registration, without any additional license, cannot solicit investments from the public.

The registration process is pretty much similar in purpose to when we register for entry into a convention hall or trade hall. You must have a legitimate business to enter and be qualified to participate. There is a screening process. And this way, it is convenient to monitor one's activities, to assure you're following the rules – all for good order.

2. Through Disclosure

Disclosure means, providing all relevant and material information about the transaction and the items subject of buy and sell, including information about the transacting parties. And the information must not just be one-sided or asymmetrical where "one side of a transaction has relevant and material information that the other side lacks." Because that would not be fair.

As regards disclosure requirements, there are two regulatory philosophies which are contrasting. The first is Merit-Based Regulation; the other is Full-disclosure based.

"Merit-based regulation, as the term implies, refers to a securities regulation policy wherein the government regulator is given the power to examine the investment 'merit' of a particular security before the same is sold or offered for sale to the public, and on the

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basis of its findings, decide whether it will allow the sale or offering for sale of such security."[15]

"Full disclosure policy, on the other hand, refers to the regulatory system wherein the job of the regulator is to compel disclosure of certain information concerning the issuer of security as well as the security itself upon application for registration and once the issuer complies with the required disclosure, the regulator shall allow the registration."[16]

As opposed to merit-based regulation, the regulator under the full disclosure policy has no authority to look into the investment merit of the security sought to be registered. We should know that our SEC follows the "Full Disclosure" policy under the SRC. We should also know that SRC-regulated entities and individuals are subject to strict and continuous reportorial requirements with the aim of making available material information to both potential and existing investors in a timely, full, and fair manner – all for investor protection.

3. Through Compliance

Compliance is the expectation to obey and follow the law and the corresponding rules and regulations prescribed for practitioners and participants in the market. Compliance refers as well to so-called "best practices" which the securities industry itself has adopted for common observance because they represent the industry-wide and worldwide consensus of best behavior in the practice of the participants in whatever market role they play. And compliance must be reported in such form and with such regularity as the regulator prescribes. Reporting is an effective measure of monitoring compliance.

4. Through Enforcement

Enforcement as a method of regulation is the exercise by the regulator of overt actions to instill the discipline of obedience to law and regulations. The SEC has powers of investigation and prosecution and, as a fast and timely action, to issue cease and desist orders to perceived violators. Penalties are provided by law to those who commit misdeeds or omit obligations.

5. Through SROs

Self-Regulatory Organizations or SROs are, as the name suggests, authorized by the SEC to "police their own ranks" in implementing securities rules and regulations pertinent to their own kind of organization. In addition, they may also adopt supplemental rules of their own to promote a more orderly functioning of the market where they make transactions. Although self-regulatory by name and enjoy some autonomy, they are still under the SEC's continuing supervisory oversight. SROs proxy for the SEC in some defined ways in the enforcement of securities laws and of SEC's regulations.

In the succeeding parts of this Module, we shall encounter the application of these methods of regulation. And by way of better organizing our understanding of these regulatory approaches, we shall use some descriptive keywords.

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[15] See Mark Sargent, Report on State Merit Regulation of Securities Offerings, 41 BUS. LAW.785.829 (1986), as cited in Roque, R. R., "*An Inquiry into the Development of Securities Regulation in the Philippines*", p. 34
[16] Roque, R.R., "*An Inquiry into the Development of Securities Regulation in the Philippines*", p. 35

REGISTRATION requirements are PREVENTIVE, so we pre-qualify participants to the market and prevent what by some criteria we consider unqualified to participate.

DISCLOSURE requirements are PRE-EMPTIVE in that by being informative to each other, market participants can make more informed decisions and pre-empt being misled.

COMPLIANCE requirements are COERCIVE, as the law displays its authority to demand observance.

ENFORCEMENT represents requirements made on the regulator to take action under certain circumstances, and is the PUNITIVE aspect of regulation.

SROs are SUBSTITUTIVE, not in the sense of replacement, but as proxy for SEC in the regulation of the market for their respective designated areas of jurisdiction, in the enforcement or securities laws and regulations.

F. Regulatory Developments

1. Sustainable Finance

The Securities and Exchange Commission (SEC) is dedicated to supporting the United Nations Sustainable Development Goals (UN SDG) and the Paris Agreement by formulating policies and regulations to encourage sustainable financing for the government and corporations through capital markets.

The SEC has played a pivotal role in the development of the Philippine sustainable finance market, aligning with ASEAN Green Bond Standards and promoting growth through various guidelines. Notable advancements include the issuance of guidelines for sustainability-linked bonds and blue bonds. The Philippines ranks third in the ASEAN-labeled Green, Social, and Sustainability Bonds landscape, issuing USD 9.98 billion bonds as of October 2023, with the private sector contributing significantly.

The SEC remains committed to establishing robust, sustainable investment frameworks, collaborating with stakeholders to deepen capital markets, boost investor confidence, encourage market participation, and promote financial inclusion. This commitment aligns with the goal of accelerating the growth of green finance and sustainable infrastructure while safeguarding resources for future generations.

SEC Issued Sustainability Rules and Regulations

a. SEC Memorandum Circular No. 12, series of 2018 - Guidelines on the Issuance of **Green Bonds** under the ASEAN Green Bonds Standards in the Philippines. (Dated 06 September 2018)

The SEC adopted the Guidelines released by the ACMF for the issuance of Green Bonds. The ASEAN Green Bonds are specific purpose bonds where proceeds will be exclusively applied to finance or refinance new and/or existing eligible Green Projects. Some of the eligible green projects include:

- Renewable Energy
- Energy Efficiency
- Pollution Prevention and Control

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- Clean Transportation
- Climate Change Adaptation

b. SEC Memorandum Circular No. 08, series of 2019 - Guidelines on the Issuance of **Sustainability Bonds** Under the ASEAN Sustainability Bonds Standards in the Philippines (Dated 26 April 2019)

The purpose of the ASEAN Sustainability Bonds is to recognize that certain Green Projects have social co-benefits, and that certain Social Projects may have environmental co-benefits. Thus, ASEAN Sustainability Bonds are specific purpose bonds where proceeds will be exclusively applied to finance or refinance a combination of both Green and Social Projects that respectively offer environmental and social benefits.

c. SEC Memorandum Circular No. 09, series of 2019 or the Guidelines on the Issuance of **Social Bonds** Under the ASEAN Social Bonds Standards in the Philippines (Dated 26 April 2019)

ASEAN Social Bonds are specific purpose bonds where proceeds will be exclusively applied to finance or refinance new and/or existing eligible Social Projects such as:

- Affordable basic infrastructure
- Access to essential services
- Affordable housing
- Employment generation
- Food security
- Socioeconomic advancement and empowerment

d. SEC Memorandum Circular No. 3, series of 2023 – Guidelines on the Issuance of the ASEAN **Sustainability-Linked Bond** Standards in the Philippines (Dated 5 April 2023)

These guidelines were also based on the Standards developed by the ACMF. Sustainability-Linked Bonds (SLB) are defined as any type of bond instrument for which financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/environmental, social, and governance (ESG) objectives, which are:

- measured through predefined Key Performance Indicators (KPIs) and
- assessed against predefined Sustainability Performance Targets (SPTs).

e. SEC Memorandum Circular No. 15, series of 2023 – Guidelines on Eligible Blue Projects and Activities for the Issuance of **Blue Bonds** in the Philippines (Dated 21 September 2023)

These guidelines were based on the Blue Finance Guidance Framework developed by the International Finance Cooperation (IFC) and the Green and Blue Bond Framework of the Asian Development Bank (ADB). Blue Bonds are a subset of Green Bonds where proceeds will be exclusively applied to finance or refinance, in part or in full, new and existing Blue-eligible projects and/or activities.

The MC provides that Eligible Blue Projects are those that directly aim to address sustainable water management and ocean protection and/or seek to contribute to the development of the blue economy.

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2. Crowdfunding

Crowdfunding is a collective effort of individuals who **pool their resources** to support initiatives promoted by other people or organizations. Using social networks and the viral nature of online communication, individuals and companies have raised billions of dollars in debt, equity, and donations over the past decade. Crowdfunding emerged from innovation in technologies that made it possible for businesses, NGOs and individuals to secure funding with no or limited intermediation.

SEC Memorandum Circular No. 14 series of 2019 – Rules and Regulations Governing Crowdfunding.

Overview

a. Crowdfunding refers to the offer or sale of securities of a limited scale, usually **for start-ups, micro, small and medium enterprises (MSMEs)** done through an online electronic platform under Section 2, Definition of Terms of the aforementioned rules.

- Start-up refers to an organization, company, venture or project which is at the initial phase of a business cycle.
- MSME, as defined in Republic Act (R.A.) 9501 or the Magna Carta for MSMEs, is "any activity or enterprise engaged in industry, agribusiness, and/or services, whether single proprietorship, cooperative, partnership or corporation whose total assets, inclusive of those arising from loans but exclusive of the land on which the particular business entity's office, plant and equipment are situated, shall have value falling under the following categories:
  - Micro: not more than P3,000,000
  - Small: P3,000,001 - P15,000,000
  - Medium: P15,000,001 - P100,000,000"

b. Provides an exemption from securities registration under the Securities Regulation Code Sec. 12

c. CF Issuers[17]

Issuer refers to the **originator, maker, obligor, or creator of the security,** which shall be registered with the intermediary.
- Transactions must be done through a registered CF intermediary
- Limited aggregate amount of securities offered and sold within a 12-month period.
- Subject to disclosures of annual reports, & progress updates

d. CF Intermediaries perform due diligence and monitoring of issuers

Crowdfunding intermediary or intermediary refers to a registered broker, investment house, or funding portal that **mediates the offer and sale of crowdfunding securities** through its online electronic platform.

[17] Section 3 of CF Rules

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- Provide review, due diligence, and/or risk assessment
- Provide educational materials
- Disclose relevant information relating to its crowdfunding activities, such as issuer information

e. Investors

Investor refers to any person or entity that **seeks to make, is making, or has made an investment in an investment vehicle with the expectation of achieving profit.**

Investment limit requirements for retail investors
- Retail Investors with income of up to Two Million Pesos or Php2,000,000.00 per year may purchase securities through a Crowdfunding Intermediary in a maximum value of 5% of their total income per year.
- Retail Investors with income of more than Two Million Pesos or Php2,000,000.00 per year may purchase securities through a Crowdfunding Intermediary in a maximum value of 10% of their total income per year.
- Qualified Investors are not subject to the limits set forth above, provided that the Qualified Investor complies with 2015 IRR Rule 10.1.3 and 2015 IRR Rule 10.1.1.

Types of Crowdfunding

	What you give	What you get
Donations	Donate to someone needy	Nothing in return
Rewards	Funds to help an entrepreneur	The product that an entrepreneur develops
Equity (Regulated by SEC)	An investment in a new company	An ownership stake (like stock)
Debt (Regulated by SEC)	A loan to someone needy	Paid back overtime with interest

SEC Registered Crowdfunding Intermediaries:

1. Investree Philippines Inc.
2. Round One (Eastern Securities Development Corporation)

3. REIT

Real Estate Investment Trust (REIT) is a stock corporation established principally for the purpose of owning income-generating real estate assets, such as apartment buildings, office buildings, medical facilities, hospitals, hotels, resorts, highways, warehouses, shopping centers, and railroads, among others. For purposes of regulation, REITS is governed by Republic Act No. 9856 or the Real Estate Investment Trust is governed by the Real Estate Investment Trust (REIT) Act of 2009.

SALIENT FEATURES OF REIT ACT OF 2009
1. REIT must distribute annually at least 90% of its distributable income as dividends to its shareholders
2. Shares of stocks of REIT are registered with the SEC and listed on the PSE

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3. It has a minimum capitalization of Php300million
4. At least 75% of the REIT's deposited property must be invested in, or consist of, income-generating real estate.

4. Digital Assets

In connection with the recognition of digital assets adoption in financial services, there are two main regulators that take part in shaping this industry – Bangko Sentral ng Pilipinas (BSP) and the Securities and Exchange Commission. BSP's Circular No. 1108 s.2021 provides for the Guidelines for Virtual Asset Service Providers (VASP), wherein it takes part in the exchange of Virtual Assets to fiat currency considered under Money Service Businesses. Whereas, the SEC takes charge of digital assets when they are used to raise funds via its offering to the public – similar to the concept of Initial Public Offering. Consequently, digital assets recognized as securities including their activities such as trading, custody, use of intermediaries, lending/ borrowing, and providing advice, shall be regulated by the SEC. The Commission is in the process of drafting the Proposed draft Rules on Digital Asset Securities Service Providers, as well as its Offering.

5. SEC POWERS

SEC POWERS or **S**ecuring and **E**xpanding **C**apital for **P**owerGen & **W**holesale **E**lectricity & **R**etail **S**ervices refers to the initiative of the Commission to reconcile the mandate of the State to broaden the ownership base of the power generation, transmission, and distribution sector under the Republic Act No 9136 (also known as "Electric Power Industry Reform Act of 2001 'EPIRA') and the registration requirement of securities under Section 8 of the Securities, Regulation Code. In particular, SEC Powers set forth the guidelines for the filing of registration statements by power generation companies and distribution utilities with the Markets and Securities Regulation Department of the Commission.

Initial draft of the said guidelines was already presented to the public and was duly commented on. Currently, the MSRD is in the process of drafting the final version for the approval of the Commission.

6. SEC HOPE

Pursuant to the initiative of the Commission to encourage the registration of securities for hospitals (SEC HOPE), SEC Memorandum Circular No. 11 series of 2017 was issued for purposes of adopting the guidelines using SEC Form 12-1 SRS which hospitals may use in lieu of the current SEC Form 12-1.

Under this initiative, the registration of securities for hospitals is simplified, and the registration process is shorter as the Commission undertakes to declare the registration statement effective or rejected within twenty-eight (28) days from the date of filing of its SEC Form 12-1 SRS.

SEC Memorandum Circular No. 11 series of 2017 was signed on 29 September 2017 and was used by different hospitals in the registration of its securities with the Commission.

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7. SEC FARMS or **S**ecuring & **E**xpanding **C**apital for **F**arms & **A**gri-Business **R**elated **M**odernization **S**chemes)

   The SEC, in line with the objectives of the Philippine Development Plan (PDP) on job creation and acceleration of poverty reduction, adopts regulation for registration of securities for agri-business companies that will help them raise up to 500 hundred million to fund their agricultural projects.

   SEC has issued Memorandum Circular No. 08 series of 2023 on 15 June 2023 which simplifies the registration form of securities and shortened the period to declare Registration Statement effective.

Part III. Regulation of Securities

A. What are Securities?

Let's do a review. *Section 3 of the SRC defines securities as: "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) Share 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 option and warrants;
(e) Certificates of assignments, certificates of participation, trust certificates, voting trust certificates or similar instruments;
(f) Proprietary or non- proprietary membership certificates in corporations; and
(g) Other instruments as may in the future be determined by the Commission.

The term "securities" was defined by way of a non-exhaustive enumeration and gives the SEC the continuing authority to determine which instruments should be considered as securities although are not deemed as such at the time the SRC was enacted.

An investment contract is a type of security defined by the SRC as "a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits primarily through the efforts of others." It is presumed to exist when a person seeks to use the money or property of other persons on the promise of profits. A common enterprise is deemed created when two or more investors pool their resources, even if the promoter received nothing more than a broker's commission.

The Howey Test is the test established to determine whether a transaction qualifies as an "investment contract" and, hence, subject to registration. It requires that a person:

1. Makes an investment of money
2. In a common enterprise
3. With the expectation of profits
4. To be derived primarily from the efforts of others

In Power Homes Unlimited Corporation vs. Securities and Exchange Commission, it was ruled that as an investment contract that is a security under R.A. No. 8799, it must be registered with

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the SEC, otherwise, the SEC cannot protect the investing public from fraudulent securities. The strict regulation of securities is founded on the premise that the capital markets depend on the investing public's level of confidence in the system.

B. How are Securities Created?

Securities are created by an Issuer, which the SRC defines as "the originator, maker, obligor, or creator of the security."[18]

The Issuer is a corporation which, through its Board of Directors and Shareholders, following prescribed legal requirements, authorizes the issuance of common stock or other types of equity shares, or the issuance of bonds or other debt papers in securities form. When first offered to the public, the issuance is an initial public offering or IPO, and thereafter, the securities are traded in the secondary market.

C. Registration of Securities Required

The requirement to register securities with the SEC is a basic and essential aspect of securities regulation. The function of registering securities is lodged by the SRC with the SEC as part of its broad mandate to develop and regulate the country's capital market.[19]
Registration is the act of filing an application to register securities with the SEC, which calls for the disclosure by the issuer of a comprehensive set of prescribed information, both financial and non-financial, about the securities to be issued and about the issuer.

The purpose of registration is "to insure full disclosure or to protect the interest of the investors and the public in general."[20] As we have mentioned, the SEC is the gatekeeper, and through registration, necessary and relevant information is made available and accessible to the investing public on which informed investment decisions can be made.

The application to be filed with the SEC for the purpose of registering securities is called a Registration Statement and is subject to the prior review and approval by the SEC.

The SRC states that securities shall not be sold or offered for sale or distribution within the Philippines without such registration statement having been filed and approved by the SEC unless they are exempt securities or exempt transactions.

D. Exempt Securities

Section 9 of the SRC enumerates securities which are themselves exempted from registration for the reason that the nature of the issue generally and presumptively assures that the securities are creditworthy or are issued by issuers adequately supervised by regulatory authorities.

These include:

1. Securities issued or guaranteed by the Philippine Government or any of its political subdivisions or agencies;
2. Securities issued or guaranteed by a foreign government with which the Philippines maintains diplomatic relations;

[18] Section 3.2, SRC.
[19] Section 5(c), SRC.
[20] Section 8, 8.5, SRC.

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3. Securities whose transactions are supervised/regulated by the Insurance Commission, Housing and Land Use Regulatory Board or the BIR;
4. Securities issued by banks (except their shares of stocks);
5. Any evidence of indebtedness issued by a financial institution that has been licensed by the BSP to engage in banking or quasi-banking;
6. Evidence of indebtedness, e.g., commercial papers, that meet the following conditions:
   a. Issued to not more than nineteen (19) non-institutional lenders;
   b. Payable to a specific person;
   c. Neither negotiable nor assignable and held on to maturity; and
   d. In an amount not exceeding One Hundred Fifty Million Pesos (PhP150,000,000.00) or such higher amount as the Commission may prescribe.

The Commission may, by rule or regulation after a public hearing, add to the foregoing any class of securities if it finds that the enforcement of this Code with respect to such securities is not necessary for the public interest and for the protection of investors.

E. Exempt Transactions

Section 10 of the SRC also exempts from the registration requirement those securities that are sold or issued under exempt transactions, which include:

1. An isolated transaction in which any security is sold by the owner not being made in the course of repeated and successive transactions.
2. The distribution of stock dividends.
3. The sale of capital stock of a corporation to its own stockholders where no commission or other remuneration is paid in connection with the sale of such capital stock.
4. Broker's transactions executed upon customer's orders on any registered Exchange.
5. Subscriptions for shares of the capital stock of a corporation prior to the incorporation thereof or in pursuance of an increase in its authorized capital stock.
6. The sale of securities by an issuer to fewer than twenty (20) persons in the Philippines during any twelve-month period; and
7. The sale of securities to any number of qualified buyers, which include, among others:[21]
   a. Bank;
   b. Registered Investment House;
   c. Insurance Company;
   d. Registered Investment Company (e.g., mutual fund company);
   e. Provident fund or pension fund maintained by the Government or managed by persons authorized by BSP or SEC to engage in trust functions or fund management;
   f. Registered Securities Dealer;
   g. Account managed by Registered Broker under a discretionary arrangement, Registered Investment companies;
   h. a Trust corporation authorized by BSP to perform acts of a trustee;
   i. Unit Investment Trust Funds established in accordance with BSP regulations;
   j. Entity with quasi-bank license issued by BSP;
   k. Pre-need company authorized by the Insurance Commission; or
   l. such other person determined by the SEC 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.

[21] SEC MC No. 6, 2021 re Amendments to SRC Rules 9 and 10.

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The Commission may exempt other transactions if it finds that the requirement of registration under this Code is not necessary for 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.

The exemption from registration of securities subject to exempt transactions is based on the assumption that the transaction does not involve, or will not prejudice, the interests of third parties or the public in general or because the securities will be issued to investors who are financially well-equipped, as well as investors who are knowledgeable and experienced. These exempt transactions are, in essence, private transactions or those where the investor is deemed to be financially sophisticated and capable of conducting its own due diligence when making investment decisions.

G. Procedure for Registration

No person shall sell or offer for sale or distribute the shares or units of an Investment Company unless such have been registered in accordance with the requirements of the ICA, SRC, and their IRR, and the registration statement has been declared effective by the Commission.[22]

1. Filing

Registration is done by the issuer filing a sworn registration statement in the SEC's main office "in such form and containing such information and documents as the Commission shall prescribe."[23]

SEC Form 12-1 is the prescribed format to be used when filing a Registration Statement of securities. Most of the information will be contained in a Prospectus, which will contain basic information required to give an adequate picture of the proposed issue, which includes:

a. The description of the securities to be registered,
b. The number and amount to be registered,
c. Proposed maximum offering price and aggregate offering price,
d. The use of proceeds,
e. Risk factors,
f. Plan of distribution, among others.

Integral to the Prospectus is information with respect to the Issuer, such as its corporate profile, description of business, Directors, Officers, and Financial Information.

2. Publication of Notice

Notice of the filing of the registration statement shall be published by the issuer reciting that a registration statement for the sale of such security has been filed with the SEC.[24]

3. Review

After the payment of applicable filing fees, a full review of the registration statement will be commenced and eventually submitted for consideration by the Commission *en banc.*

[22] Rule 4, Investment Company Act (ICA) IRR.
[23] Sec. 12.1, SRC.
[24] Section 12.5, SRC.

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4. Approval

Once the application is deemed compliant with all applicable disclosure and registration requirements, the Commission will issue:

a. An **Order** stating that the registration statement covering the securities has been rendered effective, and
b. The corresponding **Certificate of Permit to Offer Securities for Sale**.

H. Rejection and Revocation of Registration of Securities

The SEC may reject or revoke the registration of securities for various good reasons, as enumerated in Section 13 of the SRC. For example, the SEC may reject a registration statement and refuse registration or revoke the effectivity of a registration statement and of the security if, after due notice and hearing, it finds that the issuer:

1. has been judicially declared insolvent;
2. has violated any of the provisions of the SRC and its rules;
3. has been or is engaged in fraudulent transactions;
4. has made any false or misleading representation of material facts in any prospectus; or
5. has failed to comply with any requirement that the SEC may impose as a condition for registration of the security.

Additionally, the SEC may reject or revoke the registration statement if it is on its face incomplete or inaccurate in any material respect or includes any untrue statement of a material fact; and if the issuer, any officer, director or controlling person of the issuer, or person performing similar functions, or any underwriter has been convicted, of an offense involving moral turpitude and/or fraud.

Interestingly, a registration statement may be withdrawn by the issuer only with the consent of the SEC.[25]

An issuer whose registration statement has been rendered effective may **voluntarily** seek the revocation of its securities registration by filing a verified Petition for Revocation of Registration together with the supporting documents enumerated in SRC Rule 13.2.1. and will likewise comply with the notice publication requirements.

If the SEC finds that the petition is on its face complete and that no party stands to suffer any damage from the revocation, it shall prepare an order revoking the registration and the issuer shall thereafter cause the order of revocation to be published.

I. Suspension of Registration

If, at any time, the information contained in the registration statement filed is or has become misleading, incorrect, inadequate or incomplete in any material respect, or the sale or offering for sale of the security may work or tend to a work a fraud, the SEC may require from the issuer further information to ascertain whether the registration of such security should be revoked on any ground specified in the SRC. The SEC may also suspend the right to sell and offer for sale such security pending further investigation. The refusal to furnish information required by the SEC may be a ground for the issuance of an order of suspension. No further offer or sale

[25] Section 13.6, SRC.

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of any such security shall be made until the same is lifted or set aside by the Commission. Otherwise, such sale shall be void.[26]

Upon issuance of an order of suspension, the Commission shall conduct a hearing. If the Commission determines that the sale of any security should be revoked, it shall issue an order prohibiting the sale of such security.

If the Commission finds that the sale of the security will neither be fraudulent nor result in fraud, it shall forthwith issue an order revoking the order of suspension, and such security shall be restored to its status as a registered security as of the date of such order of suspension.

J. Amendments on the Registration Statement and Prospectus (Rule 14 SRC)

If a registration statement or prospectus on file with the Commission becomes incomplete or inaccurate in any material respect or if the Issuer wants to change any material information therein after a current report or SEC Form 17-C has been filed, the Issuer shall:

1. File an amendment to the registration statement with the Commission explaining in detail all proposed changes, which shall be reviewed by the Commission in accordance with Section 14 of the Code.

2. If the registration statement has been declared effective by the Commission, publish a notice of the proposed amendment/s, including the reasons for the amendments, in two (2) national newspapers of general circulation in the Philippines stating that the offering in its current form has been amended.

3. If the changes shall result in a derogation of the rights of existing security holders or purchasers of securities or membership certificates who have paid a portion of the selling price, the Issuer may include in the above-mentioned publication an offer to rescind all transactions that have been completed for sale to date, without making any deduction pursuant to SRC Rule 14.2.4 and wait for 30 days for the purchasers to respond to the rescission offer before initiating the amended offering.

4. If the conditions under SRC Rule 14.2.3 are present, the purchasers may, within 30 days from the date of such notification, renounce their purchase of the said securities. Upon such renunciation, the Issuer, or any person acting on behalf of the Issuer in connection with the distribution of the said securities, shall, within 10 days from receipt of notification of such election, return the payments made by security holders or purchasers of securities or membership certificates.

5. In case of an increase in the volume or offering price of the securities to a level higher than the range previously disclosed by the Issuer, the amended registration statement or prospectus shall be accompanied by a filing fee based on the difference between the highest aggregate amount in relation to the previous range and the total amount based on the new volume or price.

6. The Commission may, taking into consideration the interests of the investors, order the publication in a national newspaper of general circulation of its order rendering effective the amended registration statement.

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[26] Section 15.1 and 15.2, SRC.

Part IV. Regulation of Securities Market Professionals

A. Rationale for Regulation

As we have mentioned earlier, the capital market is imbued with the public interest and represents an area of activity that provides economic opportunities and risks and, therefore, merits the interventions of regulatory authority to protect investors. The capital market professionals who give investment advice, solicit sales, and effect transactions for and with investors, accordingly need to be screened for their qualifications to perform their functions and roles.

These qualifications include not just knowledge and competence, but moral integrity and all those attributes of ethical conduct that characterize transparency, accountability and fair-dealing.

The idea, of course, is by registering securities market professionals, the SEC as regulator is able to establish minimum standards for this class of market participants, and provides the convenient mechanism to monitor their actions and compliance with applicable laws and regulations, at the same time helping to ensure accountability. After all, an SEC issued license as a securities market professional is not a matter of right but a privilege. And the SEC, to reiterate, is the gatekeeper.

B. Regulation of Securities Market Professionals

Under the SRC, there are four classes of persons who need to be registered by the Commission before they can engage in the business of buying or selling securities in the Philippines:[27]

1. Broker
2. Dealer
3. Salesman
4. Associated Person

Related to this, *"No registered broker or dealer shall employ any salesman or any associated person, and no issuer shall employ any salesman, who is not registered as such with the Commission."*[28]

Additionally, a Certified Investment Solicitor is required under the Rules of the Investment Company Act to be registered with the Commission prior to offering or selling of investment company shares or units.

1. Registration by application

A broker or dealer may apply for registration by filing with the SEC a written application containing such information and documents concerning such broker or dealer as the SEC prescribes.[29]

Registration of a salesman or of an associated person of a registered broker or dealer and shall also be made upon written application filed with the SEC by such salesman or associated person. The application shall be separately signed and certified by the

[27] Section 28.2, SRC.
[28] Section 28.2, SRC.
[29] Section 28.5, SRC.

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registered broker or dealer to which such salesman or associated person is to become affiliated, or by the issuer in the case of a salesman employed, appointed or authorized solely by such issuer.[30]

Licenses of market professionals need to be renewed every November, and a three-year inactivity will invalidate the license.[31]

Similarly, the registration of a Certified Investment Solicitor shall be made upon written application with the SEC and is renewed annually. A new and complete form must be filed when an individual changes employment and desires to become registered with another investment company/mutual fund manager/adviser.

2. Conditions: Qualifications for Registration

The SEC shall promulgate rules and regulations prescribing the qualifications for registration of each category of applicant, which shall, among other things, require as a condition for registration that:

a. If a natural person, the applicant satisfactorily passes a written examination as to his proficiency and knowledge in the area of activity for which registration is sought;

b. In the case of a broker or dealer, the applicant satisfies a minimum net capital as prescribed by the SEC and provides a bond or other security as the SEC may prescribe to secure compliance with the provisions of this Code; and

c. If located outside of the Philippines, the applicant files a written consent to service of process upon the SEC pursuant to Section 65 hereof.[32]

3. Revocation, Refusal or Suspension of Registration

The registration of Brokers, Dealers, Salesman, and Associated Persons may be refused, revoked, suspended, or limitations placed thereon by the SEC for various reasons enumerated in Sec.29.1. of SRC. These reasons may refer to willful acts or failures, such as willfully violating any provision of the SRC or its rules, regulations, or orders, or in the case of a registered broker, dealer, or associated person, failing to supervise another supervised person who commits such violation; or willfully making a materially false or misleading statement in any application for registration or report filed with the SEC or an SRO, and failing to satisfy the qualifications or requirements for SEC registration.

The reason may refer to the character of the person, such as, when he has been convicted of an offense involving turpitude, fraud, embezzlement, counterfeiting, theft, estafa, misappropriation, forgery, bribery, false oath or perjury; or of a violation of securities, commodities, banking, real estate or insurance laws.

As we can see, honesty and integrity of the highest order are required of a capital market professional. And the SEC has wide powers to enforce these high standards of personal attributes and behavior.

[30] Section 28.6, SRC.
[31] SEC MC No. 17, s. 2016; Section 28.1.5.5.5.2, 2015 SRC IRR.
[32] Section 28.4, SRC.

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4. Transactions and Responsibility of Broker or Dealer

Brokers and dealers are required to act as such, i.e., "to effect any transaction in securities or attempt to induce the purchase or sale of any security" only in compliance with such rules and regulations as the SEC shall prescribe. The purpose: "to ensure fair and honest dealings in securities and provide financial safeguards and other standards for the operation of brokers and dealers, including the establishment of minimum net capital requirements, the acceptance of custody and use of securities of customers, and the carrying and use of deposits and credit balances of customers."[33]

To avoid conflict-of-interest situations, no broker or dealer shall deal in or otherwise buy or sell, for its own account or for the account of customers, securities listed on an Exchange issued by any corporation where any stockholder, director, associated person or salesman, or authorized clerk of said broker or dealer and all the relatives of the foregoing within the fourth civil degree of consanguinity or affinity, is at the same time holding office in said issuer corporation as a director, president, vice-president, manager, treasurer, comptroller, secretary or any office of trust and responsibility, or is a controlling of the issuer.[34]

Part V. Registration of Exchanges and SROs

The regulation of Exchanges starts with their registration with the SEC, and since Exchanges are likewise Self-Regulatory Organizations (SROs), we shall discuss these entities in tandem.

A. Registration of Exchanges

Trading is at the heart of a securities market, and so the SEC as regulator looks with a focus on the venue of such trading. A securities Exchange is, therefore, required to be registered with the SEC.[35] For that matter, the operation of any trading market — "otherwise than on a registered Exchange" can be done only in accordance with rules and regulations the SEC may prescribe.[36] Such prescription "may require such market to be administered by a self-regulatory organization determined by the SEC as capable of insuring the protection of investors comparable to that provided in the case of a registered Exchange."[37]

Application for Registration: Some Highlights of Requirements

The applicant must be a stock corporation engaged solely in the business of operating an exchange. No person may beneficially own or control, directly or indirectly, more than five percent (5%) of the voting rights; no industry or business organization may own control, directly or indirectly, more than twenty percent (20%) of the voting rights. The SEC may exempt the applicant from these prohibitions where it finds that such ownership or control will not negatively impact on the exchange's ability to effectively operate in the public interest.[38]

[33] Section 30.2, SRC.
[34] Section 30.1, SRC.
[35] Section 32.1, SRC.
[36] Section 32.2 (a), SRC.
[37] Section 32.2 (b), SRC.
[38] Section 33, SRC.

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B. SEC's Power to Suspend Trading

The protection of investors and the public interest are the primary objectives, and so if for these purposes the SEC finds it necessary, it may summarily suspend trading in any listed security on any Exchange or other trading market for a period not exceeding thirty (30) days. This summary suspension can be extended for a period not exceeding ninety (90) days, with the approval of the President of the Philippines. The affected issuer of this suspension shall be promptly notified and be given opportunity for a hearing to determine whether the suspension should be lifted.[39]

C. Self-Regulatory Organizations (SROs)

Rationale for SROs. Their Registration

SROs perform the useful function of co-regulators with the SEC. The current SROs operating in our domestic securities market are: the PDEX, the PSSC, the PSE, the CMIC, and the SCCP.

SROs are, upon application, accredited by the SEC and are required to be registered. These SROs are "organizations whose operations are related to or connected with the Securities Market." The SEC has the power to regulate, supervise, examine, suspend or otherwise discontinue these SROs. The SEC may prescribe rules and regulations which are necessary or appropriate in the public interest or for the protection of investors to govern self-regulatory organizations and other organizations licensed or regulated by it, including the requirement of cooperation within and among, and electronic integration of the records of, all participants in the securities market to ensure transparency and facilitate exchange of information.[40]

SROs have the power to promulgate and enforce their own rules for the proper functioning of their respective organizations, which rules require the approval of the SEC. SROs are also required to uphold and enforce compliance with all rules and regulations of the SEC. The overall objective is always, and foremost, the observance of the overarching State Policy declared in Section 2 of the SRC.

Associations of brokers and dealers are the more common entities that apply for and are granted SRO status. The Philippine Stock Exchange and the Philippine Dealing & Exchange Corp. are the foremost examples in the Philippines. The basic prescription for an SRO is that it is so organized and has the capacity to be able to carry out the purposes of this SRC and to comply with, and to enforce compliance by its members and persons associated with its members, with the provisions of the SRC, the rules and regulations thereunder, and the rules of the association.[41]

Emphatically, the SRC provides that "A registered securities association shall deny membership to any person who is not registered as a broker or dealer."[42] Also, SROs are required to comply with the provisions of the SRC, the rules and regulations thereunder, and its own rules, and enforce compliance, notwithstanding any provisions of the Corporation Code to the contrary, by its members, persons associated with its members of its participants.[43] Furthermore, each SRO is required to submit to the SEC for prior approval any

[39] Section 36, SRC.
[40] Section 39, SRC.
[41] Section 39.3, SRC.
[42] Section 39.4, SRC.
[43] Section 40.2, SRC.

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proposed rule or amendment thereto, together with a concise statement of the reason and effect of the proposed amendment.[44]

D. The Philippine Dealing System (PDS) Holdings Group

The PDS Group provides the infrastructure for the trading, clearing and settlement of fixed income securities in the Philippines. The Group also provides services as depository, registry, custodian and trustee both for equity and fixed income securities.

PDS Group

The Philippine Dealings Systems Holdings Corporation (also known as the "PDS Group") was built as a community solution following the economic stresses felt in the region in 1997. The PDS Group was formed to shepherd the implementation of a market reform – the organized market for fixed income securities.

Powered by state-of-the-art technology, PDS provides a full suite of services, from trading to clearing and settlement, and post-settlement across the fixed income and equity asset classes. It also offers learning facilities so as to equip its markets and its markets and communities in keeping pace with market development and professional practice, here and abroad.

The PDS Group is composed of a holding company, the Philippine Dealing Systems Holdings Corporation, and its operating subsidiaries:

1. Philippine Dealing and Exchange Corporation (PDEx) – Trading Services Arm
2. Philippine Depository and Trust Corporation (PDTC) – Securities Services Arm
3. Philippine Securities Settlement Corporation (PSSC) – Payment and Transfer Services Arm

The PDS Group operates in a regulatory environment that ensures conformance with governance and regulatory requirements and commitments to stability, integrity, and investor protection.

PDEX

The Philippine Dealing and Exchange Corporation (PDEx) was incorporated in 2003 to provide trading infrastructure for the Fixed-income (FI) market. As an SEC-registered Fixed Income (FI) securities market, PDEx operates the organized secondary market for the trading of FI securities, which include both government and corporate securities.
PDEx, as an SRO, has been given authority by the SEC to create and enforce its own rules, monitor and enforce compliance with securities laws and regulations, and enforce fair, ethical, and efficient practices in the securities market, with the primordial objective of investor protection. It enables the maintenance of a level playing field among players in the market in order to assure investors of fairness and safety in the marketplace.

PDTC

Incorporated in 1995, the Philippine Depository and Trust Corporation (PDTC) was previously known as the Philippine Central Depository Inc. (PCD). PDTC acts as a depository, registry, custodian, trustee or intermediary of participants for equity securities, fixed income securities and financial instruments and provides value added agreement or repo

[44] Section 40.3, SRC.

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transactions. It is also a lending agent and collateral manager for securities lending and borrowing transactions and similar activities.

PDTC provides depository and settlement services for listed fixed-income securities in the PDEx, covering both government securities and corporate debt issues. PDTC supports both broker-level and investor-level settlements for all PDEx-traded fixed-income transactions. PDTC also provides an electronic registry service for the issuers of the listed corporate bonds.

It is under the dual oversight of the SEC and the BSP because of the duality of its functions, where it performs market services for securities engaged in the market, as well as fiduciary services while securities are at rest.

PSSC

The Philippine Securities Settlement Corporation (PSSC), the payment and settlement and currency transfer services arm of the PDS Group, was incorporated in 2004.

PSSC operates the domestic transfer systems for two foreign currencies: the US Dollar through the Philippine Domestic Dollar Transfer System (PDDTS) and the Chinese Yuan through the Renminbi Transfer System (RTS). Both transfer systems handle real-time electronic transfers of USD and RMB. PSSC's partnership with USD and RMB settlement banks allows its participants to send and receive both USD and RMB payments and transfers within the Philippines and with other global payment systems.

The PSSC also operates Payment versus Payment (PvP) for interbank USD-PHP transactions, with the dollar leg settling through PDDTS, and the peso leg settling through BSP PhilPaSS, the central bank's own RTGS payment system. PSSC's settlement highways are uniquely customized to cater to the Philippine market.

E. The Market Governance Board of Philippine Dealing System (PDS)

Here's the SRO Governance Structure of PDEx to enforce Fixed Income Securities Market order, stability, investor protection, fairness, and transparency.

1. PDEX as Self-Regulatory Organization

Conscious of the role of PDEx as a Self-Regulatory Organization (SRO) for the fixed income market, the PDS Group has segregated oversight of the regulatory function from its corporate board and committee structures. This type of governance structure was designed to insulate the market governance function from its corporate governance structure, which sees to its business needs as a corporate enterprise, to achieve independence of the market regulation.

PDEx engages in rule-making and enforcement activities to bring order to the marketplace. It operates in accordance with securities laws and rules and regulations issued by PDEx and other regulatory bodies. It envisions to provide a credible, safe, and fair market.

2. Corporate Governance vs. Market Governance

While the Corporate Governance domain strives to realize the shareholder vision with a focus on return on capital, the Market Governance domain mobilizes the Self-Regulatory

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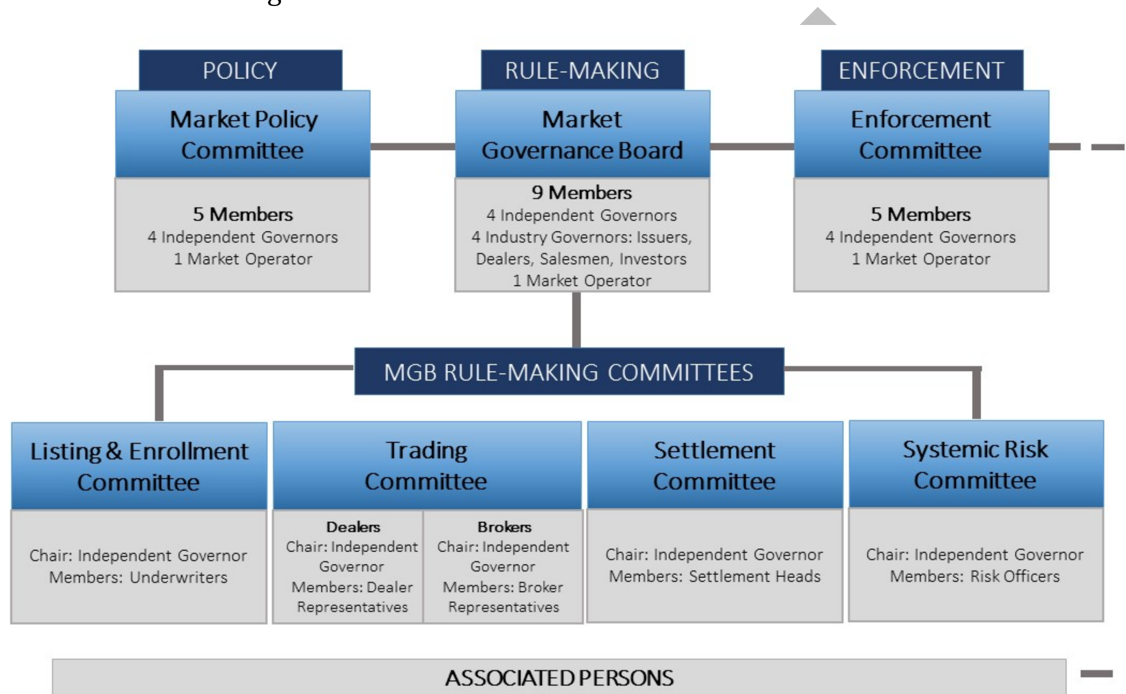
Organization (SRO) function. It engages itself in ensuring that the market structure can realize the expectations of all the stakeholders that participate in the marketplace.

Under the Securities Regulation Code (Republic Act No. 8799), an SRO is registered with the Securities and Exchange Commission (SEC) to enforce compliance with its provisions, rules and regulations. It is also mandated to make and enforce its own rules. An SRO should enforce fair, ethical, and efficient practices in the securities industry. Accordingly, with this mandate, PDEx has created a comprehensive governance structure that is designed to insulate the market governance function from its corporate governance structure. This diagram describes the structure.



F. The Philippine Stock Exchange, Inc. (PSE)

The PSE was created in 1992 from the merger of the Manila Stock Exchange and the Makati Stock Exchange. The PSE is the only stock exchange in the country and was granted SRO Status by the SEC in June 1998. In 2001, the PSE was transformed from a non-profit, non-stock member-governed organization into a stockholder-based revenue-earning corporation. Its own shares were listed in its own exchange in 2003. In October 2004, the Securities Clearing Corporation of the Philippines (SCCP), a clearing and settlement agency for depository-eligible trade, became a wholly owned subsidiary of the PSE. The SCCP acts as the settlement coordinator and risk manager for broker transactions, and is an SRO. PSE owns 20.98% of the Philippine Dealing Systems Holding Corporation.

PSE's Vital Functions

PSE functions primarily as the trading facility for the introduction of new common stock (primary) issues into the capital market to raise funds for business enterprises (IPOs) and, thereafter, for their secondary trading among the securities holders. These equity securities are the instruments for raising fairly large amounts of capital for the business expansion of companies and are, therefore, vital to the economy. At the same time, the PSE's facilities allow investors, individuals, or institutions the opportunity to participate in the ownership of issuer

companies with the expectation of profit, thereby expanding investment opportunities and "democratizing" the economy through wide ownership of businesses.

Because the PSE has rules to assure only qualified securities are accepted for trading and that there are rules for disclosures and other procedures to maintain fair dealing and good order in transactions, the PSE serves to provide a well-safeguarded market for investors. Moreover, those intermediaries who participate in trading (brokers) are pre-qualified and constantly monitored in their performance, which further assures the integrity of transactions.

1. The PSE Structure

The PSE organization structure presently has the president reporting to a fifteen-person board of directors comprised of five trading participants (member brokers) and ten independent individuals (non-brokers). A third of PSE's 15-person Board of Directors shall be composed of independent directors, starting 2020, according to SEC's rules.

At least five of them should be independent directors, at least one director should represent Issuers, at least one director should represent Investors, and at least two directors should represent other market Participants.

Member brokers should not compromise more than 49% of the board and shall proportionately represent the Exchange membership in terms of volume or value of trade and paid-up capital.[45]

2. Shareholder Protection Initiatives

The Securities and Exchange Commission (SEC) and the PSE have jointly put in place a number of initiatives designed to build market confidence and integrity through transparency, fairness, and efficient trading of stocks, wherein every individual or institutional investor is protected from fraud, trade manipulation, and malpractices by PSE trading participants.

Below are the investor protection initiatives:

a. Self-Regulatory Organization (SRO) Status

In June 1998, the SEC granted the PSE an SRO status. This empowers the PSE to formulate marketplace rules and impose penalties or sanctions on PSE trading participants who will not comply with these rules.

b. Capital Markets Integrity Corporation (CMIC)

With the primary objective of reinforcing the confidence of the investing public, the PSE Board of Directors passed Resolution No.91, series of 2010, on May 26, 2010, which approved the spin-off of its Market Regulation Division into a separate and independent corporation.

Subsequently, the CMIC was incorporated in March 2011. Then, on February 3, 2012, the SEC granted the CMIC its SRO status, and it started operating on March 12, 2012, as the primary regulator of PSE Trading Participants by performing independent audits, surveillance, and compliance enforcement.

[45] Section 33.2 (f), SRC.

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c. Risk-Based Capital Adequacy (RBCA)

SEC Memorandum Circular No.16 mandates PSE trading participants to comply with the RBCA Rules. Essentially a risk management measure enforced by the CMIC, RBCA ensures that stockbrokers have enough capital to cover their exposure to risks. It also ensures that stockbrokers are financially sound or liquid enough to promptly settle claims and other obligations to clients.

d. Customer First Policy

The CMIC regularly monitors and audits the operations of stockbrokers. It ensures that the business and trading practices of stockbrokers conform with the laws stipulated in the Securities Regulation Code of the Philippines, including the Customer-First Policy, whereby stockbrokers' orders must always surrender priority to their clients.

e. PSE Disclosure Rules

Since timely and reliable company disclosures are essential components of a fair and efficient market, the PSE makes it compulsory for listed companies to promptly disclose factual and truthful information.

1) 10-Minute Rule

The PSE requires that material information, which may affect a listed company's share price positively or negatively, should be disclosed within ten minutes after its occurrence.

2) Selective Disclosure Rule

Disclosure must also be relayed first to the PSE so that, through its communication channels, it may cascade information to each investor and the general public and not just to a select group of individuals.

f. PSE Electronic Disclosure Generation Technology (PSE EDGE)

The PSE EDGE is a fully automated system that allows the efficient processing, validation, submission, distribution, and analysis of time-sensitive disclosure reports submitted to the PSE. This new disclosure system, which was acquired from the Korea Exchange, takes the place of the PSE Online Disclosure System (ODiSy). It is equipped with a variety of features, which standardize the disclosure reporting process of PSE's listed companies and improve investors' disclosure searching and viewing experience, thus promoting greater transparency in the market.

g. Total Market Surveillance (TMS)

The CMIC monitors the market closely through a state-of-the-art surveillance system called TMS, which was developed by the Korea Exchange. TMS is equipped with the essential elements of the surveillance process and provides an active monitoring and warning mechanism. It is designed to protect the integrity of the stock market from fraud, manipulation, and breaches of marketplace rules. The CMIC investigates unusual price and volume movements so as to identify and sanction trading participants, and issuers or investors who may have done unfair market practices.

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h. Securities Investor Protection Fraud (SIPF)

Another initiative undertaken for the protection of investors is the SIPF. Similar to what the Philippine Deposit Insurance Corporation (PDIC) does, SIPF seeks to build and enhance investors' confidence in the market and is intended to protect the investing public from extraordinary losses (other than the ordinary market fluctuations) arising from fraud, failure of business, or judicial insolvency of PSE trading participants.

All of these protective initiatives collectively serve to ensure the health and integrity of the equities market. They make investing in the Philippine stock market secure.

G. The Capital Market Integrity Corporation (CMIC) of the Philippine Stock Exchange (PSE)

The CMIC is a self-regulatory organization (SRO) that acts as the independent regulatory arm of the PSE tasked to perform the audit, surveillance, and compliance monitoring of the activities of market participants.

Incorporation of CMIC[46]

On 26 May 2010, the Board of Directors of the Philippine Stock Exchange, Inc. (Exchange) passed Resolution No.91, Series of 2010, approving the spin-off of its Market Regulation Division into a separate and independent corporation. Thereafter, in March 2011, the Capital Markets Integrity Corporation (CMIC) was officially incorporated.

On 3 February 2012, CMIC was granted by the Securities and Exchange Commission (Commission) its self-regulatory organization status. CMIC was finally operational on 12 March 2012. Since then, CMIC has become the primary regulator of the Trading Participants (TPs) of the Exchange.

CMIC's Role

CMIC was established for the primary purpose of reinforcing the confidence of the investing public in capital market institutions and promoting a more active and vibrant market participation. Accordingly, CMIC acts as the independent audit, surveillance, and compliance arm of the Exchange.

As a self-regulatory organization, CMIC's primary mandate is to maintain the integrity of the market and minimize the risk of the investing public by ensuring that the TPs adhere to all pertinent rules, regulations, and code of conduct of CMIC and the Exchange, as well as all related legislative and regulatory requirements. Tasked with regulating and monitoring the activities of market participants, CMIC enforces rules, guidelines, and provisions of the Securities Regulation Code, or the SRC, and other securities laws applicable to the operations and dealings of the TPs, including, in particular cases, Issuers whose securities are listed in the Exchange. Under the CMIC Rules, which took effect in March 2012, CMIC, among other matters, enforces compliance by TPs - and, in the proper cases, by Issuers - with the securities laws.

Accordingly, CMIC has the jurisdiction to investigate and resolve all violations of the securities laws and/or the CMIC Rules by Trading Participants and trading-related irregularities and unusual trading activities involving Issuers based on any of the following: a) written complaints filed directly with CMIC by customers, Trading Participants, or any aggrieved party

[46] http://www.cmic.com.ph/main/home.html

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for alleged violation of the securities laws or the CMIC Rules; b) examination findings of CMIC based on regular annual examinations or of cause examinations of Trading Participants; c) reports of trading-related irregularities or unusual trading activities; and d) matters which CMIC has determined should be investigated and resolved to enforce the securities laws and the CMIC Rules, including matters referred to CMIC by the Securities and Exchange Commission, or a duly registered and Exchange-designated clearing agency, and the Exchange's Disclosure Department.

Exchange-designated clearing agency or the Exchange's Disclosure Department. Thus, CMIC decides in the first instance all the foregoing matters, following the procedures set forth in the CMIC Rules.

CMIC carries its functions through its three departments – the Audit and Compliance Department, the Surveillance Department, and the Investigation and Enforcement Department.

H. The IOSCO Rules on Regulations of the Securities Market

The International Organization of Securities Commissions or IOSCO is the international body of Securities Commissions of different national jurisdictions which have voluntarily organized themselves to deliberate, formulate and enforce a wide range of guiding principles and rules to establish some uniformity in their exercise and implementation of their regulatory functions.

In May 2017, IOSCO published its "Objectives and Principles of Securities Regulation," setting out 38 Principles of securities regulation, which are based upon the Objectives of securities regulation:

1. Protecting investors
2. Ensuring that markets are fair, efficient and transparent
3. Reducing systemic risk

These 38 Principles, grouped into 10 Categories, are to be practically implemented under the relevant legal framework of each IOSCO member. The 10 Categories of Principles are:

1. Principles Relating to the Regulator
2. Principles for Self-Regulation
3. Principles for the Enforcement of Securities Regulation
4. Principles for Cooperation in Regulation
5. Principles for Issuers
6. Principles for Auditors, Credit Rating Agencies, and other information service providers
7. Principles for Collective Investment Schemes
8. Principles for Market Intermediaries
9. Principles for Secondary and Other Markets
10. Principles Relating to Clearing and Settlement

This enumeration demonstrates the comprehensiveness of the covered topics and practices which characterize the securities markets, and the seriousness of the efforts of collaboration among securities regulators worldwide—all for the good order of both domestic and international markets.

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The IOSCO has a Multilateral Memorandum of Understanding (MMOU) designed to ensure compliance with and enforcement of their securities and derivatives laws and regulations, expanding cooperation among IOSCO members and providing the fullest mutual assistance possible to facilitate the performance of their respective functions in the exchange of information.[47]

The Philippine Securities and Exchange Commission did its formal signing on February 6, 2007, to be listed in Appendix B (8 signatories) of the IOSCO MMOU. This means our Philippine SEC has committed to seeking the legal authority necessary to enable it to become a full signatory to the IOSCO MMOU (Appendix A). For our SEC, cooperation in accordance with the standards set out in the IOSCO MMOU will begin on the date of its signing to Appendix A (124 signatories).

I. Key Take-Aways

1. The regulation of securities markets and their participants is a consequence of the need to "protect investors, ensure full and fair disclosure about securities, minimize if not totally eliminate insider trading and other fraudulent or manipulative devices and practices which create distortions in the free market."[48]

2. Regulation of securities is the responsibility of both the government regulators and self-regulatory organizations (SROs) authorized by the SEC to enforce market discipline in their own ranks.

3. While investor protection is the emphasis at the level of market practice, our aspiration is, and should be, to "establish a socially conscious, free market that regulates itself, encourages the widest participation of ownership in enterprises, enhances the democratization of wealth, promote the development of the capital market."[49]

Part VI. Offenses and Penalties

In this section, we shall deal with the punitive aspects of regulations, which provide for administrative, civil, and criminal liabilities for violations of the SRC or its implementing rules.

A. Commonly Violated Provisions of the SRC and Its 2015 IRR

1. Selling or offering for sale or distribution of unregistered securities in violation of Section 8 of the SRC

Under Section 8 of the SRC, only securities duly registered with the Commission shall be sold or offered for sale or distribution to the public within the Philippines. Public offering is presumed under any of the following:

a. Publication in any newspaper, magazine or printed reading material which is distributed within the Philippines;
b. Presentation in any public commercial place;

[47] May 2012
[48] Section 2, SRC - Declaration of State Policy.
[49] Section 2, SRC.

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c. Advertisement or announcement in radio, television, telephone, electronic communication, information communication technology or any other forms of communications; or
d. Distribution and/or making available flyers, brochures or any offering materials in a public commercial place or to prospective purchasers through the postal system, information communication technology and other means of information distribution.

2. Non-disclosure of information through non-submission/late submission of reportorial requirements in violation of Sections 17, 18,19, 20 and 23 of the SRC

a. Section17 – Annual Report, Quarterly Report, Current Report by registered issuers and public companies;
b. Section 18 – Report by five per centum (5%) holders of equity securities;
c. Section 19 – Report on the declaration of tender-offer;
d. Section 20 – Information Statement; and
e. Section 23 – Report of the transactions of directors and principal stockholders.

3. Market manipulation in violation of Section 24 of the SRC

Market manipulation is a type of market abuse intended to create a false and misleading appearance of active trading where there is deliberate attempt to influence the natural behavior of the market through interference in the free and fair operation of the market.

Examples of manipulative practices or prohibited conduct under Section 24 of the SRC and its implementing rules and regulations are as follows:

a. **Improper Matched Orders -** By entering an order or orders for the purchase or sale of such security with the knowledge that a simultaneous order or orders of substantially the same size, time, and price for the sale or purchase of any such security, has or will be entered by or for the same or different parties.[50]

b. **Painting the Tape -** This means engaging in a series of transactions in securities that are reported to the public to give the impression of activity or price movement in a security.[51]

c. **Marking the Close** - This means buying and selling securities at the close of the market in an effort to alter the closing price of the security.[52]

d. **Hype and Dump** - This manipulative practice involves engaging in buying activity at increasingly higher prices and then selling securities in the market at the higher prices.[53]

e. **Squeezing the Float** - This happens by taking advantage of a shortage of securities in the market by controlling the demand side and exploiting market congestion during such shortage in such a way as to create artificial prices.[54]

[50] Rule 24.1.5.3, 2015 SRC IRR.
[51] Rule 24.1.5.1, 2015 SRC IRR.
[52] Rule 24.2.5.2, 2015 SRC IRR.
[53] Rule 24.1.5.4, 2015 SRC IRR.
[54] Rule 24.1.5.6, 2015 SRC IRR.

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f. **Wash Sale** – This refers to the buying and selling of securities where there is no change in the beneficial ownership of securities.[55]

g. Disseminating false or misleading market information through media, including the internet, or any other means to move the price of a security in a direction that is favorable to a position held or a transaction.[56] An example of this would be giving a press release or a press interview announcing a company's forthcoming unverified wonder medical product or a "rumor" of a profitable joint venture.

4. Fraudulent transactions in violation of Section 26 of the SRC

Fraud is the intentional use of false or misleading information in an attempt to illegally deprive another person or entity of money, property, or legal rights. The act or transaction is fraudulent when it is obtained, done, or involves deception. So, it shall be unlawful for any person, directly or indirectly, in connection with the purchase or sale of any securities to employ any device, scheme, or artifice to defraud.[57] Bloating revenues and profits in financial statements used to sell securities is an obvious example. Knowingly including as assets of a company issuer property not owned by the company, just to add value to the company's worth is another example.

Furthermore, in the case of fraudulent transactions, the SRC Rules enjoin a Broker, Dealer, Associated Person or Salesman, or other person acting in a similar fiduciary capacity, to use the information on securities ownership obtained in some fiduciary capacity, for the purpose of making purchases, sales or exchange in securities.[58] That kind of information should be considered private and confidential.

It is also fraudulent if a person falsely represents that he is a securities intermediary or falsely represents that the SEC has passed upon or approved his financial standing, business, or conduct as a Broker, Dealer; or falsely represents that a security is of a particular type when it is not; or that falsely represents that he is authorized by the registered owner as regards a security to be sold, transferred, pledged, mortgage or encumbrance.

5. Insider trading under Section 27 of the SRC

Insider trading occurs when a person buys or sells a security of the issuer, while in possession of material information with respect to the issuer or the security that is not generally available to the public, and therefore places him at an unfair advantage over "outsiders" who do not have the same "inside" information. The general rule is: "It shall be unlawful for an insider to sell or buy a security of the issuer while in possession of material information with respect to the issuer or the security that is not generally available to the public."[59]

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[55] Rule 24.1.5.5, 2015 SRC IRR.
[56] Rule 24.1.5.7, 2015 SRC IRR.
[57] Section 26, SRC.
[58] Rule 26.2, 2015 SRC IRR.
[59] Section 27.1, SRC.

Insider means:

a. the issuer;
b. a director or officer (or any person performing similar functions) of, or a person controlling the issuer;
c. a person whose relationship or former relationship to the issuer gives or gave him access to material information about the issuer or to security that is not generally available to the public;
d. a government employee, director or officer of an exchange, clearing agency and/or self-regulatory organization who has access to material information about an issue or a security that is not generally available to the public;
e. a person who learns such information by a communication from any foregoing insiders.[60]

Under Section 27.2 of the SRC, an information is considered as "material nonpublic" if:

a. It has not been generally disclosed to the public and would likely affect the market price of the security after being disseminated to the public and the lapse of a reasonable time for the market to absorb the information; or

b. Would be considered by a reasonable person important under the circumstances in determining his course of action whether to buy, sell or hold a security.

PSE Disclosure Rules require that a director or a principal officer of an Issuer must not deal in the Issuer's securities during the period within which a material non-public information is obtained and up to two (2) full trading days after the price sensitive information is disclosed. This is known as the Blackout provision of the Disclosure Rule of the PSE. This should not be confused with insider trading under Section 27 of the SRC. In insider trading, insiders who are in possession of material nonpublic information are prohibited to buy and sell securities prior to disclosure of the material nonpublic information. In blackout provision or simply blackout rule, a director or principal officer (who are insiders) of an issuer are prohibited to buy or sell the issuer's securities after the material information is obtained until two (2) full trading days after disclosure.

6. Acting as Brokers, Dealers Salesman and Associated Person without registration from the Commission in violation of Section 28 of the SRC

7. Use of unregistered Exchange in violation of Section 32 of the SRC.

B. Liabilities and Penalties

For violation of the SRC and related rules, regulations, and orders made thereunder, there are administrative, civil, and criminal liabilities attached. These we shall now address together with the investigative powers of the SEC which helps determine these liabilities.

1. Administrative Liability

An administrative liability arises from a violation of the law where the penalty is in the form of deprivation in the exercise of official function, or denial of the benefits attached

[60] Section 3.8, SRC.

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to such official function. It is administrative because it is related to the violator's administrative function.

Administrative sanctions under Section 54.1 of the SRC:

a. Suspension or revocation of any registration for the offering of securities;
b. A fine of no less than Php10,000.00 nor more than Php1,000,000.00 plus not more than Php2,000.00 for each day of continuing violation;
c. Disqualification for being an officer, member of the Board of Directors, or person performing similar functions of an issuer for violation of Sections 19.2, 20, 24, 26, and 27;
d. A fine of no more than three (3) times the profit gain or loss avoided as a result of the purchase, sale, or communication proscribe by Section 34 of the SRC; and
e. Other penalties within the power of the Commission to impose.

The administrative sanctions enumerated are applicable to the following:

a. Violation of the SRC and its IRR;
b. Failure of the registered broker or dealer or its associated person to reasonably supervise another person subject to supervision who commits any such violation;
c. Making an untrue statement of a material fact or omission to state any material fact required to be stated in a registration statement, in other reports or applications required by law or rules to be filed with the Commission;
d. In the case of the underwriter, failure to conduct with an inquiry with reasonable diligence to insure that the registration statement is accurate and complete; and
e. Refusal to permit lawful examination into the affairs of any person.

Aside from those provided under Section 54.1 of the SRC, other administrative sanctions under the SRC includes the following:

a. Rejection and revocation of registration of securities under Section 13 of the SRC;
b. Suspension of registration under Section 15 of the SRC;
c. Revocation, refusal or suspension of registration of brokers, dealers, salesman and associated persons under Section 29 of the SRC; and
d. Suspension or revocation of registration of SRO under Section 40.5(a) of the SRC.

2. Civil Liabilities

The SRC identifies civil liabilities arising from –

- False Registration Statements;[61]
- Violation in connection with Prospectus Communication and Reports;[62]
- Fraud in connection with Securities Transactions;[63]
- Manipulation of Security Prices;[64] and
- Insider Trading[65]

[61] Section 56, SRC.
[62] Section 57, SRC.
[63] Section 58, SRC.
[64] Section 59, SRC.
[65] Section 61, SRC.

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3. Criminal Liabilities (Investigation, Injunction, Prosecution of Offenses)

The SRC gives ample power to the SEC to investigate possible violations of the SRC and its implementing rules and regulation. Section 53.1 of the SRC provides that, "The Commission, may in its discretion, make such investigations as it deems necessary to determine whether any person has violated or is about to violate" among, others, any provision of the SRC or related rules and regulation.

To aid in its investigative powers, the SEC may "subpoena witnesses, compel attendance, take evidence, require the production of any book, paper, correspondence, memorandum, or other record which the Commission deems relevant or material to the inquiry."[66]

The SEC may also declare a person guilty of contempt, punishable with a fine if such person "fails or refuses to comply with any lawful order, decision or subpoena issued by the SEC under the cited Sections.[67]

At any stage of the investigation, interim measures may be taken by the Commission through the appropriate department of the Commission in order to protect the interest of the investing public. These interim measures include the following:

1. Issuance of SEC Advisory

   This action is taken in order to inform the public that an entity or a person is engaged in an activity which appears to be in violation of the SRC. The SEC Advisory provides factual information related to the entity or individual and its activities and is issued as a precautionary measure to the public in dealing with the said entity or person.

2. Issuance of Cease and Desist Order

   The Cease and Desist Order is issued by the Commission if it shall appear that any person has engaged or is about to engage in any act or practice constituting a violation of the provision of the SRC or any rule and regulation being implemented by the Commission, among others[68] or if the act or activity/ies if not restrained, will operate as fraud on investors or is likely to cause injury or prejudice to the investing public.[69]

On prosecution of offenses, the SRC however makes clear "all criminal complaints for violations of this Code, and the implementing rules and regulations enforced or administered by the Commission shall be referred to the Department of Justice for preliminary investigation and prosecution before the proper court."[70]

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[66] Section 53.2, SRC.
[67] Section 53.4, SRC.
[68] Section 53.3, SRC.
[69] Section 64.1, SRC.
[70] Section 53.1, SRC.

C. Remedies

1. Judicial Review of SEC Orders

The Operating Departments (CRMD, MSRD, CGFD and EIPD) of the SEC may conduct an investigation for possible violation of the SRC and its implementing rules and regulations against any person under its jurisdiction. Decisions rendered by the operating department are appealable to the Commission En Banc.

Any person aggrieved by an order of the SEC may appeal the order to the Court of Appeals by petitions for review in accordance with the pertinent provisions of the Rules of Court.[71]

2. Settlement Offers

Notably, the law allows, during an investigation or proceeding under the SRC, the person under investigation or being charged to offer a settlement in writing to the SEC. The SEC may agree to the offer if it is "in the public interest." And this settlement may be accepted without a determination of guilt on the part of the person making the offer.[72]

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[71] Section 70, SRC.
[72] Section 55, SRC.

Topic 2: Corporate Governance (CG)

The purpose of this review topic is to provide the examinee with a logical and sequential guide to learning the core concepts of corporate governance in light of existing mandatory and recommendatory regulations.

It also aims to introduce globally accepted corporate governance practices, thereby encouraging a deeper appreciation of the fundamental values that govern a sustainable and successful business.

Part I. Introduction

A. Corporations and their Basic Principles

A corporation is an artificial being created by operation of law, having the right of succession and the powers, attributes, and properties expressly authorized by law or incidental to its existence.[73]

A corporation shall have perpetual existence unless its articles of incorporation provide otherwise.[74]

"This social and economic function of corporations is further acknowledged in Article XII, Section 6 of the Constitution, which provides that the use of property bears a social function, and all economic agents shall contribute to the common good."

In the traditional sense, corporations are formed as a vehicle to achieve financial gain through the pooling of resources and, subsequently, division of profits. However, over time, corporations have become more involved as partners of the national government in attaining the social and economic development of the nation.

This social and economic function of corporations is further acknowledged in Article XII, Section 6 of the 1987 Constitution, which provides that the use of property bears a social function, and all economic agents shall contribute to the common good. Individuals and private groups, including corporations, cooperatives, and similar collective organizations, shall have the right to own, establish, and operate economic enterprises, subject to the duty of the State to promote distributive justice and to intervene when the common good so demands.

Corporations formed or organized under Republic Act No. 11232, otherwise known as the "Revised Corporation Code of the Philippines" (RCC), may be stock or nonstock corporations. Stock corporations are those which have capital stock divided into shares and are authorized to distribute to the holders of such shares, dividends, or allotments of the surplus profits on the basis of the shares held. All other corporations are non-stock corporations.[75]

[73] Section 2 of Revised Corporation Code of the Philippines (RCC).
[74] Section 11 of the Revised Corporation Code.
[75] Section 3 of the Revised Corporation Code.

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Unless otherwise provided in the law, the board of directors[76] or trustees[77] shall exercise the corporate powers, conduct all business, and control all properties of the corporation. Directors shall be elected for a term of one (1) year from among the holders of stocks registered in the corporation's books, while trustees shall be elected for a term not exceeding three (3) years from among the members of the corporation. Each director and trustee shall hold office until the successor is elected and qualified. A director who ceases to own at least one (1) share of stock or a trustee who ceases to be a member of the corporation shall cease to be such.[78]

The Corporation must submit an Articles of Incorporation containing the name of the corporation, the specific purpose or purposes for which the corporation is being formed, the principal place of business of the corporation, the term for which the corporation is to exist, if the corporation has not elected perpetual existence, and the names, nationalities, and residence addresses of the incorporators and shareholders/members, among others.[79]

In addition, the Corporation must adopt its by-laws, which must indicate the time, place and manner of calling and conducting regular or special meetings of the directors or trustees, and the shareholders or members thereof, the required quorum in meetings of shareholders or members and the manner of voting therein, the modes by which a shareholder, member, director, or trustee may attend meetings and cast their votes, the form for proxies of shareholders and members and the manner of voting them, among others.[80]

1. Doctrine of Limited Liability

The doctrine of limited liability pertains to the separate legal personality of a corporation vis-à-vis the personal liability of the persons composing it.

A corporation is vested by law with a personality separate and distinct from that of the persons composing it, as well as from that of any other legal entity to which it may be related. By virtue of this attribute, a corporation may not, generally, be made to answer for acts or liabilities of its shareholders or those of the legal entities to which it may be connected[81] and the shareholders may only be held liable to the extent of their shareholdings in the corporation. In other words, the debts and obligations incurred by the corporation are its sole liability and not that of its shareholders, directors and officers.

This separate and distinct personality is, however, merely a fiction created by law for convenience and to promote the ends of justice. For this reason, it may not be used or invoked for ends subversive of the policy and purpose behind its creation or which could not have been intended by law to which it owes its being. This is particularly true where the fiction is used to defeat public convenience, justify wrong, protect fraud, defend crime, confuse legitimate legal or judicial issues.[82] For instance, if a shareholder decides to hide his/her properties in a corporation to avoid his/her personal liabilities, then the limited liability may be disregarded.

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[76] Refers to Stock Corporations.
[77] Refers to Non-stock Corporations.
[78] Section 22 of the Revised Corporation Code.
[79] Section 13 of the Revised Corporation Code.
[80] Section 46 of the Revised Corporation Code.
[81] Cease v. Court of Appeals, G.R. No. L-33172, 18 October 1979.
[82] *Ibid.*

2. Principal-Agent Relationship

The board of directors or trustees shall exercise the corporate powers, conduct all business, and control all properties of the corporation.[83]

As such, a director of a corporation holds a position of trust and owes loyalty to his/her corporation. This fiduciary duty of a director to the corporation creates a principal-agent relationship between them. This trust relationship springs from the fact that directors have the control and guidance of corporate affairs and property and hence of the property interests of the shareholders.[84] The same concept is also true on the part of management who is entrusted to carry out the day-to-day affairs of the corporation.

In case the director's interests conflict with that of the corporation, he cannot sacrifice the latter to his/her own advantage and benefit. Conflict of interest is a situation whereby two or more of the interests held by, or entrusted to, a single person or party are considered incompatible such that the pursuit of one interest can or may cause harm to the other.

To manage conflict of interest situations arising out of or in connection with this principal-agent relationship, the Revised Corporation Code provides several safeguards. One such provision states that where a director, by virtue of such office, acquires a business opportunity which should belong to the corporation, thereby obtaining profits to the prejudice of such corporation, the director must account for and refund to the latter all such profits, unless the act has been ratified by a vote of the shareholders owning or representing at least two-thirds (2/3) of the outstanding capital stock. This provision shall be applicable, notwithstanding the fact that the director risked one's own funds in the venture.[85] In addition, a director, trustee or officer shall not attempt to acquire, or acquire any interest adverse to the corporation in respect of any matter which has been reposed in them in confidence, and upon which, equity imposes a disability upon themselves to deal in their own behalf; otherwise, the said director, trustee or officer shall be liable as a trustee for the corporation and must account for the profits which otherwise would have accrued to the corporation.[86]

3. Trust Fund Doctrine

The trust fund doctrine is an established principle in commercial law which provides for the rule that the property of a corporation is considered as a fund held in trust for the creditors. Hence, subscriptions to the capital of the corporation constitute a fund to which creditors have a right to look for satisfaction of their claims.[87]

As agents of the corporation, the directors are entrusted with the duty to ensure that the funds and property of the corporation are managed prudently primarily for the benefit of corporate creditors and secondarily, the shareholders who are only entitled to the residual assets of the corporation.

[83] Section 22 of the Revised Corporation Code.
[84] Prime White Cement Corporation v. Court of Appeals, G.R. No. L-68555, 19 March 1993.
[85] Section 33 of the Revised Corporation Code.
[86] Section 30 of the Revised Corporation Code.
[87] Velasco v. Poizat, 37 Phil. 802.

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B. Definition of Corporate Governance

Corporate governance is the system of stewardship and control to guide corporations in fulfilling their long-term economic, moral, legal and social obligations to act as economic agents in the promotion of common good and distributive justice towards their stakeholders[88], including, but not limited to, customers, employees, suppliers, shareholders, investors, creditors, the community the company operates in, society, the government, regulators, competitors, external auditors, etc.

It is a system of direction, feedback and control using regulations, performance standards and ethical guidelines to hold the Board and senior management accountable for ensuring ethical behavior – reconciling long-term customer satisfaction with shareholder value – to the benefit of all stakeholders and society.[89]

Its purpose is to maximize the organization's long-term success, creating sustainable value for its shareholders, stakeholders, and the nation through the adoption of recommended best practices in areas such as board composition and independence, stakeholder engagement, audit and internal control, business ethics and transparency, among others.

C. Importance of Corporate Governance

The existing Codes of Corporate Governance in the country are intended to raise the corporate governance standards of Philippine corporations to a level at par or eventually surpassing its regional and global counterparts.

Putting in place a strong culture of accountability in companies would help to create an environment of trust, transparency and inclusiveness that is necessary for the long-term success and sustainability of corporations. A review of major financial crises in recent times reveals the absence of control mechanisms in the decision-making process at the executive level, particularly the lack of transparency in corporate dealings and the lack of accountability of directors and key officers.

In addition, recent years have shown an increase in institutional investors' clamor for the adoption of good corporate governance practices, particularly in the areas of economic, environmental, and social best practices.

One area of interest in corporate governance is board effectiveness. In the aftermath of the global financial crisis and numerous corporate scandals, a director now confronts not only complex oversight accountability, but also personal risk and liability.[90]

Classic dysfunctional examples include organizations where the company founder dominates board discussions and stifles all attempts to change and modernize the company or alter the composition of the board (i.e., poor team dynamics). In other cases, highly compensated boards literally run a company into the ground by churning through CEO after CEO (lack of strategic alignment). Other weak-performing boards focus on recruiting "big-name" directors — typically high-profile CEOs — who are simply too distracted by operational and financial issues facing their own companies to make any significant contribution (poor board

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[88] Code of Corporate Governance for Publicly-listed Companies (CG Code for PLCs).
[89] *Ibid.*
[90] Dutra, Ana, *A More Effective Board of Directors*, 5 November 2012, Harvard Business Review, https://hbr.org/2012/11/a-more-effective-board-of-dire, last accessed: 10 September 2020.

composition).[91] Good corporate governance best practices aim to manage, if not eradicate, these so-called "disrupters."

Finally, a study conducted by the Asian Development Bank entitled "Corporate Governance, Firm Profitability, and Share Valuation in the Philippines" showed that there is a positive and statistically significant relationship between: (i) corporate governance and market capitalization; (ii) corporate governance and market valuation; and (iii) corporate governance and profitability as measured by return on equity. These results indicate that publicly-listed companies that have given importance to the practice of good corporate governance are positively rewarded by the market, and they prove that costs attributed to good corporate governance practices eventually result in financial gains on the part of PLCs.

DISRUPTERS

In a study conducted by Harvard Business Review, they found five elements — "disrupters" — that tend to hinder the progression of boards toward self-actualization and high performance:

Lack of clarity on the roles of individual directors and the board as a whole. Role ambiguity slows decision-making and causes unnecessary director conflicts.

Poor process management hinders effective board preparation, meeting management, and communications. This results in indecisiveness and a lack of urgency on critical challenges facing the organization.

Lack of alignment and agreement on company strategy causes disinterest among board members, who then simply default to tackling regulatory and compliance issues. Poor strategic alignment also hampers a board's ability to prioritize issues and set their near-term agendas. This often causes board disruption and sends damaging signals to financial markets.

Poor team dynamics fracture boards and lead to power struggles. Like any effective working group, a board should be comprised of professional peers who respect and work well with each other.

Board composition is a serious impediment, if not done right. Today's challenges require new perspectives and skills. But boards often lack the ability to objectively evaluate their makeup to determine if they have the right people and skills at the table.

D. Four Core Principles of Corporate Governance

Adding long-term value to a corporation is the ultimate goal of good corporate governance. The following core principles shall serve as guidance for corporations in the formulation of their policies and reforms relating to increased investor confidence, development of capital market, and sustainable growth:

1. **Fairness.** This means that all shareholders of the same class should be treated equally and without discrimination. All shareholders and stakeholders should receive equal consideration by the directors and management with a sense of justice and avoidance of bias or vested interests. As provided in the Revised Corporation Code, each share shall be equal in all respects to every other share, except as otherwise provided in the Articles of Incorporation and in the Certificate of Stock.

   For instance, the share of stock corporations may be divided into classes or series of shares, or both. In this case, no share may be deprived of voting rights except those classified and issued as "preferred" or "redeemable" shares pursuant to the Revised Corporation Code.[92]

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[91] *Ibid.*
[92] Section 6 of the Revised Corporation Code.

2. **Responsibility**. This refers to the obligation of the Board to carry out their duties with honesty, probity, and integrity. The Revised Corporation Code gives the Board of Directors the authority to exercise corporate powers, conduct all business, and control all properties of the corporations, in other words, to act on behalf of the company. As such, directors shall have full responsibility for the exercise of their powers and authority.

   For instance, the Board of Directors is responsible for overseeing the development of the company's business objectives and strategy and monitoring its implementation in order to sustain the company's long-term viability and strength.[93] They are also responsible for overseeing the management of the business and the selection or appointment of the Management led by the Chief Executive Officer (CEO) and control functions led by their respective heads (Chief Risk Officer, Chief Compliance Officer, and Chief Audit Executive).[94]

   In doing so, they are required to act in good faith, with due diligence and care, and in the best interest of the company and all shareholders.

3. **Accountability.** This refers to the obligation of the Board to the shareholders to give an explanation and answer for the company's actions and conduct. Directors should be held accountable for their decisions and submit themselves to shareholders' and stakeholders' scrutiny.

   For instance, during the company's Annual Stockholders' Meeting, all directors must be present. They are expected not only to provide or present to the shareholders a balanced and understandable assessment of the company's financial position, financial performance as well as its prospects and/or future plans, but most importantly, they must be willing and eager to respond to the questions posed by the shareholders on relevant matters discussed in the meeting.

4. **Transparency.** This refers to the openness or willingness of the Board to provide clear information or reason to the shareholders and other key stakeholders why every material decision was made. It is a fundamental principle of good governance that shareholders and other key stakeholders should be timely and accurately informed about the company's activities, future business undertakings, and any risks involved in its business strategies.

   For instance, transparency may refer to the openness and willingness to disclose financial reports and other corporate records which are truthful and accurate.

E. Compliance Regimes

The corporate governance regulations in the Philippines are a mix of mandatory and recommendatory compliance regimes. The applicability of these regimes depends on the classification of covered corporations.

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[93] 2.2
[94] 2.8

1. **Mandatory**

The Revised Code of Corporate Governance (RCCG)[95] governs the corporate governance practices and regulatory compliance of the registered corporations and branches or subsidiaries of foreign corporations operating in the Philippines that are grantees of secondary licenses from the Commission (Secondary Licensees), such as broker-dealers, securities depository, investment house, clearing agency, among others. Secondary Licensees that are also publicly listed companies (PLCs), Registered Issuers (RIs), and Public Companies (PCs) shall be governed by the immediately succeeding section.

2. **Recommendatory**

In recognition of the critical role of PLCs, RIs, and PCs in the country's commercial and economic growth, these companies were encouraged to adhere to more stringent principles and recommendations built upon internationally recognized best practices such as the G20/OECD Principles of Corporate Governance, and the Association of Southeast Asian Nations (ASEAN) Corporate Governance Scorecard. However, the SEC acknowledges that the move towards adopting international best practices is a long process and that these companies would have varying levels of preparedness in this transition.

In this regard, a series of Corporate Governance Codes were enacted by the SEC. The Code of Corporate Governance for PLCs was enacted through SEC Memorandum Circular (MC) No. 19, Series of 2016, and covers all corporate governance practices of companies listed in the Philippine Stock Exchange (PSE).

On the other hand, the Code of Corporate Governance for PCs and RIs was enacted through SEC MC No. 24, Series of 2019, and covers all corporate governance practices of public companies[96] and registered issuers[97] that are not listed in the PSE. Both of these regulations are recommendatory in nature and compliance with the recommendations thereon was made on a "comply or explain" approach.

<u>"Comply or Explain" Approach</u>

This approach combines voluntary compliance with mandatory disclosure. Covered companies are not required to comply with all the recommendations of the applicable CG Codes, but they must state in their annual corporate governance reports whether they comply with the Code provisions, identify any areas of non-compliance, and explain the reasons for non-compliance.

In case of non-compliance, the covered company must explain how the overall principle is being achieved by the company through existing or alternative practices. A sample disclosure in the annual corporate governance report is illustrated in the table below:

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[95] SEC Memorandum Circular No. 6, Series of 2009.
[96] Public company - a company with assets of at least Fifty Million Pesos (Php50,000,000.00) and having two hundred (200) or more shareholders holding at least one hundred (100) shares each of equity securities.
[97] Registered Issuer - a company that: (1) issues proprietary and/or non-proprietary shares/certificates; (2) sells its equity securities to the public that are not listed; or (3) sells debt securities to the public that are required to be registered to the SEC.

ANNUAL CORPORATE GOVERNANCE REPORT			
Recommendation 3.4			
	Compliant/ Non-Compliant	Additional Information (to support compliance)	Explanation for non-compliance
1. Board establishes a separate Board Risk Oversight Committee (BROC) that should be responsible for the oversight of a company's Enterprise Risk Management system to ensure its functionality and effectiveness.	Non-compliant		The Company is exposed to minimal to no risk, therefore, the establishment of a BROC is impractical and unnecessary.
Recommendation 3.5			
1. Board establishes a Related Party Transactions (RPT) Committee, which is tasked with reviewing all material related party transactions of the company.	Compliant	Additional information may be found in the company website: www.plc.com.ph/MCG	

Principle of Proportionality

The principle of proportionality is one of the underlying principles behind the adoption of the "comply or explain" approach.

It must be noted that the CG Codes do not prescribe a "one size fits all" framework. It recognizes certain considerations in the application of corporate governance standards as may be fit and beneficial to companies, taking into account the peculiar nature of their business and operations.

Thus, in applying the principle of proportionality, boards or companies are allowed flexibility in establishing their corporate governance policies. The policies should take into consideration the size and risk profile of the company, among others, and ensure proportionality. Larger companies and financial institutions would generally be expected to follow most of the Code's provisions. Smaller companies may decide that the costs of some of the provisions outweigh the benefits, or are less relevant in their case.

For instance, the establishment of a Board Risk Oversight Committee is particularly recommended for conglomerates, issuers of debt securities and for companies with a

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high-risk profile.[98] While the establishment of the Related Party Transactions Committee is highly recommended for conglomerates and universal/commercial banks.[99]

On the other hand, smaller and low-risk companies may opt not to establish a separate Board Risk Oversight Committee and/or Related Party Transactions Committee. In such cases, the Audit Committee shall perform the functions of said committees.[100]

F. Corporate Governance Framework/Standards

OECD Principle

The G20/OECD Principles of Corporate Governance[101], as the leading international standard for corporate governance, aims to help policymakers and regulators evaluate and improve legal, regulatory, and institutional frameworks for corporate governance, with a view to supporting market confidence and integrity, economic efficiency, sustainable growth, and financial stability. The Principles identify the building blocks for a sound corporate governance framework and offer practical guidance for implementation at a national level. These Principles are aligned with the four core corporate governance principles, namely, fairness, responsibility, accountability, and transparency.

ASEAN Corporate Governance Scorecard

The ASEAN Corporate Governance Scorecard is an initiative of the ASEAN Capital Markets Forum (ACMF) and is a tool to assess the level of compliance of PLCs in the ASEAN region with globally accepted corporate governance practices and is based on publicly available information. Six ASEAN countries participate in this initiative, namely: Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

G. Legal Bases to Issue Corporate Governance Rules

Section 179 (d) of the Revised Corporation Code empowers the Securities and Exchange Commission (SEC) to enact corporate governance rules and regulations consistent with best practices, thus:

SEC. 179. Powers, Functions, and Jurisdiction of the Commission. – The Commission shall have the power and authority to:

xxx xxx xxx

(d) Promote corporate governance and the protection of minority investors, through, among others, the issuance of rules and regulations consistent with international best practices.

Further, Section 5 (b) of the Securities Regulation Code authorizes the SEC to "formulate policies and recommendations on issues concerning the securities market, advise Congress and other government agencies on all aspects of the securities market and propose legislation and amendments thereto."

[98] Recommendation 3.4 of the CG Code for PLCs and the CG Code for PCs and RIs.
[99] Recommendation 3.5 of the CG Code for PLCs.
[100] Recommendation 3.2 of the CG Code for PLCs and the CG Code for PCs and RIs.
[101] Revised on 8 June 2023

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Finally, Sections 2(d) and 3 of the Office of the President Administrative Order No. 38 empowers concerned agencies, including the SEC, to implement various Ease of Doing Business reform initiatives aimed at improving the ranking of the Philippines in the Doing Business Survey.

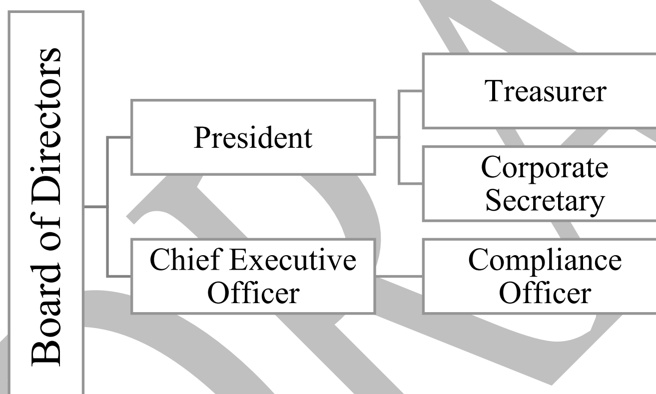
Part II. Areas of Corporate Governance

A. Board's Governance Responsibilities

1. Establishing a Competent Board

The company should be headed by a competent, working board to foster the long-term success of the corporation, and to sustain its competitiveness and profitability in a manner consistent with its corporate objectives and the long-term best interests of its shareholders and other stakeholders.[102]

As such, the CG Codes recommend that the Board must be headed by a competent and qualified Chairperson[103] and is composed of a majority of non-executive directors[104] with an individual and collective working knowledge, experience or expertise that is relevant to the company's industry/sector.[105] Under both regulations, the directors must remain qualified for their positions individually and collectively.



For corporations covered by the RCCG, the Board shall be composed of at least five (5), but not more than fifteen (15), directors who are elected by the shareholders. The membership of the Board may be a combination of executive and non-executive directors in order that no director or small group of directors can dominate the decision-making process. A non-executive director is a director who has no executive responsibility and does not perform any work related to the operations of the corporation.[106] They should possess such qualifications and stature that would enable them to effectively participate in the deliberations of the Board.[107]

Finally, the board should be assisted in its duties by the corporate officers of the company, including, but not limited to, the corporation's president, treasurer, corporate secretary, compliance officer and other corporate officers as may be identified in the corporation's by-laws, such as, but not limited to, the Chief Executive Officer (CEO), Chief Operations Officer, and Chief Financial Officer.

[102] Principle 1 of the CG Code for PLCs and the CG Code for PCs and RIs..
[103] Recommendation 2.3 of the CG Code for PLCs and Recommendation 1.2 of the CG Code for PCs and RIs.
[104] Recommendation 1.2 of the CG Code for PLCs and Recommendation 5.1 of the CG Code for PCs and RIs.
[105] Recommendation 1.1 of the CG Code for PLCs.
[106] CG Code for PLCs.
[107] Article 3 (A) of the RCCG.

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Corporate Secretary and Compliance Officer

A Corporate Secretary, who must be a citizen and resident of the Philippines[108] is the corporate officer responsible for the safekeeping and preservation of the integrity of the minutes of the meetings of the Board and its committees, as well as the other official records of the corporation.[109] He must have a working knowledge of the operations of the corporation and inform the directors, in accordance with the by-laws, of the agenda of their meetings and ensure that the members have before them accurate information that will enable them to arrive at intelligent decisions on matters that require their approval.

On the other hand, the Compliance Officer is the corporate officer tasked to monitor compliance by the corporation with the rules and regulations of regulatory agencies and, if any violations are found, report the matter to the Board and recommend the imposition of appropriate disciplinary action on the responsible parties and the adoption of measures to prevent a repetition of the violation.[110]

Under the CG Codes, it is recommended that the Corporate Secretary and Compliance Officer should be separate individuals.[111] Additionally, both should not be members of the Board of Directors and should annually attend a training on corporate governance.[112]

Training of Directors

It is further recommended that the orientation program for first-time directors be for at least eight hours, while the annual continuing training be for at least four hours.

Under the CG Codes, it is recommended that the company should provide in its Board Charter and Manual on Corporate Governance a policy on the training of directors, including an orientation program for first-time directors and relevant annual continuing training for all directors.[113]

The orientation program for first-time directors and relevant annual continuing training for all directors aim to promote effective board performance and continuing qualification of the directors in carrying out their duties and responsibilities. It is further recommended that the orientation program for first-time directors be for at least eight hours, while the annual continuing training be for at least four hours.

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[108] Section 24 of the Revised Corporation Code .
[109] Article 3 (L) of the RCCG.
[110] Article 3 (M) of the RCCG.
[111] Recommendation 1.5 of the CG Code for PLCs and CG Code for PCs and RIs.
[112] Recommendations 1.5 and 1.6 of the CG Code for PLCs and CG Code for PCs and RIs.
[113] Recommendation 1.3 of the CG Code for PLCs and CG Code for PCs and RIs.

Board Diversity

In recent years, there has been an increasing global demand for board diversity. A corporation's board diversity policy ensures that the board is composed of individuals of different gender, background, age, skills, competence, knowledge or experience, among others. Having a board diversity policy is a move to avoid groupthink and ensures that optimal decision-making is achieved.[114] Groupthink is a mode of thinking in which individual members of small cohesive groups tend to accept a viewpoint or conclusion that represents a perceived group consensus, whether or not the group members believe it to be valid, correct, or optimal. Groupthink reduces the efficiency of collective problem-solving within such groups.[115]

GENDER DIVERSITY IN BUSINESS

In the Philippines, the survey was conducted with 389 enterprises of different sizes and sectors. More than eight out of ten enterprises in the Philippines recognize the positive impacts of gender diversity on business. About 84 per cent of the Filipino companies polled say gender diversity has brought several benefits to their businesses.
Source: Leading to Success: the business case for women in business and management in the Philippines (https://www.ilo.org/manila/publications/WCMS_755607/lang--en/index.htm)

2. Establishing Clear Roles and Responsibilities of the Board

The fiduciary duty of board members can be broken down into two main components: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. The duty of loyalty is also of central importance; the board member should act in the interest of the company and all its shareholders and not those of the controlling company of the group or any other stakeholder.

Consistent with these fiduciary duties, the CG Code for PLCs provided that the Board of Directors shall have the following roles and responsibilities[116]:

a. To act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and all shareholders/members;
b. To oversee the development of and approve the company's business objectives and strategy, and monitor their implementation, in order to sustain the company's long-term viability and strength;
c. To ensure and adopt an effective succession planning program for directors, key officers and management;
d. To align the remuneration of key officers and directors with the long-term interests of the company/organization;
e. To develop a policy on board nomination and election;
f. To ensure proper implementation of the policy and system governing related party transactions (RPTs) and other unusual or infrequently occurring transactions;
g. Responsible for approving the selection and assessing the performance of the Management led by the Chief Executive Officer (CEO) or his/her equivalent, and control functions led by their respective heads (Chief Risk Officer, Chief Compliance Officer, and Chief Audit Executive, as applicable);
h. To establish an effective performance management framework;

[114] Recommendation 1.4 of the CG Code for PLCs and CG Code for PCs and RIs.
[115] Recommendation 1.4 of the CG Code for PCs and RIs.
[116] Principle 2 of the CG Code for PLCs and CG Code for PCs and RIs.

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i. To oversee that an appropriate internal control system is in place; and
j. To oversee that a sound enterprise risk management (ERM) framework is in place.

Board Charter

The Board Charter is a document that clearly defines the power, authority, roles, and accountabilities of the directors in carrying out their fiduciary duties. It should serve as a guide to the directors in the performance of their functions and should be publicly available and posted on the company's website.

3. Establishing Board Committees

The Board should establish board committees that focus on specific functions to aid in the optimal performance of the board's roles and responsibilities.[117] Board Committees are sub-committees organized by the Board of Directors to assist the latter in its performance and oversight of specific functions, i.e. audit, nomination and election, compensation, risk management, corporate governance and related party transactions, among others.

In this regard, it is recommended that each board committee should have a board committee charter which clearly defines the power, authority, roles and accountabilities of each committee.

Types of Board Committees

a. **Audit Committee**

The establishment of an Audit Committee is **MANDATORY for all PLCs and Secondary Licensees.**[118]

The Audit Committee enhances the Board's oversight capability over the company's financial reporting, internal control system, internal and external audit processes, and compliance with applicable laws and regulations.[119]

All members of the Audit Committee must be directors[120] and must have relevant background, knowledge, skills, and/or experience in the areas of accounting, auditing and finance. [121]

It is further recommended that the Committee be composed of at least three (3) appropriately qualified non-executive directors. The majority of the members of the Committee, including the Committee Chairperson, should be independent directors.[122] Finally, it is recommended that the Chairperson of the Audit Committee should not be the chairman of the Board or of any other committees.[123]

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[117] Recommendation 3.1 of the CG Code for PLCs and CG Code for PCs and RIs.
[118] Article 3 (K)(i) of the RCCG and SEC Memorandum Circular No. 8, Series of 2018.
[119] Recommendation 3.2 of the CG Code for PLCs.
[120] SEC Memorandum Circular No. 8, Series of 2018.
[121] Recommendation 3.2 of the CG Code for PLCs.
[122] *Ibid.*
[123] *Ibid.*

b. **Nomination Committee**[124]

The establishment of a Nomination Committee is MANDATORY for all PLCs, PCs, RIs, and Secondary Licensees.[125]

The Nomination Committee shall have at least three (3) members, one of whom should be an independent director. It shall promulgate the guidelines or criteria to govern the conduct of the nomination.[126] It shall review and evaluate the qualifications of all persons nominated to the Board and other appointments that require Board approval, and assess the effectiveness of the Board's processes and procedures in the election or replacement of directors.

c. **Compensation or Remuneration Committee**[127]

A Compensation or Remuneration Committee may be composed of at least three (3) members, one of whom should be an independent director. It shall establish a formal and transparent procedure for developing a policy on remuneration of directors and officers to ensure that their compensation is consistent with the corporation's culture, strategy and the business environment in which it operates.

d. **Corporate Governance Committee**

The Corporate Governance Committee assists the Board in the performance of its corporate governance responsibilities, including the functions assigned to Nomination and Remuneration Committees,[128] if the Board opts not to have said Committees.

For PLCs, the Corporate Governance Committee should be composed of at least three directors, all of whom should be independent directors, including the Committee Chairperson.[129]

For PCs and RIs, the Corporate Governance Committee should be composed of at least three directors, majority of whom should be independent directors, including the Committee Chairperson.[130]

e. **Board Risk Oversight Committee**

The Board Risk Oversight Committee oversees the proper implementation of the company's Enterprise Risk Management (ERM) system.[131]

ERM is a process, effected by the corporation's Board of Directors, management and other personnel, applied during strategy setting and across the enterprise that is designed to identify potential events that may affect the corporation, manage risks to

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[124] Article 3 (K)(ii) of the RCCG.
[125] Rule 38.8.1 of the SRC IRR.
[126] *Ibid.*
[127] *Ibid.*
[128] Recommendation 3.3 of the CG Code for PLCs.
[129] *Ibid.*
[130] Recommendation 3.3 of the CG Code for PCs and RIs.
[131] Recommendation 3.4 of the CG Code for PLCs and CG Code for PCs and RIs.

be within its risk appetite, and provide a reasonable assurance regarding the achievement of the corporation's objectives.[132]

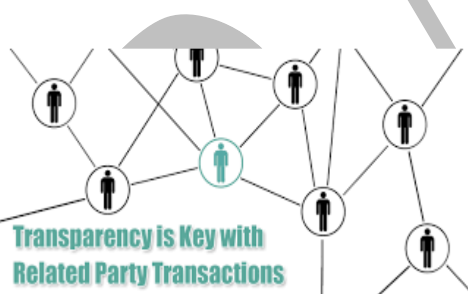
ERM is integral to an effective corporate governance process and the achievement of a company's value creation objectives. With an integrated ERM approach, the Board and top management will be in a position to make well-informed decisions, having taken into consideration risks related to significant business activities, plans and opportunities.

The Committee should be composed of at least three (3) directors, the majority of whom should be independent directors, including the Committee Chairperson . At least one member of the committee must have relevant thorough knowledge and experience on risk and risk management.[133]

The establishment of a Board Risk Oversight Committee is particularly recommended for conglomerates, issuers of debt securities and for companies with a high-risk profile.

f. **Related Party Transactions (RPT) Committee**[134]

The RPT Committee reviews all material related party transactions of the company. A related party transaction is defined as a transfer of resources, services or obligations between a reporting PLC and a related party, regardless of whether a price is charged. It should be interpreted broadly to include not only transactions that are entered into with related parties, but also outstanding transactions that are entered into with an unrelated party that subsequently becomes a related party.[135]



Additionally, a material related party transaction is defined as any related party transaction, either individually, or in aggregate over a twelve (12)-month period with the same related party, amounting to ten percent (10%) or higher of a company's total assets based on its latest audited financial statement.[136]

The Related Party Transactions Committee should be composed of at least three (3) non-executive directors, two (2) of whom should be independent directors, including the Chairperson.[137] The establishment of the committee is particularly recommended for conglomerates and universal/commercial banks.

4. Fostering Commitment

To show full commitment to the company, the directors should devote the time and attention necessary to properly and effectively perform their duties and responsibilities, including sufficient time to be familiar with the corporation's business.

[132] Committee of Sponsoring Organizations of the Treadway Commission (COSO Framework).
[133] Recommendation 3.4 of the CG Code for PLCs and CG Code for PCs and RIs.
[134] Recommendation 3.5 of the CG Code for PLCs.
[135] CG Code for PLCs and CG Code for PCs and RIs.
[136] SEC Memorandum Circular No. 10, Series of 2019.
[137] Recommendation 3.5 of the CG Code for PLCs.

Directors should attend and actively participate in all board meetings, committee meetings and shareholders' meetings, except for justifiable causes, such as, but not limited to, illness, death in the immediate family, serious accident or other unforeseen or fortuitous events.

In addition, directors should review meeting materials and if called for, ask the necessary questions and seek clarifications and explanations.

Attendance Record of Directors

The company should include in its Annual Corporate Governance Report the attendance record of the company's directors for the previous year.

The absence of a director in more than fifty percent (50%) of all regular and special meetings of the Board during his/her incumbency is a ground for temporary disqualification of the director in the succeeding election unless the absence is due to illness, death in the immediate family, serious accident or other unforeseen or fortuitous events.[138]

Restrictions in the Number of Directorships

The Board may consider the adoption of guidelines on the number of concurrent directorships that its directors can hold in other stock and non-stock corporations. The optimum number should take into consideration the capacity of a director to diligently and efficiently perform his/her duties and responsibilities.[139]

Covered Company	Maximum recommended number of concurrent directorship in other stock corporations	Exception
Publicly-Listed Companies	Maximum of five (5) PLCs[140]	-
Registered Issuers and Public Companies	Maximum of ten (10) public companies and/or registered issuers.[141]	Maximum of five (5) public companies and/or registered issuers if the director also sits in at least three (3) PLCs.[142]

It is recommended that a director notify the Board where he/she is an incumbent director before accepting a directorship in another company. This is for the company to be able to assess if the director's responsibilities and commitment to the company will be affected, i.e. instances when a concurrent directorship will give rise to potential and actual conflict of interest under the Revised Corporation Code[143], and if the director can still adequately provide what is expected of him/her. [144]

[138] Recommendation 2.6 of the CG Code for PLCs and Recommendation 2.5 of the CG Code for PCs and RIs.
[139] Article 3 (B) of the RCCG.
[140] Recommendation 4.2 of the CG Code for PLCs.
[141] Recommendation 4.2 of the CG Code for PCs and RIs.
[142] *Ibid.*
[143] Sections 30 to 33 of the Revised Corporation Code .
[144] Recommendation 4.3. of the CG Code for PLCs and CG Code for PCs and RIs.

5. Reinforcing Board Independence

The board should endeavor to exercise an objective and independent judgment on all corporate affairs. [145]

In this regard, the Revised Corporation Code mandates that corporations vested with public interest,[146] including registered issuers, public companies, and publicly-listed companies, must have independent directors constituting at least twenty percent (20%) of such board. Secondary Licensees are likewise required to have at least two (2) independent directors or such number of independent directors that constitutes twenty percent (20%) of the members of the Board, whichever is lesser, but in no case less than two (2), pursuant to the RCCG.[147]

However, it is recommended that at least three (3) or one-third (1/3) (whichever is higher) of the board should be independent for PLCs[148], and that at least two (2) or one-third (1/3) (whichever is higher) of the board should be independent for PCs and RIs.[149]

This is in recognition that more independent directors lead to more objective decision-making, particularly in conflict-of-interest situations.

Independent Director

An Independent Director is defined as a person who is independent of management and the controlling shareholder, and is free from any business or other relationship which could, or could reasonably be perceived to, materially interfere with his/her exercise of independent judgment in carrying out his/her responsibilities as a director.[150]

The presence of independent directors on the Board ensures the exercise of independent judgment on corporate affairs and proper oversight of managerial performance, including the prevention of conflict of interests and balancing of competing demands of the corporation. There is increasing global recognition that more independent directors on the Board lead to more objective decision-making, particularly in conflict-of-interest situations. In addition, experts have recognized that there are varying opinions on the optimal number of independent directors on the board. However, the ideal number ranges from one-third to a substantial majority.

Conflict of Interest

A person with manifest material or potential conflict of interest[151] with the company is disqualified to sit as an independent director of said company.

A conflict of interest shall be considered material if the director's personal or business interest is antagonistic to that of the corporation, or stands to acquire or gain financial advantage at the expense of the corporation.[152]

[145] Principle 5 of the CG Code for PLCs and CG Code for PCs and RIs.
[146] Section 22 (a) of the Revised Corporation Code.
[147] Article 3 (A) of the RCCG.
[148] Recommendation 5.1 of the CG Code for PLCs.
[149] Recommendation 5.2 of the CG Code for PCs and RIs.
[150] Section 38.2 of SRC IRR.
[151] Any personal or pecuniary interest in conflict with their duty as such directors.
[152] Article 3 (G) (i) of the RCCG.

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For instance, to avoid conflict of interest, a securities broker-dealer is disqualified to sit as an independent director of PLCs and registered issuers. As a securities intermediary, a securities broker-dealer will be representing two conflicting interests: the interest of the issuer of securities and the interest of the buyer of securities.

"Securities broker-dealer" refers to any person holding any office of trust and responsibility in a broker-dealer firm, which includes, among others, a director, officer, principal shareholder, nominee of the firm to the Exchange, an associated person or salesman, and an authorized clerk of the broker or dealer.[153]

Term Limit for Independent Directors[154]

The independent directors should serve for a maximum cumulative term of nine (9) years. The reckoning of the cumulative nine-year term is from 2012. After which, the independent director should be perpetually barred from re-election as an independent director in the same company, but may continue to qualify for nomination and election as a non-independent director. In the instance that a company wants to retain an independent director who has served for nine (9) years, the Board should provide meritorious justification/s and seek shareholders' approval during the annual shareholders' meeting.

Separation of Functions of the Chairperson of the Board and the Chief Executive Officer[155]

"It is highly recommended that the roles of Chairman and CEO be separated."

The positions of Chairperson of the Board and Chief Executive Officer should be held by separate individuals. In cases where the Chairperson is not independent or where the roles of Chair and CEO are combined, the Board should designate a lead director among the independent directors. The lead director should have sufficient authority to lead the Board.

Putting in place proper mechanisms help foster an appropriate balance of power, increased accountability and better capacity for independent decision-making. More importantly, it avoids the abuse of power and authority and potential conflict of interest.

For instance, one of the main roles of the Chairperson, as head of the Board, is to ensure effective oversight over the company's business operations and to ensure that it is being run in accordance with the mandate of the company. On the other hand, the CEO is primarily responsible for making major corporate decisions and managing the overall operations and resources of a company. Thus, having a combined role results in an absurd situation of having the same person monitor his/her own performance. This opens the door to abuse of both positions and a possible conflict of interest.

Accordingly, the division of responsibilities and accountabilities between the Chairperson and CEO should be clearly defined, delineated, and disclosed in the Board Charter.

[153] SEC Memorandum Circular No. 16, Series of 2006.
[154] Recommendation 5.3 of the CG Code for PLCs, Recommendation 5.4 of the CG Code for PCs and RIs and SEC Memorandum Circular No. 4, Series of 2017.
[155] Recommendations 5.4 and 5.5 of the CG Code for PLCs, Recommendation 5.5 of the CG Code for PCs and RIs and Article 3(c) of the Revised Code of Corporate Governance.

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The CEO has the following roles and responsibilities, among others:

a. Determines the corporation's strategic direction and formulates and implements its strategic plan on the direction of the business;
b. Communicates and implements the corporation's vision, mission, values and overall strategy and promotes any organization or stakeholder change in relation to the same;
c. Oversees the operations of the corporation and manages human and financial resources in accordance with the strategic plan;
d. Has a good working knowledge of the corporation's industry and market and keeps up-to-date with its core business purpose;
e. Directs, evaluates and guides the work of the key officers of the corporation;
f. Manages the corporation's resources prudently and ensures a proper balance of the same;
g. Provides the Board with timely information and interfaces between the Board and the employees;
h. Builds the corporate culture and motivates the employees of the corporation; and
i. Serves as the link between internal operations and external stakeholders.

Under the CG Code for PLCs, the roles and responsibilities of the Chairperson include, among others, the following:[156]

a. Ensures that the Board sufficiently challenges or inquires on reports submitted and representations made by Management;
b. Ensures that the Board effectively performs its oversight role over Management;
c. Makes certain that the meeting agenda focuses on strategic matters, including the overall risk appetite of the corporation, considering the developments in the business and regulatory environments, key governance concerns, and contentious issues that will significantly affect operations;
d. Guarantees that the Board receives accurate, timely, relevant, insightful, concise, and clear information to enable it to make sound decisions;
e. Facilitates discussions on key issues by fostering an environment conducive for constructive debate and leveraging on the skills and expertise of individual directors;
f. Assures the availability of proper orientation for first-time directors and continuing training opportunities for all directors; and
g. Makes sure that performance of the Board is evaluated at least once a year and discussed/followed up on.

Replacement of Citigroup's CEO

One controversial CEO transition was the sudden replacement of Vikram Pandit as the head of Citigroup Inc. in late 2012. The independent members of the board, led by the independent chair, Michael O'Neill, had evidently planned this move over several months and even had their chosen successor, Michael Corbat, ready to step in when the pressure was put on Vikram Pandit to resign. The departure followed a clash between Pandit and the company's Board over strategy and performance at some business.

While this action received much adverse publicity, it demonstrates well the value of splitting the roles of the board chair and CEO. If one person had held both roles, the process would have become considerably more complicated and almost inevitably would have led to a split board – at least for a period.

Source: New York Times and Citigroup public releases (October 2012)

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[156] Recommendation 2.3 of the CG Code for PLCs and Recommendation 1.2 of the CG Code for PCs and RIs.

6. Assessing Board Performance

The Revised Corporation Code requires that at each regular meeting of shareholders or members, the board of directors or trustees shall endeavor to present to shareholders or members the appraisals and performance reports for the board and the criteria and procedure for assessment.[157] It also requires every corporation vested with public interest, domestic or foreign, doing business in the Philippines to submit to the SEC a director or trustee appraisal or performance report and the standards or criteria used to assess each director or trustee.[158]

Moreover, the CG Code for PLCs recommends that every three years, the assessment should be supported by an external facilitator. The use of an external facilitator in the assessment process increases the objectivity of the same. The external facilitator can be any independent third party such as, but not limited to, a consulting firm, academic institution or professional organization.[159]

7. Strengthening Board Ethics[160]

Directors are duty-bound to apply high ethical standards, taking into account the interests of all stakeholders. The ethical standard refers to standard principles that encourage the greater values of fairness, responsibility, accountability, and transparency. For example, an ethical Board is fair and just in all its dealings and does not use underhanded or unlawful means to gain or to take undue advantage at the expense of the corporation and the shareholders. Also, an ethical Board carries out its responsibilities with due diligence and care and takes full accountability for its actions and conduct.

There is no "one size fits all" Code of Business Conduct and Ethics.

Ethical standards may vary from one corporation to another. Thus, it is imperative that the Board of every company adopts its own Code of Business Conduct and Ethics, which would provide standards for professional and ethical behavior for the Board, as well as articulate acceptable and unacceptable conduct and practices in internal and external dealings. Ideally, the Code of Business Conduct and Ethics should set clear limits on the pursuit of private interest, including dealings in the shares of the company, related party transactions, and other dealings that could pose a potential conflict of interest. An overall framework for ethical conduct should always go beyond compliance with the law and must aim to protect the best interest of the company's stakeholders. It is an important tool which may be used to instill an ethical corporate culture throughout the company.

Code of Business Conduct and Ethics should be properly disseminated to the Board, senior management and employees, and should be disclosed or made available to the public through the company website. Moreover, to ensure proper compliance with the Code of Business Conduct and Ethics, the Board should ensure that there are efficient communication channels, which aid and encourage employees, customers, suppliers and creditors to raise concerns on potential unethical/unlawful behavior without fear of retribution. Further, it is the Board's primary duty to make sure that the internal controls are in place to ensure the company's compliance with the Code of Business Conduct and Ethics and its internal policies and procedures.

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[157] Section 49(h) of the Revised Corporation Code.
[158] Section 177 of the Revised Corporation Code.
[159] Recommendation 6.1 of the CG Code for PLCs.
[160] Principle 7 of the CG Code for PLCs and the CG Code for PCs and RIs.

B. Disclosure and Transparency

"A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis."
**OECD (2015)*

Transparency is one of the core principles of corporate governance. To ensure the better protection of shareholders and other stakeholders' rights, full disclosure of the company's corporate governance policies, programs and procedures is imperative.

Moreover, high-quality disclosure and transparency help raise capital and build confidence in the market. It helps secure ethical and professional behavior. In general, they build trust among various stakeholders and thereby facilitate sustainable wealth creation, through strengthening the ability of capital markets to function and to widen participation.

1. Enhance Company Disclosure Policies and Procedures

To enhance the company's disclosure, PLCs, PCs, RIs, and Secondary Licensees are recommended to adopt disclosure policies and procedures and are required to submit to the SEC a Manual on Corporate Governance. In this regard, PLCs are required to submit to the SEC and PSE an Integrated Annual Corporate Governance Report (I-ACGR)[161] while, PCs and RIs are required to submit their Annual Corporate Governance Report (ACGR)[162] to the SEC. On the other hand, Secondary Licensees are required to submit a Certification on the extent of their compliance with the RCCG[163] and a Certification on attendance in board meetings. [164]

a. **Recommended Disclosure Policies and Procedures**[165]

The company should establish corporate disclosure policies and procedures that are practical and in accordance with best practices and regulatory expectations to ensure a comprehensive, accurate, reliable, and timely report to shareholders and other stakeholders. The following, among others, are the recommended disclosure policies and procedures:

1) Disclosure of directors' and officers' dealings in the company's shares within three business days for PLCs[166] and five business days for PCs and RIs[167];
2) Disclosure of all relevant and material information on individual board directors and key executives to evaluate their experience and qualifications;
3) Establish policies and procedures for setting Board and executive remuneration;
4) Establish an RPT Policy;
5) Disclosure of material and significant RPTs reviewed and approved during the year in the I-ACGR/ACGR; and

[161] SEC Memorandum Circular No. 15, Series of 2017.
[162] SEC Memorandum Circular No. 13, Series of 2021.
[163] Article 3 (m) iii of the RCCG.
[164] Article 3 (I) of the RCCG.
[165] Principle 8 of the CG Code for PLCs and the CG Code for PCs and RIs.
[166] Recommendation 8.2 of the CG Code for PLCs.
[167] Recommendation 8.2 of the CG Code for PCs and RIs.

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6) Make a full, fair, accurate and timely disclosure to the public of every material fact or event that occurs, particularly on the acquisition or disposal of significant assets.

b. **Integrated Annual Corporate Governance Report (I-ACGR) / Annual Corporate Governance Report (ACGR)**

The I-ACGR and ACGR are comprehensive reports containing all of the PLCs and PCs/RIs' pertinent corporate governance policies and programs, respectively, as well as information on their level of compliance with globally accepted corporate governance practices. They are also used to facilitate the disclosure of their compliance/non-compliance with the recommendations provided under the CG Code for PLCs and the CG Code for PCs and RIs.

For PLCs, it is called an "Integrated" report as it harmonizes the corporate governance requirements of the SEC and the PSE. The I-ACGR shall cover all relevant information from January to December of the given year and is required to be submitted to the Commission by all PLCs every May 30 of the following year. The I-ACGR with accessible links shall be posted on the company's website within five (5) business days from submission to the SEC.[168]

In the case of PCs and RIs, their ACGRs are required to be submitted on or before June 30 of the following year for every year that the company qualifies as a PC or RI. The ACGR shall cover all relevant information from January to December of the given year, regardless of registration date. The first submission of the ACGR shall cover the period of January – December 2021.

PCs and RIs registered or have qualified as such from July to December of a given year shall be allowed to indicate "newly-registered" in the Explanation portion of the ACGR for its first submission. The same shall not be considered as sufficient explanation if the PC fails to indicate the date of its registration, or when it has qualified as such or if the RI fails to indicate the date of effectivity of its registration statement.

However, PCs and RIs that are listed in the PSE shall be excluded from the coverage of SEC Memorandum Circular No. 13, Series of 2021. Publicly listed PCs and RIs shall instead submit an I-ACGR in accordance with SEC Memorandum Circular No. 15, Series of 2017.

The I-ACGR and ACGR shall bear the **original and manual** signatures of the following required signatories:

a. Chairperson of the Board;
b. Chief Executive Officer or President;
c. All Independent Directors;
d. Compliance Officer; and
e. Corporate Secretary.

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[168] SEC Memorandum Circular No. 15, Series of 2017.

c. **Adopt a Manual on Corporate Governance**

The company's corporate governance policies, programs, and procedures should be contained in its Manual on Corporate Governance, which should be signed by the company's Chairperson of the Board and Compliance Officer. The PLCs, PCs, RIs, and companies with secondary license are required to submit their Manual on Corporate Governance to the SEC.[169] The PLCs' Manual on Corporate Governance is also required to be submitted to the PSE and should be posted on the PLCs' website.

2. Promote a Comprehensive and Cost-Efficient Access to Relevant Information

The company should maintain a comprehensive and cost-efficient communication channel for disseminating relevant information. This channel is crucial for informed decision-making by investors, stakeholders, and other interested users.

Although SEC and PSE filings are publicly available and are reliable disclosure channels, the following, among others, are also considered good communication channels that will ensure timely and comprehensive disclosures:

a. **Media and Analysts' Briefings**

As recommended in the CG Code for PLCs, companies should include media and analysts' briefings as channels of communication. These channels ensure the timely and accurate dissemination of public, material and relevant information to its shareholders and other investors.[170]

b. **Company Website**

A company website that is easily accessible, user-friendly and with a dedicated section for corporate governance is required for all PLCs[171] and is recommended for all PCs and RIs[172].

Furthermore, all companies applying for registration of its securities for listing are directed to comply with the SEC-prescribed website template as one of the requirements before the Registration Statement is rendered effective.[173]

This is to ensure a comprehensive, cost-efficient, transparent, and timely manner of disseminating relevant information to the public.

3. Increase Focus on Non-Financial and Sustainability Reporting

As external pressures including resource scarcity, globalization, and access to information continue to increase, the way corporations respond to sustainability challenges in addition to financial challenges determines their long-term viability and competitiveness.[174]

[169] Recommendation 8.7 of the CG Code for PLCs, Recommendation 8.3 of the CG Code for PCs and RIs and Article 9 of the Revised Code of Corporate Governance.
[170] Recommendation 11.1 of the CG Code for PLCs.
[171] SEC Memorandum Circular No. 11, Series of 2014.
[172] Recommendation 11.1 of the CG Code for PCs and RIs.
[173] SEC Memorandum Circular No. 2, Series of 2018.
[174] Principle 10 of the CG Code for PLCs and the CG Code for PCs and RIs.

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In this regard, a company should be socially responsible in all its dealings with the communities where it operates. It should ensure that its interactions serve its environment and stakeholders in a positive and progressive manner that is fully supportive of its comprehensive and balanced development.[175] Sustainable development means that the company not only complies with existing regulations but makes sure that it takes into consideration economic, environmental, social, and governance (EESG) issues and concerns.

Further, companies should disclose to all shareholders and other stakeholders the company's strategic (long-term goals) and operational objectives (short-term goals) as well as the impacts of a wide range of sustainability issues, with emphasis on the management of EESG issues of its business which underpin sustainability. [176]

To aid PLCs in their Sustainability Reporting, the SEC issued the Sustainability Reporting Guidelines for PLCs. The Guidelines are intended to help PLCs assess and manage non-financial performance across Economic, Environmental, and Social aspects of their organization and enable PLCs to measure and monitor their contributions towards achieving universal targets of sustainability. The Guidelines adopt a "comply or explain" approach, which requires the PLCs to provide explanations for items which they still have no available data on. The Sustainability Report is required to be submitted as an attachment to the company's Annual Report.[177]

The implementation of the Revised Sustainability Reporting Guidelines for Publicly-Listed Companies and the SEC Sustainability Reporting Form was deferred after careful consideration of the feedback received from stakeholders and in the interest of ensuring and maintaining meaningful compliance by PLCs. The SEC is looking at making the new compliance applicable to data covering the year 2024, with reporting due in 2025.

C. Internal Control and Risk Management Framework

Strengthening Internal Control and Risk Management Systems[178]

To ensure the integrity, transparency, and proper governance in the conduct of its affairs, the company should have a strong and effective internal control system and enterprise risk management system.

1. Internal Control System[179]

Internal control is a process designed and effected by the board of directors, senior management, and all levels of personnel to provide reasonable assurance on the achievement of objectives through efficient and effective operations; reliable, complete, and timely financial and management information; and compliance with applicable laws, regulations, and the organization's policies and procedures.

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[175] Principle 16 of the CG Code for PLCs.
[176] Recommendation 10.1 of the CG Code for PLCs and the CG Code for PCs and RIs.
[177] SEC Memorandum Circular No. 4, Series of 2019.
[178] Principle 12 of the CG Code for PLCs and the CG Code for PCs and RIs.
[179] Recommendation 12.1 of the CG Code for PLCs and the CG Code for PCs and RIs.

The company's internal control system should include activities such as, but not limited to, the following:

a. management oversight and control culture;
b. risk recognition and assessment;
c. control activities;
d. information and communication;
e. monitoring activities; and
f. correcting deficiencies.

To monitor and guide the implementation of a company's internal control processes and procedures, the company must have a separate internal audit function.[180]

Moreover, PLCs are recommended to have a qualified Chief Audit Executive (CAE) who shall oversee and be responsible for the internal audit activity of the organization and must be appointed by the Board, subject to the Principle of Proportionality [181]

2. Enterprise Risk Management[182]

Enterprise Risk Management is a process, effected by an entity's Board of Directors, management and other personnel, applied in strategy setting and across the enterprise that is designed to identify potential events that may affect the entity, manage risks to be within its risk appetite, and provide reasonable assurance regarding the achievement of entity objectives.[183]

The company's enterprise risk management framework should include activities, such as, the identification, sourcing, measurement, evaluation, mitigation and monitoring of risk.

Moreover, PLCs are recommended to have a separate risk management function headed by a Chief Risk Officer (CRO), subject to the Principle of Proportionality.[184]

D. Cultivating a Synergic Relation with Shareholders/Members

The companies should treat all shareholders fairly and equitably. They should ensure that basic shareholder rights are properly disclosed and communicated to all shareholders, effective mechanisms to protect these rights are properly in place and active shareholders' participation is encouraged.

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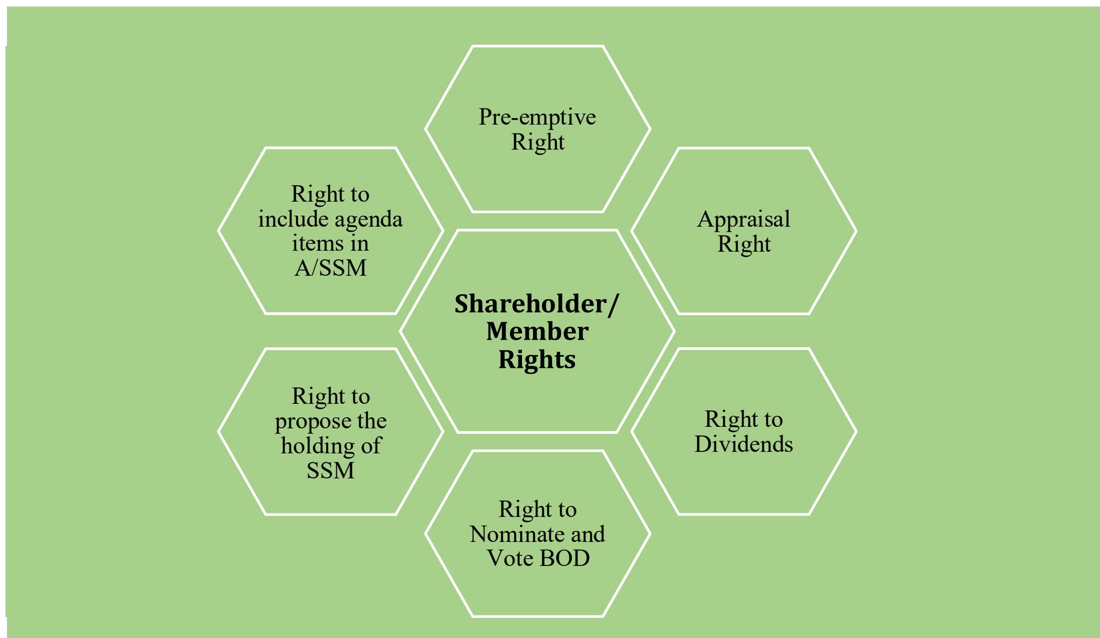
[180] Recommendation 12.2 of the CG Code for PLCs and the CG Code for PCs and RIs.
[181] Recommendation 12.3 of the CG Code for PLCs.
[182] Recommendation 12.1 of the CG Code for PLCs and the CG Code for PCs and RIs.
[183] COSO Framework.
[184] Recommendation 12.5 of the CG Code for PLCs.

1. Shareholder/Member Rights[185]



a. Pre-emptive right

It is the right of all shareholders of a stock corporation to subscribe to all issues or disposition of shares of any class, in proportion to their respective shareholdings. This gives an existing shareholder the right to maintain his/her percentage ownership of a company by buying a proportionate number of shares of any future issuances of securities before they can be offered to a third party or a new investor.[186]

b. Appraisal right

It is the right of any shareholder of a corporation to dissent and demand payment of the fair value of the shares under the conditions provided in the Revised Corporation Code, company's Articles of Incorporation and/or By-Laws.[187]

As provided in the Revised Corporation Code, an appraisal right may be exercised in the following corporate actions which significantly alters the terms of a shareholder's investment in the company:

1) In case an amendment to the articles of incorporation has the effect of changing or restricting the rights of any shareholder or class of shares, or of authorizing preferences in any respect superior to those of outstanding shares of any class, or of extending or shortening the term of corporate existence;
2) In case of sale, lease, exchange, transfer, mortgage, pledge or other disposition of all or substantially all of the corporate property and assets as provided in this Code;
3) In case of merger or consolidation; and
4) In case of investment of corporate funds for any purpose other than the primary purpose of the corporation.

[185] Recommendation 13.1 of the CG Code for PLCs and the CG Code for PCs and RIs.
[186] Section 38 of the Revised Corporation Code.
[187] Section 80 of the Revised Corporation Code.

c. Right to dividends

It is the right of all shareholders of a stock corporation to receive profits in the form of cash, property, or stock dividends subject to a declaration by the Board.

As provided in the Revised Corporation Code, the board of directors of a stock corporation may only declare dividends if there are unrestricted retained earnings. On the other hand, directors must declare dividends if unrestricted retained earnings already exceed one hundred percent (100%) of paid-in capital, subject to some exceptions.[188] Dividends shall be payable in cash, property, or in stock to all shareholders on the basis of outstanding stock held by them.

d. Right to vote

One of the rights of a stockholder is the right to participate in the control and management of the corporation, which is exercised through his/her vote. The right to vote is a right inherent in and incidental to the ownership of corporate stock and, as such, is a property right.[189]

Shareholders may vote on matters of corporate policy, including the election of the members of the board of directors, issuing securities, initiating corporate actions, and making substantial changes in the corporation's operations.

While there may be a class of shares that are non-voting, they shall nevertheless be entitled to vote on the following corporate acts that have a significant impact on their investment in the company:

1) Amendment of the articles of incorporation;
2) Adoption and amendment of bylaws;
3) Sale, lease, exchange, mortgage, pledge, or other disposition of all or substantially all of the corporate property;
4) Incurring, creating, or increasing bonded indebtedness;
5) Increase or decrease of authorized capital stock;
6) Merger or consolidation of the corporation with another corporation or other corporations;
7) Investment of corporate funds in another corporation or business in accordance with this Code; and
8) Dissolution of the corporation.[190]

e. Right to nominate candidates to the Board of Directors[191]

As provided in the Revised Corporation Code, each shareholder or member shall have the right to nominate any director or trustee who possesses all the qualifications and none of the disqualifications set forth under the law.

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[188] Section 42 of the Revised Corporation Code.
[189] Castillo v. Balinghasay, G.R. No. 150976, 18 October 2004.
[190] Section 6 of the Revised Corporation Code.
[191] Section 23 of the Revised Corporation Code.

f. Right to propose the holding of Special Shareholders' Meeting[192]

As provided in the Revised Corporation Code, a shareholder or member may propose the holding of a special meeting.

Any number of shareholders of a corporation who hold at least ten percent (10%) or more of the outstanding capital stock of a PLC shall have the right to call for a Special Stockholders' Meeting.[193]

Whenever, for any cause, there is no person authorized or the person authorized unjustly refuses to call a meeting, the Commission, upon petition of a shareholder or member on a showing of good cause therefor, may issue an order directing the petitioning shareholder or member to call a meeting of the corporation by giving proper notice. The petitioning shareholder or member shall preside thereat until at least a majority of the shareholders or members present have chosen from among themselves a presiding officer.

g. Right to include agenda items in an Annual and Special Shareholders' Meeting

A shareholder or member may propose any other matter for inclusion in the agenda at any regular or special meeting of shareholders or members.[194]

However, shareholders who, alone or together with other shareholders, hold at least five percent (5%) of the outstanding capital stock of a PLC shall have the right to include items on the agenda prior to the regular/special stockholders' meeting.[195]

2. Mechanisms to Protect Shareholders/Members

a. Alternative Dispute Resolution

The Board should make available, at the option of a shareholder or member, an alternative dispute mechanism to resolve intra-corporate disputes in an amicable and effective manner.

An intra-corporate dispute has been defined as a dispute which arises between or among shareholders or between any or all of them and the corporation.[196] The dispute must be rooted in the existence of an intra-corporate relationship as well as the enforcement of the parties' correlative rights and obligations under the Revised Corporation Code and the internal rules of the corporation.[197]

Moreover, as provided in the Revised Corporation Code, an arbitration agreement may be provided in the articles of incorporation or by-laws of an unlisted corporation. When such an agreement is in place, disputes between the corporation, its stockholders or members, which arise from the implementation of the articles of incorporation or by-laws, or from intra-corporate relations, shall be referred to arbitration.[198]

[192] Section 49 of the Revised Corporation Code.
[193] SEC Memorandum Circular No. 7, Series of 2021
[194] Section 49 of the Revised Corporation Code.
[195] SEC Memorandum Circular No. 14, Series of 2020.
[196] Philex Mining Corp. v. Reyes, 118 SCRA 602.
[197] Reyes v. Zenith Insurance Corporation, G.R. No. 165744, 11 August 2008.
[198] Section 181 of the Revised Corporation Code.

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b. Investor Relations Office (IRO)

Under the CG Code for PLCs, the Board should establish an IRO to ensure constant engagement with its shareholders or members. The IRO should be present at every shareholders' or members' meeting.

Putting in place proper safeguards ensures suitable remedies for the infringement of shareholders' rights and prevents excessive litigation.

c. Sale of All or Substantially All Corporate Assets

For PLCs, the sale or disposal of corporate property and assets amounting to at least 51% of the corporation's total assets shall be considered as sale of all or substantially all of corporate property and assets, whether such sale accrued in a single transaction or in several transactions taking place within one (1) year from the date of the first transaction (aggregate sale transactions).[199]

3. Encourage Active Shareholders' and Members' Participation

The Board should encourage active shareholder participation by sending the Notice of Annual and Special Shareholders' Meeting with sufficient and relevant information in a timely manner. Sending the Notice in a timely manner allows shareholders to plan their participation in the meetings. The required information in the Notice include, among others, the date, location, meeting agenda and its rationale and explanation, and details of issues to be deliberated on and approved or ratified at the meeting.

Written notice of regular meetings shall be sent to all shareholders or members of record at least twenty-one (21) days prior to the meeting.[200] However, it is a good corporate governance practice to have the Notice sent to all shareholders or members at least twenty (28) days before the meeting.[201]

Moreover, the Board should also make publicly available the result of the votes taken during the most recent Annual or Special Shareholders' Meeting by the next working day. In addition, the Minutes of the Annual and Special Shareholders' Meeting should be available on the company website within five business days from the end of the meeting.

E. Duties to Stakeholders

1. Respecting the Rights of Stakeholders and Effective Redress for Violation of Stakeholder's Rights

Who Are Stakeholders?

The Board should identify the company's various stakeholders and promote cooperation between them and the company in creating wealth, growth, and sustainability.[202]

[199] SEC Memorandum Circular No. 12, Series of 2020.
[200] SEC Memorandum Circular No. 3, Series of 2020 in relation to Section 49 of the Revised Corporation Code
[201] Recommendation 13.2 of the CG Code for PLCs.
[202] Recommendation 14.1 of the CG Code for PLCs and CG Code for PCs and RIs.

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Stakeholders are those that are directly or indirectly affected by the company's affairs or operations. **Stakeholders** in corporate governance include, but are not limited to, customers, employees, suppliers, shareholders, investors, creditors, the community the company operates in, society, the government, regulators, competitors, external auditors, etc.

Redress for Violation of Stakeholders' Rights

The Board should establish clear policies and programs to provide a mechanism for the fair treatment and protection of stakeholders.[203] In instances when stakeholders' interests are not legislated, companies' voluntary commitments ensure the protection of the stakeholders' rights.

Moreover, the Board should adopt a transparent framework and process that allows stakeholders to communicate with the company and to obtain redress for the violation of their rights.[204]

2. Encouraging Employees' Participation

The Board should establish policies, programs, and procedures that encourage employees to actively participate in the realization of the company's goals and in its governance.[205] It should set the tone and make a stand against corrupt practices by adopting an anti-corruption policy and program in its Code of Conduct.[206] Moreover, it should establish a suitable framework for whistleblowing that allows employees to freely communicate their concerns about illegal or unethical practices without fear of retaliation.[207]

[203] Recommendation 14.2 of the CG Code for PLCs and CG Code for PCs and RIs.
[204] Recommendation 14.3 of the CG Code for PLCs.
[205] Recommendation 15.1 of the CG Code for PLCs and CG Code for PCs and RIs.
[206] Recommendation 15.2 of the CG Code for PLCs and CG Code for PCs and RIs.
[207] Recommendation 15.3 of the CG Code for PLCs and CG Code for PCs and RIs.

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Policies and Programs to Encourage Employees' Participation

a. A policy on the health, safety, and welfare of employees, training and development of employees, and reward/compensation for employees to encourage employees to perform better and motivates them to take a more dynamic role in the corporation;

b. An **anti-corruption program** that encourages employees to report corrupt practices and outlines procedures on how to combat, resist, and stop these corrupt practices; and

c. A **whistleblowing framework** that provides procedures and safe harbors for complaints of employees, either personally or through their representative bodies, concerning illegal and unethical behavior. One essential aspect of the framework is the inclusion of safeguards to secure the confidentiality of the informer and to ensure protection from retaliation. Individuals or representative bodies must be granted confidential direct access to either an independent director or a unit designed to deal with whistleblowing concerns.

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Topic 3: Anti-Money Laundering (AML)

The objective of this section is to assist covered persons in understanding the Anti-Money Laundering Act (RA No. 9160), as amended, (AMLA) and its 2018 Implementing Rules and Regulations (IRR); Financial Action Task Force (FATF) Recommendations; duties and responsibilities of the covered persons; and regulatory issuances of both the Anti-Money Laundering Council (AMLC) and the Securities and Exchange Commission (SEC).

Part I. An Introduction to Money Laundering

A. Definition of Money Laundering

Money laundering is defined as *"the processing of the proceeds of a crime to disguise their origin. It is a process intended to mask the benefits derived from serious offenses or criminal conduct as described under the Act [AMLA], so that they appear to have originated from a legitimate source."*[208]

While money laundering is a criminal offense on its own, it cannot be committed independent of any of the predicate offenses enumerated under Rule 3, Section 1 of the 2018 IRR.

The aim of the process, from the criminals' perspective, is, therefore, to achieve a situation where the proceeds of their activities appear legitimate; this can enable them to avoid prosecution, conviction, and the confiscation of the criminal funds. Criminals use financial institutions as the major conduits to assist in these activities. This means that it is important that those working in the financial services sector are fully aware of the risks of money laundering, the relevant regulatory requirements, and their personal responsibilities.

B. Why Do Criminals Launder Money?

Criminals launder money to:
1. conceal the source of the proceeds;
2. avoid prosecution;
3. avoid taxes; and/or
4. make illegally obtained money appear legal.

C. Three Stages of Money Laundering

Money laundering typically involves three basic stages. These stages do not necessarily occur in every laundering case. In addition, the boundaries between the stages may be blurred or may overlap, and in some cases, they may occur simultaneously (though this is not common).

Placement is the physical disposal of cash proceeds derived from illegal activity. This may be done through depositing cash into different accounts; multiple cash deposits of smaller amounts; buying monetary instruments and financial products; and/or international fund transfers.

[208] Section 3.1 of the 2018 Guidelines on Anti-Money Laundering and Combating the Financing of Terrorism for SEC Covered persons ("2018 AML/CFT Guidelines").

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Layering involves separating the illicit proceeds from their source by creating complex layers of financial transactions designed to disguise the audit trail and provide anonymity or to obscure the source of the funds.[209]

Integration provides appearance of legitimacy to criminally -derived wealth. If the layering process has succeeded, the integration schemes place the laundered proceeds back into the economy in such a way that they re-enter the financial system appearing to be normal business funds.[210] The source of the money could be masked by investing in real estate, cars, jewels, investment products, etc.

Laundering does not have to involve money at all since the proceeds to be laundered can involve any sort of tangible or intangible property derived from crime. Because of the nature of the business relationships entered into and among clients and the covered persons, which are no longer predominantly cash-based, they are less conducive to the initial placement of criminally derived funds other than financial industries such as banking. The businesses of SEC-covered persons are at risk of being used at the layering stage, as they provide a potential avenue to alter the form of funds from cash to securities such as stock certificates, investment contracts, evidences of indebtedness, bearer, and other negotiable instruments. Laundered proceeds may also be integrated into the economy through investment portfolios. Due diligence must, therefore, be exercised to prevent the use of SEC-covered persons as instruments for money laundering.

Similarly, the proceeds of frauds, bribery, corruption, investment scams, stock manipulation, fraudulent transactions and insider trading often involve the use and abuse of corporations and dummies set up in jurisdictions well away from the scenes of these crimes. In this way, criminals avoid detection of the criminal offense[211] by entering into arrangements designed to disguise the true ownership of those vehicles.

In most jurisdictions, anti-money laundering (AML) laws are aimed at identifying personal customers and the ultimate beneficial ownership of corporate customers, monitoring transactions, keeping good records and reporting suspicions to the authorities.

Illustration

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[209] Section 3.2.2 of the 2018 AML/CFT Guidelines.
[210] Section 3.2.3 of the 2018 AML/CFT Guidelines.
[211] Predicate offenses.

D. The Global Extent of the Problem

The clandestine nature of money laundering makes it difficult to produce an accurate estimate of the total amount of money being laundered each year. Estimates suggest that in excess of a staggering US $1 trillion per year is being laundered by financial criminals, drug dealers, and arms traffickers worldwide. This figure is broadly in line with United Nations Office on Drugs and Crime (UNODC) estimates, which suggest that between US $800 billion and US $2 trillion is laundered globally each year.

Based on the available information[212], from the year 2017-2018, the AMLC has:

- turned over forfeited assets to the Bureau of Treasury:
  - Php48.856 million worth of cash and bank assets
  - 7-hectare land
- investigated and prosecuted:
  - Php1,718,386,789 worth of frozen assets, 41 vehicles, and 7 firearms
  - Php1,009,116,707 worth of assets subject to civil forfeiture, 14 real properties, 5 watercrafts, 59 vehicles, 8 motorcycles, and 25 firearms.

The Global Anti-Money Laundering Survey results for 2016, jointly conducted by the Association of Certified Anti-Money Laundering Specialists (ACAMS) and Dow Jones, revealed the following key findings with respect to AML[213]:

1. The greatest AML compliance challenge continues to be increased regulatory expectations.
2. Politically exposed person (PEP) screening forms a major part of respondents' customer due diligence (CDD) processes – about 80% of survey respondents screen for domestic PEPs; among them, more than 90% also screen for local-level PEPs, even where not required by regulations.
3. Most organizations have client-screening technology solutions in place, and have implemented governance, risk and compliance (GRC) platforms.
4. Most organizations have modified AML training and/or transaction monitoring to incorporate human trafficking and smuggling red flags and typologies and have taken similar steps to address terrorist financing and recruitment risks.

Given the scale of the problem, it is unsurprising that AML policies and actions are high on the international agenda, and combating this issue continues to be a major challenge for the financial sector globally. Increasingly, AML provisions are being seen as the frontline in the battle against drug dealing, organized crime, and the financing of terrorism. Much law enforcement activity is directed towards making the disposal of criminal assets more difficult, monitoring the movement of assets, and the seizure or freezing of laundered assets where possible.

Technology is always evolving, and this provides more ways for criminals to launder their proceeds. It also means that organizations have to find new ways to counter the threat of money laundering.

The development of **artificial intelligence (AI)** and **digital currencies**, such as **Bitcoin**, has created many new opportunities for money launderers. However, developers are creating

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[212] http://www.amlc.gov.ph/images/PDFs/2017-2018%20AMLC%20ANNUAL%20REPORT.pdf
[213] Based on latest available information, as of March 2019.

AML Bitcoin, a cryptocurrency that promises to offer built-in AML, anti-theft, and anti-criminal features.

E. Global AML Standards

Most countries have now implemented AML legislation. In the majority of cases, this has been developed following the standards established by the 40 Recommendations produced by the Financial Action Task Force (FATF), an inter-governmental body established in Paris in 1989. The FATF Recommendations set out a comprehensive and consistent framework of measures that countries should implement in order to combat money laundering and terrorist financing, as well as the financing of the proliferation of weapons of mass destruction.

The key aspects of the revised FATF Recommendations are:

1. global recognition of the risk-based approach to AML and terrorist finance;
2. further focus on ultimate beneficial ownership of companies and other entities;
3. inclusion of compliance with international sanctions and counter-proliferation measures as global standards;
4. revised definition of PEPs to include domestic PEPs (the previous definition only included foreign PEPs);
5. inclusion of tax crimes as predicate offences of money laundering; and
6. prevention of abuse of non-profit organizations.

In 2000, FATF undertook the Non-Cooperative Countries and Territories (NCCT) initiative, the objective of which was *"to reduce the vulnerability of the financial system to money laundering by ensuring that all financial centres adopt and implement measures for the prevention, detection and punishment of money laundering according to internationally recognised standards"*. It accomplished this by establishing four regional groups representing the Americas, Asia Pacific, Europe and the Middle East, and Africa. Using inputs from these regional groups, 47 countries were selected for examination, 23 of which were listed as NCCTs.

The Philippines was removed from the list of NCCTs and is no longer subject to FATF monitoring since February 11, 2005, for the following reasons:

1. Enactment of AMLA in 2001
2. Creation of the AMLC as Financial Intelligence Unit (FIU)
3. Provided exemptions to the bank secrecy law
4. Banks and FIs are now required to report covered and suspicious transactions.

Since October 2006, there have been no more NCCTs, and no new jurisdictions have been reviewed under the initiative since 2001. Instead, since 2007, the FATF has established the International Cooperation Review Group (ICRG), which analyses high-risk jurisdictions and recommends specific actions to address the risks posed by them.

F. National Risk Assessment and Mutual Evaluation

The National Risk Assessment (NRA) on Money Laundering and Terrorist Financing (ML/TF) of the Philippines is a government-wide assessment of the overall exposure of the country to money laundering and its related predicate offenses, terrorism, and terrorist financing. It is a comprehensive process of identifying and analyzing the ML/TF risks within the realm of the supervised sectors, financial institutions, and covered persons and entities under the AMLA, as amended.

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Mutual Evaluation is a peer review of each member conducted by the FATF on an ongoing basis to assess levels of implementation of the FATF Recommendations, providing an in-depth description and analysis of each country's system for preventing criminal abuse of the financial system[214]. A poor rating in the ME will lead to additional scrutiny from foreign regulators and financial institutions that discourage trade and investment and increase the cost of doing business. Restrictions, such as limits to the amount of cross-border transactions with the Philippines, may be imposed. For example, remittance transaction fees will rise, resulting in less money actually received by families of Filipino OFWs intended to cover their basic needs.

The outcome of the ME could also reshape the country's financial and economic landscape through the adoption of responsive and effective policies that are based on reliable data to combat ML/TF.

Q & A
You are an investment manager in an investment firm. You have a client on whom your firm's due diligence has been satisfactorily carried out. They transfer funds to their account with you, from another institution. A few days later, the client advises that they wish to cash in their investment, even though they will suffer a loss, and that they wish to transfer the funds to another institution. You report your concerns to your Compliance Office. Which of the stages of money laundering is this potentially an example of?

Layering (CORRECT)
Placement
Integration

Part II. Philippine Legislation and Regulation

The primary Philippine laws on AML and combatting terrorist financing are RA No. 9160, otherwise known as the "Anti-Money Laundering Act of 2001" (AMLA), as amended, and its 2018 IRR; and RA No. 10168, otherwise known as the "Terrorism Financing Prevention and Suppression Act of 2012" and its Implementing Rules and Regulations.

A. The AMLA, as amended

The AMLA, as amended, aims to protect and preserve the integrity and confidentiality of bank accounts and ensure that the Philippines shall not be used as a money laundering site for the proceeds of any unlawful activity. Among its salient features are as follows:

1. Criminalizes money laundering.
2. Identifies and defines predicate offenses to money laundering.
3. Imposes preventive measures to be undertaken by covered persons (customer due diligence, record keeping and transaction reporting).
4. Created a financial intelligence unit, the AMLC, empowering the same to recover criminal proceeds and prosecute money launderers.
5. Authorizes international and domestic cooperation.
6. Requires covered persons to properly identify their customers, keep records and report covered and suspicious transactions.

[214] http://www.fatf-gafi.org/publications/mutualevaluations/?hf=10&b=0&s=desc(fatf_releasedate)

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B. The Role of AMLC and Its Secretariat

The AMLC was created pursuant to the AMLA to ensure that the Philippines shall not be used as a money laundering site for the proceeds of any unlawful activity. The AMLC is the Philippines' FIU tasked to implement the AMLA, as amended by RA Nos. 9194, 10167, 10365, and 10927, as well as RA No. 10168.

The AMLC is composed of:

1. Governor of the Bangko Sentral ng Pilipinas (BSP) as Chairman;
2. Commissioner of the Insurance Commission (IC), Member; and
3. Chairperson of the SEC, Member.

The AMLC acts unanimously in the discharge of the following functions, among others:

1. Requires and receives covered transaction reports (CTRs) or suspicious transaction reports (STRs) from covered persons.
2. Issues orders addressed to appropriate Supervising Authority or the covered persons to determine true identity of the owner of any monetary instrument or property subject of investigation.
3. Investigates suspicious transactions or covered transactions deemed suspicious, money laundering activities, and other violations of RA No. 9160, as amended.
4. Applies before the Court of Appeals (CA), ex-parte, for the freezing of any monetary instrument or property alleged to be the proceeds of any unlawful activity as defined in the AMLA.
5. Develops educational programs on the pernicious effects of money laundering, the methods and techniques used in money laundering, the viable means of preventing money laundering, and the effective ways of prosecuting and punishing offenders.
6. Inquires into or examines any particular deposit or investment with any banking institution or non-bank financial institution where probable cause exists that the deposits or investments are related to an unlawful activity as defined in the AMLA or money laundering offense under Section 4.
7. Imposes administrative sanctions for violation of laws, rules, regulations, orders, and resolutions issued pursuant thereto.

The AMLC is assisted by a Secretariat headed by an Executive Director, who shall be appointed by the AMLC for a term of five (5) years.

C. The Role of SEC

As Supervising Authority, SEC is mandated to issue and/or update its AML guidelines and circulars for the guidance and compliance of covered persons under its jurisdiction, to assist the AMLC in effectively implementing the provisions of the AMLA, the 2016 RIRR, and other AMLC issuances.[215]

On 07 November 2018, the SEC issued Memorandum Circular (MC) No. 16, s. 2018 or the 2018 Guidelines on Anti-Money Laundering and Combating the Financing of Terrorism for SEC Covered Persons (2018 AML/CFT Guidelines). Under these Guidelines, all covered persons as defined therein are required to submit a Money Laundering and Terrorist Financing Prevention Program (MTPP), which shall replace the AML Manual previously required under M.C. No. 2, s. 2010.

[215] Rule 18 of the 2016 RIRR.

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On 13 October 2020, the SEC issued MC No. 29, s. 2020 to clarify the provisions of the 2018 AML/CFT Guidelines regarding the submission and monitoring of MTPPs. The SEC likewise issued MC No. 4, s. 2021 on 30 March 2021 amending certain provisions of MC No. 16, s. 2018 and MC No. 29, s. 2020.

D. SEC Covered Persons[216]

The following are the SEC covered persons:

1. Securities Brokers, Dealers and Salesmen, Associated Person of a Broker Dealer, Investment Houses, and other similar entities managing securities or rendering similar services;
2. Investment Company Advisers/Fund Managers, Mutual Fund Distributors, Mutual Fund Companies, Closed-End Investment Companies;
3. Investment Advisor, Agent or Consultant;
4. Financing Companies and Lending Companies; and
5. Other entities administering or otherwise dealing in currency, commodities or financial derivatives based thereon, cash substitutes and other similar monetary instruments or property supervised or regulated by SEC[217].

The SEC issued rules and regulations[218], which incorporated several provisions requiring covered persons' compliance with the following AML related requirements:

1. Filing of revised AML Manual[219].
2. Written supervision and control procedures shall take into account the requirements of AMLA.
3. The Associated Person is responsible for the supervisory system to achieve compliance with AMLA.
4. Broker Dealer is required to update its internal procedures to be compliant with new rules and regulations issued by the AMLC.
5. Broker Dealer is required to have updated file of all AMLA resolutions released by the AMLC.
6. Broker Dealer, its director, officer and Associated Person are required to report any suspicious client transaction to the AMLC.
7. As part of the requirements for request for withdrawal of business and cancellation of license, Broker Dealers are required to submit undertaking by the person responsible for the safekeeping of records pursuant to the record retention requirement of the AMLA.

Q & A
Which of the following is a covered person/institution supervised or regulated by the SEC?

Pre-need companies
Investment advisor, agent or consultant (CORRECT)
Issuer of proprietary or non-proprietary shares

[216] "Covered persons" referred to in this BOK also refers to the "covered persons/institutions" mentioned in the 2018 AMLC/CFT Guidelines.
[217] Sec. 1.2.1 to 1.2.5 of the 2018 AML/CFT Guidelines.
[218] 2015 SRC Implementing Rules and Regulations (IRR) and 2018 IRR of the Investment Company Act (ICA).
[219] Under MC 16, s. 2018, the AML Manual now refers to the MTPP.

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Part III. Money Laundering and Terrorist Financing Prevention Program

The Money Laundering and Terrorist Financing Prevention Program (MTPP) must be submitted to the SEC and need to be updated at least once every two (2) years. The submission is governed by the following rules and regulations:

Timeline	Submission Date	Basis
1. All covered persons registered before November 23, 2018	May 23, 2019	2018 AML/CFT Guidelines (MC 16, s. 2018)
2. All covered persons registered on or after November 20, 2020	within ten (10) days from the receipt of its Certificate of Registration and/or secondary license from SEC	SEC Memorandum Circular 29 Series of 2020 - *2020 Guidelines on the Submission and Monitoring of the MTPP*
Covered Persons registered from November 23, 2018 to November 19, 2020 who have not yet submitted its MTPP as of November 20, 2020 shall do so within two (2) months from November 20, 2020.		

Covered persons shall make their MTPPs readily available for inspection during the onsite examination.[220]

A. Overview

The MTPP shall be comprehensive, risk-based, and designed according to the covered person's corporate structure and risk profile. It is geared toward the promotion of high ethical and professional standards and the prevention of the covered persons from being used, intentionally or unintentionally, for money laundering and terrorism financing.[221]

Where a covered person has branches, subsidiaries, affiliates, or offices located within and/or outside the Philippines, there shall be a consolidated system to ensure the coordination and implementation of the MTPP on a group-wide basis, taking into account local business considerations and the requirements of the host jurisdiction. The covered person at the head of the group shall be responsible for the effective implementation of the MTPP at the level of the group.[222]

MTPPs must be consistent with the AMLA, its RIRR, and the SEC's 2018 AML/CFT Guidelines[223], and other AMLC and SEC issuances.

Covered persons are required to develop clear written client identification and graduated acceptance policies and procedures, including a set of criteria for customers that are likely to pose a low, normal, or high risk to their operations. Such policies and procedures must be designed to ensure that the financially or socially disadvantaged are not denied access to financial services while at the same time preventing suspicious individuals or entities from opening an account or establishing a relationship.[224]

[220] Sec. 4.4 of the 2018 AML/CFT Guidelines.
[221] Sec. 4.1 of the 2018 AML/CFT Guidelines.
[222] Sec. 4.1 of the 2018 AML/CFT Guidelines.
[223] Sec. 1 of M.C. No. 16, s. 2018; Sec. 4.1 of the 2018 AML/CFT Guidelines.
[224] Sec. 5.A.1 of the 2018 AML/CFT Guidelines.

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The policies and procedures must include procedures for providing customers with adequate notice that the covered person is requesting information to verify their identities.

B. Contents of the MTPP

The MTPP shall, at the minimum, embody the following:

1. Detailed procedures on the covered person's compliance and implementation of the requirements of the AMLA and its RIRR, which shall include the following:

    a. Customer identification process, including acceptance policies and ongoing monitoring processes;
    b. Record keeping and retention;
    c. Covered transaction (CT) reporting; and
    d. Suspicious Transaction (ST) reporting.

2. An effective and continuous AML/CFT training program, including refresher trainings, for all directors, responsible officers, and employees to enable them to fully comply with their obligations under the AMLA, its RIRR, and AML-related issuances of the SEC

3. An adequate screening and recruitment process to ensure that only qualified personnel who have no criminal record/s or adverse circumstances in their backgrounds are employed to assume sensitive functions within the covered person

4. An internal audit system in accordance with Chapter 10 of the 2018 AML/CFT Guidelines[225]

5. An independent audit program with a written scope of audit that will ensure the completeness and accuracy of the information and identification documents obtained from clients, the CT and ST reports submitted to the AMLC, and the records retained in compliance with these Guidelines, as well as the adequacy and effectiveness of the training program on the prevention of ML/TF [226]

6. A mechanism that ensures that all deficiencies noted during the audit, SEC examination, and/or other regulator's examination are immediately corrected[227]

7. Cooperation with the AMLC

8. Designation of an AML Compliance Officer, who shall be the lead implementor of the program

9. A mechanism where the information required for customer due diligence and ML/TF risk management are accessible by the parent-covered person, and information is freely shared among branches, subsidiaries, affiliates, and offices located within and/or outside the Philippines

10. Policies and control procedures and monitoring mechanisms for prevention or mitigation of ML/TF risks

[225] Sec. 4.1.4 of the 2018 AML/CFT Guidelines.
[226] Sec. 4.1.5 of the 2018 AML/CFT Guidelines.
[227] Sec. 4.1.6 of the 2018 AML/CFT Guidelines.

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C. Basic Concepts in Combatting Money Laundering

The SEC requires its covered persons to apply the following concepts to combat money laundering:

1. **Know Your Customer**. covered person shall obtain competent evidence of the customer's identity and have effective procedures for verifying the bona fide identity of new customers, including their beneficial owners, if applicable.

   "Know your customer" (KYC) measures of the covered person should include conducting continuing due diligence on the business relationship to ensure that the transactions being conducted are consistent with the covered person's knowledge of the customer and/or beneficial owner, their business profile, including, where necessary, the source of its funds.[228]

2. **Compliance with Laws**. Covered persons shall ensure that business is conducted in conformity with high ethical standards, that laws and regulations are adhered to, and that service is not provided where there is good reason to believe that transactions are associated with money laundering activities.

3. **Cooperation with the Law Enforcement Agencies**. Covered persons shall cooperate fully with law enforcement agencies. Disclosure of information by covered persons for the purpose of the AMLA regarding covered transactions and suspicious transactions shall be made to the AMLC.

4. **Policies, Procedures, and Training**. Each covered person shall adopt policies consistent with the principles set out in the guidelines and ensure that its directors, officers, and employees, wherever located, are informed of these policies and adequately trained in matters covered herein.

Q & A

True or False? Submission of MTPP constitutes substantial compliance of covered persons with SEC Memorandum Circular No. 2, series of 2010.

Answer: FALSE

Part IV. Duties of Covered Persons

To promote adherence to these principles, covered persons shall implement specific procedures for customer identification, record keeping and retention of transaction documents, reporting of covered and suspicious transactions, and ensure that its directors, officers and employees are periodically trained on these matters.

[228] Section 5.A.2 of the 2018 AML/CFT Guidelines.

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A. Customer Identification and Customer Due Diligence

Customer Due Diligence (CDD) refers to the procedure of identifying and verifying the true identity, of customers, and their agents and beneficial owners, including understanding and monitoring of their transactions and activities[229].

The objective of customer due diligence (CDD) is to gain a holistic understanding of a client, including their risk profile. The covered persons shall establish and record the true identity of clients based on official documents and shall maintain a system of verifying the identity.

Appropriate procedures must be in place to verify that the client is who they say they are (known as identification and verification, or ID and V). Further, firms must acquire sufficient extra information on the client to inform their monitoring activity and establish the purpose of the relationship, the source of funds for proposed transactions and the likely volumes and types of transactions (known as 'know your customer', or KYC). Both existing and new clients must be covered by the firm's CDD procedures.

<u>Customer Identification</u>

Customer Identification Process (CIP) refers to the process of determining the identity of the customer vis-à-vis the valid and acceptable identification document submitted to, and/or presented before, the covered person[230].

Customer Verification Process (CVP) refers to the process of validating the truthfulness of the information, and confirming the authenticity of the identification documents, presented, submitted and provided by the customer; or other ways of verifying the identity and assessing the risk profile of customers, and their agents and beneficial owners, through the use of reliable and independent sources, documents, data or information[231].

Customer Information and Identification Documents. Covered persons shall obtain and record competent evidence of the true and full identity, representative capacity, domicile, legal capacity, occupation or business purposes of clients, as well as other identifying information on those clients, whether they be occasional or usual, through the use of documents such as, but not limited to:[232]

1. Identity documents, such as passports, birth certificates, driver's licenses, and other similar identity documents, which are verifiable from the institution issuing the same.

   The identifying documents should provide evidence of the complete name or names used, residential address, date of birth, nationality, office address, and contact details. They should include at least one (1) identifying document bearing the photograph and signature of the client. The identifying documents which are considered most reliable are official identity cards and passports. While identification documents that are easily obtained in any name e.g. medical cards, credit cards and student identification cards, may be used, they should not be accepted as the sole means of identification.

   Clients engaging in transactions with covered persons shall present one (1) original official identity card with a photo and signature. For this purpose, the term "official

[229] Rule 2 Section 1 (aa) of the 2018 AMLA IRR.
[230] Rule 2 Section 1 (bb) of the 2018 AMLA IRR.
[231] Rule 2 Section 1 (cc) of the 2018 AMLA IRR.
[232] Section 5.A.3 of the 2018 AML/CFT Guidelines.

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identity card" shall refer to those issued by any of the following: the National Government of the Republic of the Philippines, its political subdivisions or instrumentalities, or government owned and controlled corporations.

Passports issued by foreign governments shall be considered as prima facie identification documents of persons engaging in transactions with the covered persons.

2. Incorporation and partnership papers for corporate and partnership accounts. These documents should be certified as true copies from the issuing government agency.

3. Special authorizations for representatives, which must be duly notarized.[233]

Covered persons shall obtain from all individual clients the following information:[234]

1. Complete name and names used
2. Present address
3. Permanent address
4. Mailing address
5. Date and Place of birth
6. Nationality
7. Contact details (avoid pre-paid cellular phone numbers)
8. Nature of work, name of employer, or nature of self-employment or business
9. Tax Identification Number, Social Security number, or Government Service and Insurance System number
10. Specimen signature
11. Sources of funds, whenever necessary
12. Names of beneficial owner or beneficiaries, if applicable
13. Complete name, address, and contact information of the beneficial owner, if applicable

In account opening involving low-risk accounts, the following minimum information and documents shall be required:[235]

1. Complete Name of Customer
2. Birthdate of customer
3. E-mail address
4. Residential/business address
5. Mobile and/or Landline Number
6. Source of Income
7. Copy of a verifiable Identification Card or Document with Photo
8. Signature card

The account opening may be allowed and transaction may be commenced once the customer has declared in writing, digitally or through a physical medium, the above information, provide the required documents and at least two responsible staff and/or officers of a covered person, acting as checker and maker, have vetted the whole process. A covered person may prescribe other criteria and measures for account opening in addition to the minimum information required above.

[233] Section 5.A.3 of the 2018 AML/CFT Guidelines.
[234] Section 5.B.1 of the 2018 AML/CFT Guidelines.
[235] Section 4 of MC No. 21, s. 2020.

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"Identification Document" (ID) refers to any of the following evidence of identity[236]:

a. For Filipino citizens:

1) Phil ID;
2) Other identification documents issued by the Government of the Republic of the Philippines, including its political subdivisions, agencies, and instrumentalities; and
3) Other identification documents that can be verified using reliable, independent source documents, data, or information.

b. For foreign nationals:

1) Phil ID, for resident aliens;
2) Passport;
3) Alien Certificate of Registration; and
4) Other identification documents issued by the Government of the Republic of the Philippines, including its political subdivisions, agencies, and instrumentalities.

c. For Filipino students:

1) Phil ID;
2) School ID signed by the school principal or head of the educational institution; and
3) Birth Certificate issued by the Philippine Statistics Authority; and

d. For low-risk customers: Any document or information reduced in writing that the covered person deems sufficient to establish the client's identity.

Presentation of Original Identification Documents. Covered persons shall request individual clients who present only photocopies of identification cards and other documents to produce the original documents thereof for verification purposes.[237]

Examples of relevant documents for single proprietorships, corporations, stock or non-stock, and partnerships:

1. Certificates of Registration or Certificate of Incorporation
2. Secondary License or Certificate of Authority
3. Articles of Incorporation/Certificate of Partnerships
4. Latest General Information Sheet (GIS)
5. Corporate/Partners' Secretary Certificate citing the Board/Partners' Resolution authorizing the signatory to sign on behalf of the entity
6. Other documents, such as but not limited to clearance/certification from the SEC that the company is active and compliant with the reportorial requirements

Before establishing a business relationship, inquiries shall be made to ensure that the corporate and/or business applicant has not been, or is not in the process of being dissolved, struck off, wound up, or terminated.

Additional or Further Verification Measures. Clients should be made aware of the covered persons' explicit policy that business transactions will not be conducted with applicants who

[236] Section 14 AMLC Regulatory Issuance (ARI) A, B, and C No. 1 Series 2020.
[237] Section 5.A.10 of the 2018 AML/CFT Guidelines.

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fail to provide competent evidence of their identity, but without derogating from the covered persons' obligation to report suspicious transactions. Where initial verification fails to identify the applicant or gives rise to suspicion/s that the information provided is false, additional verification measures should be undertaken to determine whether to proceed with the business and/or make a suspicious transaction report if circumstances under Section 3(b-1) of the AMLA, as amended, would apply. Details of the additional verification are to be recorded in writing and made available for inspection by the SEC or appropriate authorities.

The covered person shall take further measures to verify the identity of the customer or the beneficial owner, as applicable, if during the business relationship, it has reason to doubt:

1. the accuracy of the information relating to the customer's identity;
2. that the customer is the beneficial owner; or
3. the customer's declaration of beneficial ownership.[238]

   "Beneficial Owner" refers to any natural person who:[239]

   a. ultimately owns or controls the customer and/or on whose behalf a transaction or activity is being conducted; or
   b. has ultimate effective control over a customer that is a legal person or arrangement.

      Legal Arrangements shall refer to express trusts or other similar legal arrangements. Examples of other similar arrangements (for AML/CFT purposes) include *fiducie*, *treuhand,* and *fideicomiso*.

      Ultimate effective control refers to any situation in which ownership/control is exercised through actual or chain of ownership or by means other than direct control. This may be achieved through, but not limited to, any of the following situations:

      1) direct or indirect ownership of at least 25% of any category of voting shares or capital of a legal person, arrangement, understanding, relationship, or otherwise has or shares voting power, which includes the power to vote or to direct the voting of, such security; and/or investment returns or power, which includes the power to dispose of, or to direct, the disposition of such security; *Provided*, that a person shall be deemed to have an indirect beneficial ownership interest in any security which is:

         a) held by members of his/her immediate family sharing the same household;
         b) held by a partnership in which he/she is a general partner;
         c) held by a corporation of which he/she is the controlling shareholder; or
         d) subject to any contract, arrangement, or understanding which gives him/her voting power or investment power with respect to such securities: *Provided, however*, that a person shall not be deemed to be a beneficial owner of securities held by him/her for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business, so long as such shares were acquired by such person without the purpose or effect of changing or influencing control of the issuer.

      2) the ability to elect a majority of the board of directors, or any similar body, of a legal person or arrangement; or

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[238] Section 5.A.4 of the 2018 AML/CFT Guidelines.
[239] Section 2.1.16 of the 2018 AML/CFT Guidelines.

3) any situation in which:

   a) a person has the ability, in fact, to exert a dominant influence over the management or policies of a legal person or arrangement; or
   b) a majority of the members of the board of directors of such a legal person or arrangement, or any equivalent body, are accustomed or under an obligation, whether formal or informal, to act in accordance with a given person's directions, instructions, or wishes in conducting the affairs of the legal person or arrangement.

In exceptional cases where no natural person is identifiable who ultimately owns or exerts control over the legal entity, covered persons, having exhausted all other means of identification, and provided there are no grounds for suspicion, may consider the senior managing official/s to be the beneficial owner/s.

All securities of the same class beneficially owned by a person, regardless of the form such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person.

A person shall be deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership within thirty (30) days, including, but not limited to, any right to acquire, through the exercise of any option, warrant or right; through the conversion of any security; pursuant to the power to revoke a trust, discretionary account or similar arrangement; or pursuant to automatic termination of a trust, discretionary account or similar arrangement.

Identify the Source of a Customer's Assets. The firm's processes should satisfactorily identify the source from which a customer's assets have been derived. The principle is that if a customer can be identified and the source of funds ascertained, then either the dealings are more likely to be legitimate or, if they are not, there may at least be a partial audit trail to trace their origins.

Updating Client Information. Covered persons shall ensure that they know their customers well and, accordingly, shall keep current and accurate all material information with respect to their customers by regularly conducting verification and an update thereof.[240]

Covered persons shall, based on materiality and risk, ensure that information and documents collected under the CDD process are kept up-to-date and relevant by undertaking reviews of existing records, particularly for higher-risk categories of customers. Covered persons shall also ensure that beneficial ownership information is updated in case of any changes. Updating of records shall be mandatory when an enhanced ongoing monitoring process is warranted.

Unusual Transactions. A covered person should pay special attention to all unusually large transactions or unusual patterns of transactions. This requirement applies both to the establishment of a business relationship and to ongoing due diligence. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities.[241]

Acquisition by a covered person of the Business of Another covered person. When a covered person acquires the business of another covered person, either in whole or as a

[240] Section 5.A.5 of the 2018 AML/CFT Guidelines.
[241] Section 5.A.6 of the 2018 AML/CFT Guidelines.

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product portfolio, it is not necessary for the identity of all existing customers to be re-identified, provided that:[242]

1. all customer account records are acquired with the business; and
2. due diligence inquiries do not raise any doubt as to whether the anti-money laundering procedures previously adopted by the acquired business have satisfied Philippine requirements.

If the True identity of the Customer cannot be Established. The covered person's policies and procedures must include procedures for responding to circumstances in which the covered person cannot form a reasonable belief that it knows the true identity of a customer or when the covered person is unable to comply with the required certification documents. These procedures should include, among others, the following:[243]

1. When the covered person should not open the account, or commence business relations, or perform the transaction
2. The terms under which a customer may conduct transactions while the covered person attempts to verify the customer's identity
3. When the covered person should close an account or terminate a business relationship after attempts to verify the customer's identity fail
4. Should consider filing a Suspicious Transaction Report with the AMLC

Conduct of Face-to-Face Contact. Covered persons shall conduct face-to-face contact at the commencement of the relationship, or as reasonably practicable so as not to interrupt the normal conduct of business, taking into account the nature of the product, type of business, and the risks involved; *Provided,* that money laundering risks are effectively managed.[244]

The use of Information and Communication Technology in the conduct of face-to-face contact may be allowed, provided that the covered person is in possession of and has verified the identification documents submitted by the prospective client prior to the interview and that the entire procedure is documented.

Use of New or Developing Technologies. Covered persons should pay special attention to any money laundering threats that may arise from new or developing technologies that might favor anonymity and take measures, if needed, to prevent their use in money laundering schemes.[245]

In the Philippines, the BSP established a formal regulatory framework for virtual currency (VC) exchanges in 2017, including requirements for the exchanges to put in place adequate safeguards against money laundering and terrorism financing. Following the BSP's introduction of the regulation in 2017, over **14,500 suspicious transaction reports were submitted that year** by VC exchanges, demonstrating the importance of adequate regulation of new technologies to help prevent money laundering.

The SEC, on the other hand, is in the process of developing its own rules on initial coin offering (ICO) and digital asset exchange (DAE).

[242] Section 5.A.7 of the 2018 AML/CFT Guidelines.
[243] Section 5.A.8 of the 2018 AML/CFT Guidelines.
[244] Section 5.A.9 of the 2018 AML/CFT Guidelines.
[245] Section 5.A.11 of the 2018 AML/CFT Guidelines.

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Third Party Reliance. The covered institution's policies and procedures may include procedure specifying reliance on an intermediary or third party for its KYC or CDD requirements as long as the intermediary or third party relied upon is considered a covered person as defined under these Guidelines or any other guidelines or rules issued by BSP or the IC, or as defined and identified by foreign jurisdictions in so far as covered persons in their respective jurisdictions are concerned.[246]

It is understood that the SEC reserves the right to disapprove arrangements of covered persons with intermediaries or third parties when it has been proven to have been abused by covered persons.

Where such reliance is permitted, the following criteria should be met:

1. The covered person, relying on the intermediary or third party, should immediately take adequate steps to satisfy itself that copies of identification data and other relevant documentation relating to the customer due diligence requirements will be made available from the intermediaries and third parties upon request without delay. The covered person should be satisfied with the quality of the due diligence undertaken by the intermediaries and third parties.
2. The covered person should satisfy itself that the intermediaries and third parties are regulated and supervised and have measures in place to comply with customer due diligence requirements.
3. The customer identification program of the third-party intermediary is similar to or is equivalent to the customer identification program of the covered person.
4. Ultimate responsibility for customer and/or beneficial owner identification and verification remains with the covered person relying on intermediaries or third parties.

In cases of high-risk customers, the covered person relying on the third person shall also conduct EDD procedures.

Outsourcing the Conduct of Customer Identification. Covered persons may outsource the conduct of customer identification, including face-to-face contact, to a counterparty, intermediary, or agent. The outsource, counter-party, or intermediary shall be regarded as an agent of the covered person – that is, the processes and documentation are those of the covered person itself. The ultimate responsibility for identifying the customer and keeping the identification documents remains with the covered person.[247]

The covered person outsourcing the conduct of customer identification, including face-to-face contact, shall ensure that the employees or representatives of the counter-party, intermediary, or agent undergo an equivalent training program as that of the covered person's own employees undertaking similar activity.

Prohibited Accounts. Covered persons shall maintain customer accounts only in the name of the account holder. They shall not open or keep anonymous accounts, fictitious name accounts, incorrect name accounts, and similar accounts.[248]

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[246] Section 5.A.12 of the 2018 AML/CFT Guidelines.
[247] Section 5.A.13 of the 2018 AML/CFT Guidelines.
[248] Section 5.A.14 of the 2018 AML/CFT Guidelines.

<u>Customer Due Diligence</u>

Risk-Assessment/Risk-Profiling of Customers. Covered persons shall set the standards in applying reduced, average/normal, and enhanced CDD, including a set of conditions for the denial of account opening or services.

In low-risk scenarios, firms are able to apply reduced due diligence. However, the obligation to conduct ongoing monitoring of the client relationship still applies.

A covered person shall formulate a risk-based and tiered customer acceptance, identification, and retention policy that involves reduced CDD and EDD.[249]

The following criteria relating to the product or services, the customer, and geographical location, at a minimum, shall be taken into account:

1. The nature of the service or product to be availed of the customer and the purpose of the account or transaction
2. Source of funds/nature of business activities
3. Public or high-profile position of the customer or its directors/trustees, stockholders, officers, and/or authorized signatory
4. Country of origin and residence of operations or the fact that a customer case from a high-risk jurisdiction
5. The existence of suspicious transactions (ST) indicators
6. Watch a list of individuals and entities engaged in illegal activities or terrorist-related activities as circularized by the BSP, SEC AMLC, and other international entities or organizations, such as the Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury and United Nations Sanctions List
7. Such other factors, e.g., the amount of the funds involved or the size of the transaction undertaken by a customer or the size of transactions, and regularity or duration of the transaction, as the covered person may deem reasonable or necessary to consider in assessing the risk of a customer to ML/TF.

Reduced Due Diligence. Applicable to potentially low-risk clients. A low-risk account is an account opened and maintained by an individual investor with an initial and subsequent deposit, investment, or re-investment amounting to an aggregate of not more than Fifty-Thousand Pesos (PhP 50,000.00).[250] Only individual Filipino investors shall be allowed to open low-risk accounts. These investors shall be presumed to beneficially own the said accounts. Subject to prior approval, the Commission may allow a covered person to prescribe a different threshold amount in determining an account as being low risk.[251]

If the risk of money laundering or the financing of terrorism is lower based on the covered persons' assessment, and if information on the identity of the customer and the beneficial owner is publicly available, or adequate checks and controls exist elsewhere in national systems, it could be reasonable for covered persons to apply simplified or reduced customer due diligence measures when identifying and verifying the identity of the customer, the beneficial owner and other parties to the business relationship. Examples:

[249] Section 5.C.1 of the 2018 AML/CFT Guidelines.
[250] Section 2 of MC No. 21, s. 2020.
[251] Section 3 of MC No. 21, s. 2020.

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1. Financial institutions where the subject requirements to combat money laundering and financing terrorism consistent with the Financial Action Task Force (FATF) Recommendations and are supervised for compliance with those controls
2. Public companies that are subject to regulatory disclosure requirements
3. Government institutions and their instrumentalities

Reduced due diligence shall not be applied if there is suspicion of ML/TF.[252]

Enhanced Due Diligence. Applicable to higher-risk accounts or when the risk of ML/TF is higher. Covered persons shall examine, as far as reasonable, the background and purpose of all complex, unusual large transactions, and/or unusual patterns of transactions which have no apparent economic or lawful purpose, and other transactions that may be considered suspicious.[253]

EDD means carrying out additional money laundering checks, where a firm has concluded under its risk-based approach that the standard evidence of identity is insufficient in relation to the money laundering or terrorist financing risk and that it must obtain additional information.

Whenever EDD is applied as required, the covered persons shall do all of the following, in addition to profiling of customer and monitoring of their transactions:[254]

1. Gather additional customer information and/or identification documents other than the minimum information and/or documents required for the conduct of normal due diligence.

   a. In the case of individual customers—
      1) supporting information on the intended nature of the business relationship/source of funds/source of wealth (such as financial profile, ITR, etc.);
      2) reasons for intended or performed transactions;
      3) list of companies where he/she is a stockholder, beneficial owner, director, officer, or authorized signatory;
      4) other relevant information available through public databases or the internet; and
      5) a list of banks where the individual has maintained or is maintaining an account.

   b. In the case of entities—
      1) prior or existing bank references;
      2) the name, present address, nationality, date of birth, nature of work, contact number, and source of funds of each of the primary officers (e.g., President, Treasurer);
      3) volume of assets, other information available through public databases or the internet, and supporting information on the intended nature of the business relationship, source of funds or source of wealth of the customer (ITR, Audited Financial Statements, etc.); and
      4) reasons for intended or performed transactions.

2. Conduct validation procedures on any or all of the information provided.

[252] Section 5.C.2 of the 2018 AML/CFT Guidelines.
[253] Section 5.C.3 of the 2018 AML/CFT Guidelines.
[254] Section 5.C.3 of the 2018 AML/CFT Guidelines.

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3. Secure senior management approval to commence or continue business relationship/ transacting with the customer.
4. Conduct enhanced ongoing monitoring of the business relationship, by, among others, increasing the number and timing of controls applied, and selecting patterns of transactions that need further examination.
5. Require the first payment to be carried out through an account in the customer's name with a bank subject to similar CDD standards, where applicable.
6. Perform such other measures as the covered person may deem reasonable or necessary.

Minimum Validation Procedures for EDD. The procedures performed must enable the covered person to achieve reasonable confidence and assurance that the information obtained is true and reliable. The validation procedures must include, but not limited to, the following:[255]

1. For individual customers—
   a. Confirming the date of birth from a duly authenticated official document;
   b. Verifying the address through evaluation of utility bills, bank or credit card statements, or other documents showing address or through on-site visitation;
   c. Contacting the customer by phone or e-mail;
   d. Determining the authenticity of the identification documents through validation of its issuance by requesting certification from the issuing authority or by any other effective and reliable means; or
   e. Determining the veracity of the declared source of funds.

2. For corporate or juridical entities—
   a. Validating source of funds or source of wealth from reliable documents such as audited financial statements, ITR, bank references, etc.;
   b. In the case of an entity that is subject to supervision by a financial regulatory/supervisory body, inquiring from the supervising authority the status of the entity;
   c. Verifying the address through on-site visitation of the company, sending thank you letters or other documents showing address; or
   d. Contacting the entity by phone or e-mail.

If there is a failure to conduct /complete EDD, the covered person shall decline to establish a relationship with the customer or to execute the requested transaction without prejudice to the reporting of a suspicious transaction to the AMLC.[256]

High Risk Customers. Covered persons should give special attention to business relationships and transactions with persons, including companies and financial institutions, from countries which:[257]

1. are subject to financial sanctions, embargoes, or similar measures by the United Nations or other public international organizations;

[255] Section 5.C.4 of the 2018 AML/CFT Guidelines.
[256] Section 5.C.5 of the 2018 AML/CFT Guidelines.
[257] Section 5.D.1 of the 2018 AML/CFT Guidelines.

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2. have been identified by credible sources as:
    a. having deficient AML/CFT regimes;
    b. having significant amounts of corruption or other criminal activity, including in particular illegal drug production, distribution or trafficking, money laundering, or human trafficking;
    c. providing financing or supporting terrorism or terrorist activities, or having terrorist organizations operating within their territory;
    d. being tax havens; and
    e. experiencing significant civil unrest.

Covered persons should ensure that the principles applicable to covered persons are also applied to branches and majority-owned subsidiaries located abroad, especially in countries that do not or insufficiently apply the AML measures implemented in the Philippines, to the extent that local applicable laws and regulations permit. When local applicable laws and regulations of the foreign branch or subsidiary prohibit such implementation, the covered persons should inform the SEC that they cannot apply the AML measures of the Philippines.

The covered person shall: [258]

1. formally notify the SEC of this situation;
2. furnish a copy of the applicable laws and/or regulations or the supervising authority's directive, as the case may be;
3. advise the SEC of what measures or mitigating controls it intends to adopt to manage the money laundering (ML) and terrorist financing (TF) risks in such branches, offices, subsidiaries, or affiliates to the extent feasible;
4. keep the SEC apprised of its efforts in this area, including any updates to the measures or controls referred to in point "(c)" above; and
5. at the direction of the SEC, close any branch or office, or divest itself of its interest in any subsidiary or affiliate, as the case may be, if the SEC determines that the covered person cannot effectively manage the ML and/or TF risks arising from its relationship with such branch, office, subsidiary, or affiliate.

Customers from the countries referred to above are considered higher-risk customers. In addition to the requirements for continuing due diligence, and customer information and identification of documents, covered persons are required to establish the source of wealth of higher-risk customers. Decisions on business relations with higher-risk customers must be taken by its senior management.[259]

The following are the red flag indicators for high-risk customers:

1. Inaccurate information or document
2. Transacting without any underlying legal or trade obligation, purpose, or economic justification
3. Transacting an amount that is not commensurate with the business or financial capacity or deviates from his profile
4. Structuring transactions in order to avoid being the subject of Covered Transaction Reporting
5. Knowing that the customer was or is engaged in any unlawful activity
6. Customers from a country with inadequate AML standards or does not sufficiently apply FATF recommendations

[258] Section 5.D.2 of the 2018 AML/CFT Guidelines.
[259] Section 5.D.3 of the 2018 AML/CFT Guidelines.

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Politically Exposed Person. A "Politically Exposed Person" (PEP) refers to an individual who is or has been entrusted with a prominent public position in (a) the Philippines with substantial authority over policy, operations, or the use or allocation of government-owned resources; (b) a foreign State; or (c) an international organization.

It shall be presumed that a person who has been entrusted with a prominent public position/function as referenced above shall continue to be considered a PEP, even if he or she no longer holds such a position unless it is clearly shown otherwise.

The term PEP shall include immediate family members and close relationships and associates that are reputedly known to have:

1. joint beneficial ownership of a legal entity or legal arrangement with the main/principal PEP; or
2. sole beneficial ownership of a legal entity or legal arrangement that is known to exist for the benefit of the main/principal PEP.

Immediate family members of PEPs refer to spouse or partner, children and their spouses, parents and parents-in-law, and siblings.

Close associates of PEPs refer to persons who maintain a particularly close relationship with the PEP and include persons who are in a position to conduct substantial domestic and international financial transactions on behalf of the PEP. Close associates may include:

1. beneficial owners of a legal entity or legal arrangement that is known to exist for the benefit of the main/ principal PEP;
2. business partners or associates, especially those that share beneficial ownership of legal entities or legal arrangements with the PEP;
3. persons who are otherwise connected to the PEP (e.g., through joint membership of a company board);
4. prominent members of the same political party, civil organization, labor, or employee union as the PEP; and
5. persons (sexual and/or romantic) partners outside the family unit (e.g. girlfriends, boyfriends, mistresses, etc.).[260]

Covered persons shall establish and record the true and full identity of PEPs, as well as their immediate family members and entities related to them.

In case of domestic PEPs or persons who have been entrusted with a prominent function by an international organization, or their immediate family members or close associates, in addition to performing the applicable due diligence measures, covered persons shall:

1. take reasonable measures to determine whether a customer or the beneficial owner is a PEP; and
2. in cases when there is a higher-risk business relationship, adopt measures under Section 5.C.3 and Section 5.C.4 of the 2018 AML/CFT Guidelines on EDD relative to individual customers.

In relation to foreign PEPs or their immediate family members or close associates, in addition to performing the applicable customer due diligence measures, covered persons shall:

[260] Section 2.1.18 of the 2018 AML/CFT Guidelines.

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1. put in place risk management systems to determine whether a customer or the beneficial owner is a PEP; and
2. adopt measures under Section 5.C.3 and Section 5.C.4 of the 2018 AML/CFT Guidelines on EDD relative to individual customers.[261]

Shell Companies. Shell companies are legal entities that have no business substance in their own right but through which financial transactions may be conducted. Covered persons should note that Shell companies may be abused by money launderers and, therefore, be cautious in their dealings with them.[262]

In addition to the documents required for single proprietorship, partnerships, and corporations, covered persons should also obtain Board of Directors' Certification as to the purposes of the owners/stockholders in acquiring the Shell company. There must likewise be satisfactory evidence of the identities of the beneficial owners, bearing in mind the KYC principle.[263]

Trust, Nominee and Fiduciary Accounts. A covered person shall establish whether the applicant for a business relationship is acting on behalf of another person as a trustee, nominee, or agent. Competent evidence of the identity of such agents and authorized signatories and the nature of their trustee or nominee capacity and duties.[264] If in doubt as to whether the trustee nominee or agent is being used as a dummy in circumvention of existing laws, it shall verify the status of the business relationship between the parties and shall decide, bearing in mind the KYC principle.[265]

Where the account is opened by a firm of lawyers or accountants, the covered person should make reasonable inquiries about transactions passing through the subject accounts that give cause for concern or from reporting those transactions if any suspicion is aroused.[266]

Transactions Undertaken on Behalf of Account Holders or Non-Account Holders. Transactions undertaken on behalf of account holders of a covered person shall be given particular cases to ensure that the person giving instructions is authorized to do so by the account holder.

Transactions undertaken for non-account holders demand special care and vigilance. If the transaction involves significant amounts, the customer should be asked to produce competent evidence of identity, including nationality, the purpose of the transaction, and the sources of funds.[267]

Wire Transfers. Where a covered person may unknowingly transmit proceeds of unlawful activities or funds intended to finance terrorist activities, it shall establish policies and procedures designed to prevent it from being utilized for that purpose, which shall include, but not limited to, the following:

1. A beneficiary institution shall not accept instructions to pay-out fund transfers to non-customer beneficiaries, unless it has conducted the necessary customer due diligence to establish the true and full identity and existence of said beneficiary.

[261] Section 5.E.1 of the 2018 AML/CFT Guidelines.
[262] Section 5.G.1 of the 2018 AML/CFT Guidelines.
[263] Section 5.G.2 of the 2018 AML/CFT Guidelines.
[264] Section 5.H.1 of the 2015 AML/CFT Guidelines.
[265] Section 5.H.2 of the 2015 AML/CFT Guidelines.
[266] Section 5.H.3 of the 2018 AML/CFT Guidelines.
[267] Section 5.I.1 of the 2018 AML/CFT Guidelines.

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2. An originating institution shall not accept instructions to fund/wire transfer from a non-customer originator unless it has conducted the necessary customer due diligence to establish the true and full identity and existence of said originator.
3. In cross border transfers, if the originator is a high risk customer, the beneficiary institution shall conduct EDD on the beneficiary and the originator.
4. Whenever possible, manually initiated fund transfer (MIFT) instructions should not be the primary delivery method. Every effort shall be made to provide the client with an electronic solution.
5. Cross-border and domestic fund/wire transfers and related messages not exceeding PhP 50,000.00 or its equivalent in foreign currency shall include information on the originator and beneficiary. The following information shall remain with the transfer or related message through the payment chain:
   a. Name of the originator;
   b. Name of the beneficiary; and
   c. Account number of the originator and beneficiary, or in its absence, a unique reference number.
6. For cross-border and domestic fund/wire transfers and related messages amounting to PhP 50,000.00 or more, or its equivalent in foreign currency, the following information shall be obtained and accompany the wire transfer:
   a. Name of the originator;
   b. Originator account number or unique transaction reference;
   c. Originator's address, or national identity number, or customer identification number, or date and place of birth;
   d. Name of the beneficiary;
   e. Beneficiary account number or unique transaction reference.
7. Should any wire/fund transfer amounting to PhP 50,000.00 or more or its equivalent be unaccompanied by the required originator information, the beneficiary institution shall exert all efforts to establish the true and full identity and existence of the originator by requiring additional information from the originating institution or intermediary institution. EDD shall be applied.[268]

Did You Know?
While the regulations use the term 'customer due diligence,' it is common within the industry to refer to 'know your customer/client' or 'KYC.'

B. Record Keeping

Covered persons shall maintain and safely store for five (5) years from the dates of transactions all records of customer identification and transaction documents.[269]

1. ***Retention of Records Where the Account is the Subject of a Case.*** If a case has been filed in court involving the account, records must be retained and safely kept beyond the five (5)-year period until it is officially confirmed by the AMLC Secretariat that the case has been resolved, decided, or terminated with finality.

2. ***Closed Accounts.*** Covered persons shall maintain and safely store for at least five (5) years from the dates the accounts were closed, all records of customer identification and transaction documents.

[268] Section 5.K.1 of the 2018 AML/CFT Guidelines.
[269] Section 6.2 2018 AML/CFT Guidelines.

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3. ***Form of Records.*** Covered persons shall retain all records as originals or in such forms as are admissible in court.

4. ***Digitization of Customer Records.*** Covered persons shall comply with the Guidelines on Digitization of Customer Records as promulgated by the AMLC in accordance with the terms thereof, as may be applicable.[270]

Covered persons shall, likewise, keep the electronic copies of all CTRs and STRs for, at least, five (5) years from the dates of submission to the AMLC.

Under the Securities Regulation Code (SRC), every Broker Dealer shall preserve its books and records for a period of not less than five (5) years, the first two (2) years in an easily accessible place.[271]

C. Reporting of Covered and Suspicious Transactions

Covered Transaction Report (CTR). Covered persons shall file a Covered Transaction Report (CTR) with the AMLC involving any transaction in cash or other equivalent monetary instrument involving a total amount in excess of Five Hundred Thousand Pesos (PhP 500,000.00) within one (1) banking day;[272]

Suspicious Transaction Report (STR). Covered persons shall file Suspicious Transaction Reports (STR) with the AMLC for transactions, regardless of the amount of the transaction, where any of the following circumstances exists:[273]

1. There is no underlying legal or trade obligation, purpose, or economic justification.
2. The client is not properly identified.
3. The amount involved is not commensurate with the business or financial capacity of the client.
4. Taking into account all known circumstances, it may be perceived that the client's transaction is structured in order to avoid being the subject of reporting requirements under the AMLA.
5. Any circumstance relating to the transaction which is observed to deviate from the file of the client and/or the client's past transactions with the covered person.
6. The transaction is in any way related to an unlawful activity or offense under the AMLA that is about to be, is being, or has been committed.
7. Any transaction that is similar or analogous to any of the foregoing.

In this regard, the covered person should exercise due diligence by implementing adequate systems for identifying and detecting suspicious transactions.

Suspicious transactions are likely to involve a number of factors which together raise a suspicion in the mind of the covered person that the transaction may be connected with any unlawful activity.

Transaction Reporting. Covered persons shall file all CTRS and STRS in accordance with the registration and reporting guidelines of the AMLC.

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[270] AMLC Regulatory Issuance (ARI) A, B, and C, No. 2, series of 2018.
[271] SRC Rule 52.1.2.
[272] Section 7.3 of the 2018 AML/CFT Guidelines.
[273] Section 7.4 of the 2018 AML/CFT Guidelines.

CTRs shall be filed within five (5) working days, unless the AMLC prescribes a different period not exceeding fifteen (15) working days, from the occurrence thereof.[274]

STRs shall be promptly filed within the next working day from the occurrence thereof, which shall be the date of establishment of suspicion or determination of the suspicious nature of the transaction[275].

Transactions that are Both Covered and Suspicious. Should a transaction be determined to be both a covered and a suspicious transaction, the covered person shall report the same as a suspicious transaction.

Attempted Suspicious Transactions. Covered persons shall likewise file STR for suspicious attempted transactions. An ***attempted transaction*** is one that a client intended to conduct and made overt acts to do so. Such overt acts include entering into negotiations or discussions to conduct the transaction and involve definite measures to be undertaken by the SEC covered person or the client. In order for an attempted transaction to be reported as an ***attempted suspicious transaction***, there must be reasonable grounds to suspect that said attempted transaction is related to money laundering or terrorist financing or when any of the circumstances enumerated in Section 7.4 hereof exists.[276]

STRs shall cover all transactions, whether completed or attempted[277].

Reporting of Customer's Unlawful Activities. Where any employee or personnel, director, or officer of the covered person knows that the client has engaged in any of the unlawful activities under the AMLA, the matter must be promptly reported to its Compliance Officer, who, in turn, must immediately report the details to the AMLC.[278]

If there is reasonable ground to suspect that the customer has engaged in an unlawful activity, the Compliance Officer, on receiving such a report, must promptly evaluate whether there are reasonable grounds for such belief and must then immediately report the case to the AMLC, unless he considers, and records an opinion, that such reasonable grounds do not exist.

Register of Suspicious and Covered Transactions. Each covered person shall maintain a register of all suspicious transactions that have been brought to the attention of its Compliance Officer, including transactions that are not reported to the AMLC.[279]

Each covered person shall likewise maintain a register of all covered transactions which are not reported to the AMLC pursuant to AMLC Resolution No. 292, Series of 2003.

The registers shall contain details of the date on which the report is made, the person who made the report to its Compliance Officer, and information sufficient to identify the relevant papers related to said reports.

Confidentiality of CTR and STR. Covered persons, their directors, officers and employees, shall not warn their customers that information relating to them has been reported or is in the process of being reported to the AMLC, or communicate, directly or indirectly, such

[274] Section 2.1 Rule 22 of the 2018 IRR AMLA.
[275] Section 9 ARI A, B, and C No. 1 Series of 2020.
[276] Section 7.7 of the 2018 AML/CFT Guidelines.
[277] Section 8 ARI A, B, and C No. 1 Series of 2020.
[278] Section 7.8 of the 2018 AML/CFT Guidelines.
[279] Section 7.9 of the 2018 AML/CFT Guidelines.

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information to any person other than the AMLC. Any violation of this confidentiality provision shall render them liable for criminal, civil and administrative sanctions under the AMLA.[280]

When reporting CTs and STs to the AMLC, covered persons, their directors, officers, and employees are prohibited from communicating, directly or indirectly, in any manner or by any means, to any person or entity or the media, the fact that a covered or suspicious transaction report was made, the contents thereof, or any other information in relation thereto. Any information about such reporting shall not be published or aired, in any manner or form, by the mass media, or through electronic mail, or other similar devices.

In case of violation thereof, the concerned officer and employee of the covered person shall be criminally liable in accordance with the provision of the AMLA, as amended. Covered persons, their directors, officers and employees, shall not notify their customers that information relating to them has been flagged internally with a view toward making a determination as to whether to file a ST, or communicate, directly or indirectly, such information to any person other than the AMLC.

Safe Harbor Provision. No administrative, criminal or civil proceedings shall lie against any person for having made a suspicious or covered transaction report in the regular performance of his duties and in good faith, whether or not such reporting results in any criminal prosecution under the AMLA or any other Philippine law. Covered persons, its directors and employees shall likewise not be liable for any loss arising out of such disclosure, or any act or omission, in relation to the fund, property or investment in consequence of the disclosure, where such is made in good faith and in the regular performance of their duties under the Act.[281]

Did You Know?
Anyone working in the regulated sector must report to the AMLC where they know or suspect, or have reasonable grounds for knowing or suspecting, that another person is engaged in money laundering or the financing of terrorism. This state of knowledge or suspicion (or grounds for suspicion) is not restricted to the covered persons'/institutions' clients; it extends to the activities of prospective clients, where that knowledge/suspicion comes or should come to them in the course of their business activities.

It is clear from the offenses detailed earlier that recognizing a suspicious transaction is extremely important. If the covered person is concerned that the source of funds may be illegitimate, he must report these suspicions to AMLC.

D. Periodic Training

The covered person shall provide education and continuing training for all its staff and personnel, including directors and officers, to ensure that they are fully aware of their personal obligations and responsibilities in combatting money laundering and to be familiar with its system for reporting and investigating suspicious matters.[282]

The timing and content of training for various sectors of staff will need to be adapted by the covered person to its own needs. The following training programs are recommended:[283]

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[280] Section 7.10 of the 2018 AML/CFT Guidelines.
[281] Section 7.11 of the 2018 AML/CFT Guidelines.
[282] Section 11.1 of the 2018 AML/CFT Guidelines.
[283] Section 11.3 of 2018 AML/CFT Guidelines.

1. ***New Staff***. A general appreciation of the background to money laundering, the need to be able to identify suspicious transactions and report such transactions to the appropriate designated point within the covered person. This training shall be provided to all new employees, regardless of level of seniority.

2. ***Cashiers/Dealers' Representatives or Investment Representatives/Advisory Staff***. Personnel who deal directly with the clients are the first point of contact with potential money launderers. Their efforts are, therefore, vital to the covered persons' reporting system for such transactions. They should be trained to identify suspicious transactions and on the procedure to be adopted when a transaction is deemed to be suspicious. "Front-line" staff should be made aware of the covered person's policy for dealing with non-regular customers, particularly where large cash transactions are involved, and the need for extra vigilance in cases under suspicious circumstances.

3. ***Supervisors and Managers***. A higher level of instruction covering all aspects of money laundering procedures should be provided to supervisors and managers. This will include the offences and penalties arising from the AMLA, procedures relating to service of production and restraint orders, internal reporting procedures, and the requirements for verification of identity and the retention of records.

Covered persons shall, at least once a year, make arrangements for refresher training to remind key staff of their responsibilities and to make them aware of any changes in the laws and rules relating to money laundering, as well as the internal procedures of the covered persons.[284]

Covered persons shall ensure that all relevant personnel are informed in a timely manner of any new provisions, updates or changes in laws, as well as new, amended or updated SEC rules, regulations, guidelines and circulars relating to money laundering and/or terrorist financing, and the internal procedures of the covered persons based on any of the foregoing.[285]

Did You Know?
In order to transmit CTRs and STRs, covered persons need to register with the AMLC in order to be given access to the AMLC Portal.

The Online Registration System for covered persons will allow Compliance Officers to manage their user accounts as well as their alternates. The system will also provide a means of monitoring covered person's user accounts by requiring Compliance Officers to update their information every two (2) years.

[284] Section 11.4 of 2018 AML/CFT Guidelines.
[285] Section 11.6 of 2018 AML/CFT Guidelines.

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Q & A

You are a business relationship manager of a covered person. A prospective new client approaches you to establish a business relationship. The client advises that she has an urgent transaction to undertake while you are carrying out the identification procedure. The client cannot produce satisfactory proof of identification. What must you do?

Undertake the transaction, but make a suspicion report to the AMLC.
Establish the relationship and hope satisfactory identification documents are provided.
Refuse to proceed and submit an STR to the AMLC. (CORRECT)

Which of the following would require covered persons to conduct enhanced due diligence (EDD)?

When the prospective client has romantic relationship with a cabinet secretary. (CORRECT)
When the prospective client is a government institution.
When the prospective client is a public company that is subject to regulatory disclosure requirement.

Part V. Predicate Crimes/Unlawful Activities

A. Who Commits Money Laundering

Money laundering[286] is committed by:

1. Any person who, knowing that any monetary instrument or property represents, involves, or relates to the proceeds of any unlawful activity:

    a. transacts said monetary instrument or property;
    b. converts, transfers, disposes of, moves, acquires, possesses, or uses said monetary instrument or property;
    c. conceals or disguises the true nature, source, location, disposition, movement, or ownership of or rights with respect to said monetary instrument or property;
    d. attempts or conspires to commit money laundering offenses referred to in the first three unlawful activities cited above;
    e. aids, abets, assists in or counsels the commission of the money laundering offenses referred to in the first three unlawful activities cited above; and
    f. performs or fails to perform any act as a result of which he facilitates the offense of money laundering referred to in the first three unlawful activities cited above.

2. Any covered person who, knowing that a covered or suspicious transaction is required under the AMLA to be reported to the AMLC, fails to do so.

B. Unlawful Activities under AMLA, as amended

There are 34 predicate crimes, which include, but are not limited to, the following:

1. Sections 4, 5, 6, 8, 9, 10, 11, 12,13, 14, 15 and 16 of RA No. 9165, otherwise known as the "*Comprehensive Dangerous Drugs Act of 2002*";
2. Section 3 paragraphs b, c, e, g, h and i of RA No. 3019, as amended, otherwise known as the "*Anti-Graft and Corrupt Practices Act*";
3. "*Plunder*" under RA No. 7080, as amended;

[286] Section 3.1 of the 2018 AML/CFT Guidelines.

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4. "*Robbery*" and "*Extortion*" under Articles 294, 295, 296, 299, 300, 301, and 302 of the Revised Penal Code, as amended;
5. "*Jueteng*" and "*Masiao*" punished as illegal gambling under Presidential Decree No. 1602;
6. "*Swindling*" under Article 315 and "*Other Forms of Swindling*" under Article 316 of the Revised Penal Code, as amended:
7. "*Smuggling*" under RA No. 455 and under RA No. 1937, as amended, otherwise known as the "*Tariff and Customs Code of the Philippines*";
8. Violations under RA No. 8792, otherwise known as the "*Electronic Commerce Act of 2000*";
9. "*Terrorism*" and "*Conspiracy to Commit Terrorism*" as defined and penalized under Sections 3 and 4 of RA No. 9372;
10. "*Financing of Terrorism*" under Section 4 and offenses punishable under Sections 5, 6, 7, and 8 of RA No. 10168, otherwise known as the "*Terrorism Financing Prevention and Suppression Act of 2012*";
11. "*Malversation of Public Funds*" and Property under Articles 217 and 222 of the Revised Penal Code, as amended; and
12. Fraudulent practices and other violations under RA No. 8799, otherwise known as the "*Securities Regulation Code of 2000*."

C. Penal Provisions under AMLA, as amended[287]

Penalties for Money Laundering. The following are the penalties to be imposed on persons convicted of money laundering:

Violation	Penalty
(a) transacts said monetary instrument or property;	Imprisonment ranging from seven (7) to fourteen (14) years and a fine of not less than three million pesos (PhP 3,000,000.00), but not more than twice the value of the monetary instrument or property involved in the offense
(b) converts, transfers, disposes of, moves, acquires, possesses or uses said monetary instrument or property;	
(c) conceals or disguises the true nature, source, location, disposition, movement or ownership of or rights with respect to said monetary instrument or property;	
(d) attempts or conspires to commit money laundering offenses referred to in paragraphs (a), (b) or (c);	
(e) aids, abets, assists in or counsels the commission of the money laundering offenses referred to in paragraphs (a), (b) or (c) above; and	Imprisonment from four (4) to seven (7) years and a fine of not less than one million five hundred thousand pesos (PhP 1,500,000.00) but not more than three million pesos (PhP 3,000,000.00),
(f) performs or fails to perform any act as a result of which he facilitates the offense of money laundering referred to in paragraphs (a), (b) or (c) above.	

[287] Rule 25 of the 2018 AMLA IRR.

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(g) Any covered person who, knowing that a covered or suspicious transaction is required under this Act to be reported to the Anti-Money Laundering Council (AMLC), fails to do so.	Imprisonment from six (6) months to four (4) years or a fine of not less than one hundred thousand pesos (PhP 100,000.00) but not more than five hundred thousand pesos (PhP 500,000.00), or both.
(h) Covered person, its directors, officers or personnel who knowingly participated in the commission of the crime of ML	Imprisonment ranging from four (4) to seven (7) years and a fine corresponding to not more than two hundred percent (200%) of the value of the monetary instrument or property laundered
(i) Failure to keep records of covered persons to be maintained and safely stored for five (5) years from the dates of transactions. With respect to closed accounts, the records on customer identification, account files and business correspondence, shall be preserved and safely stored for at least five (5) years from the dates when they were closed.	Imprisonment from six (6) months to one (1) year or a fine of not less than one hundred thousand pesos (PhP 100,000.00), but not more than five hundred thousand pesos (PhP 500,000.00), or both
(j) Malicious Reporting Any person who, with malice, or in bad faith, reports or files a completely unwarranted or false information relative to money laundering transaction against any person. If the offender is: a. corporation, association, partnership or any other juridical person, its license may be suspended and revoked b. an alien shall be deported after serving the penalties. c. a public official or employee shall also suffer perpetual or temporary disqualification from office aside from the penalties provided herein.	Imprisonment of six (6) months to four (4) years and a fine of not less than one hundred thousand pesos (PhP 100,000.00) but not more than five hundred thousand pesos (PhP 500,000.00)
(k) Breach of Confidentiality When reporting CTRs and STRs, covered persons and their officers and employees are prohibited from communicating directly or indirectly, in any manner or by any means, to any person or entity, the media, the fact that a covered or suspicious transaction report was made, the contents thereof, or any other information in relation thereto. Neither may such reporting be published or aired in any manner or form by the mass media, electronic mail, or other similar devices.	Imprisonment ranging from three (3) to eight (8) years and a fine of not less than five hundred thousand pesos (PhP 500,000.00) but not more than one million pesos (PhP 1,000,000.00)

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In case of a breach of confidentiality that is published or reported by the media, the responsible reporter, writer, president, publisher, manager and editor-in-chief shall be liable under the AMLA.	
Note on Criminal Liability of Corporate Entities: If the offender is a corporate entity, the penalties herein shall be imposed upon the responsible officers who participated in, or allowed by their gross negligence the commission of the crime; and/or directors or trustees who willfully and knowingly voted for or assented to violate the AMLA, this RIRR, or other AMLC issuances.	

D. Administrative Sanctions[288]

The Council shall, after due notice and hearing, impose administrative sanctions upon covered persons, and their responsible directors, officers and employees, or any other person for violation of the AMLA, this IRR, or for failure or refusal to comply with the orders, resolutions and other issuances of the AMLC.

The Council shall, at its discretion, impose sanctions, including reprimand, warning, fine, or such other measures as may be necessary and justified to prevent and counteract ML/TF, as identified in the rules on the imposition of administrative sanctions.

Fines shall be in amounts as may be determined by the Council to be appropriate, which shall not be more than five hundred thousand pesos (PhP 500,000.00) per violation.

E. Predicate Crimes/Unlawful Activities and Sanctions under SRC

The following are some of the SRC violations constituting predicate crimes/unlawful activities:

1. Sale or offer of unregistered securities (Section 8)
2. Stock manipulation (Section 24)
3. Fraudulent transactions (investment scams) (Section 26)
4. Insider trading (Section 27)
5. Unlicensed securities market institutions and professionals (Section 28)

The SEC has the power to revoke, refuse and suspend the license and registration of brokers, dealers, salesmen and associated persons who have willfully violated any regulations of the SEC, or who have failed to supervise, with a view to preventing such violation, another person who commits such violation.[289]

The SEC may impose administrative sanctions for the following findings:[290]

1. Violation of the SRC, SEC rules or orders.
2. Any registered broker or dealer, associated person thereof has failed reasonably to supervise, with a view to preventing violations, another person subject to supervision who commits any such violation.

[288] Rule 26 of the 2018 AMLA IRR.
[289] Sec. 29 of the SRC.
[290] Sec. 54 of the SRC.

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3. Any registrant or other person has made any untrue statement of a material fact or omitted to state any material fact required to be stated or necessary to make such statements not misleading in a registration statement or in other reports, applications, accounts, records, or documents required by law or rules to be filed with the SEC. Also included are underwriters who failed to conduct an inquiry with reasonable diligence to ensure that a registration statement is accurate and complete in all material respects.
4. Any person has refused to permit any lawful examinations into its affairs.

The SEC may impose any or all of the following sanctions for any of the above-enumerated findings:[291]

1. Suspension or revocation of any registration for the offering of securities
2. A fine of no less than Ten thousand pesos (PhP 10,000.00) nor more than One million pesos (PhP 1,000,000.00) plus not more than Two thousand pesos (PhP 2,000.00)/day of continuing violation
3. In certain violations involving fraud, disqualification from being an officer, member of the Board of Directors, or person performing similar functions, of an issuer required to file mandatory reports under the SRC or any other act, rule, or regulation administered by the SEC
4. In the cases involving members, brokers, and dealers, a fine of no more than three (3) times the profit gained or loss avoided as a result of the transactions mentioned under Section 34 of the SRC[292]
5. Other penalties within the power of the SEC to impose

F. Administrative Sanctions under 2018 AML/CFT Guidelines

Any violation of the requirements in the 2018 AML/CFT Guidelines shall be considered a violation of the Rules, Regulations or Orders promulgated by the SEC, and shall be penalized in accordance with Section 54.1(a) in relation to Section 54.1(a)(i), (ii) and (v) of the SRC without prejudice to the penalties that may be imposed by the AMLA IRR. Accordingly, the SEC may impose any or all of the following sanctions as may be appropriate in the light of the facts and circumstances:

1. Suspension or revocation of any registration for the offering of securities;
2. A fine of no less than Ten Thousand Pesos (PhP 10,000.00) nor more than One Million Pesos (PhP 1,000,000.00) plus not more than Two Thousand Pesos (PhP 2,000.00) for each day of continuing violation; and
3. Other penalties within the power of the SEC to impose.

The imposition of administrative sanctions shall be without prejudice to the filing of criminal charges against the persons responsible for the violation.

The commission of a predicate offense may subject the perpetrator to criminal and administrative liabilities under the AMLA and its IRR and the SRC and the 2018 AML/CFT Guidelines.

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[291] Reiterated also in Section 12.1 of 2018 AML/CFT Guidelines.
[292] Section 34 of the SRC.

Q & A

A single AML violation committed by a person may subject him to which of the following penalties?

Imprisonment and/or the payment of a fine under criminal liability in the AMLA
Revocation or suspension of their license and/or payment of a fine under administrative liability based on the SRC
A warning/reprimand and/or the payment of a monetary penalty under administrative liability based on the AMLA RIRR
All of the above (CORRECT)

Part VI. Terrorist Financing

"The Terrorism Financing Prevention and Suppression Act of 2012" (RA No. 10168)

A. Definition of Terrorism[293]

Terrorism covers several punishable acts, which includes, among others, the following:

1. Violations of the Human Security Act of 2007 such as Rebellion, Insurrection and Coup d' etat[294]
2. Any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act

B. Terrorist Organization[295]

Any entity owned/controlled by any terrorist or group of terrorists that:

1. commits, or attempts to commit, terrorist acts by any means, directly or indirectly, unlawfully and willfully;
2. participates as an accomplice in terrorist acts;
3. organizes or directs others to commit terrorist acts; or
4. contributes to the commission of terrorist acts by a group of persons acting.

Common purpose: furthering terrorist acts where the contribution is made intentionally and with the aim of furthering the terrorist acts or with the knowledge of the intention of the group to commit terrorist acts.

C. Terrorist Financing[296]

1. The willful and unlawful possession, provision, collection, use of property or funds or making available property, funds or other related services by any means.

[293] Section 3(j) of RA 10168.
[294] Section 3 and 4 of RA 9372.
[295] Rule 3.a.13, IRR RA 10168.
[296] Section 4 of RA 10168.

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PURPOSE: in full or in part

a. to carry out or facilitate the commission of any terrorist act;
b. by a terrorist organization, association or group; or
c. by an individual terrorist

2. Organizing or directing others to commit financing of terrorism

D. Prohibition against Dealing with Property or Fund of a Proscribed Organization[297]

1. Dealing with any property or fund that he/she knows or has reasonable ground to believe is owned or controlled by a designated person/organization, including funds derived or generated from property or funds owned or controlled, directly or indirectly, by a designated person/organization.

2. Making available any property or funds, or financial services or other related services to a designated and/or identified person/organization.

Persons, including companies and financial institutions, from countries which provide financing or support for terrorism or terrorist activities, or having terrorist organizations operating within their territory are considered as High Risk Customers.[298]

Q & A

Which of the following is not considered terrorist financing?

Willful and unlawful use of funds to carry out commission of terrorist act.
Organizing or directing others to commit financing of terrorism.
Participation in terrorist activities. (CORRECT)
Intentionally collecting funds by an individual terrorist.

E. Suspicious Transaction related to terrorism financing or terrorist acts[299]

It includes attempted transactions made by suspected or designated terrorist individuals, organizations, associations, or groups of persons.

In determining whether a transaction is suspicious, covered persons should consider the following circumstances:

1. Wire transfers between accounts without a visible legal, economic, or business purpose, especially if the wire transfers are effected through countries which are identified or connected with terrorist activities;
2. Sourced and/or beneficiaries of wire transfers are citizens of countries which are identified or connected with terrorist activities;
3. Repetitive deposits or withdrawals that cannot be satisfactorily explained or do not make economic or business sense;
4. Value of the transaction is grossly over and above what the client is capable of earning;
5. Client is conducting a transaction that is out of the ordinary for his known business interests;

[297] Section 8 of RA 10168
[298] Section 5.D.1. of 2018 AML/CFT Guidelines
[299] Rule 3.a.15 of RA 1068 IRR

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6. Deposits by individuals who have no known connection or relation with the account holder;
7. Client is receiving remittances from a country where none of his family members is working or residing;
8. Client was reported and/or mentioned in the news to be involved in terrorist activities;
9. Client is under investigation by law enforcement agencies for possible involvement in terrorist activities;
10. Transactions of individuals, companies or Non-Government Organizations (NGOs)/Non-Profit Organizations (NPOs) that are affiliated or related to people suspected of having connection with a terrorist individual, organization, association or group of persons;
11. Transactions of individuals, companies or NGOs/NPOs that are suspected of being' used to payor receive funds from a terrorist individual, organization, association or group of persons;
12. The NGO/NPO does not appear to have expenses normally related to relief or humanitarian efforts;
13. The absence of contributions from donors located within the country of origin of the NGO/NPO;
14. The volume and frequency of transactions of the NGO/NPO are not commensurate with its stated purpose and activity; and
15. Any other transaction that is similar, identical or analogous to any of the foregoing.

F. Duties of the Covered Persons Upon Receipt of the Freeze Order[300]

Duty to Preserve the Frozen Property or Funds

Upon receipt of the notice of a freeze order, the covered persons shall immediately preserve the subject property or funds in accordance with the order of the AMLC and shall forthwith serve a copy of the notice of the freeze order upon the owner or holder of the property or funds. Any responsible officer or person who fails to comply with a freeze order shall suffer the penalty of imprisonment ranging from six (6) months to four (4) years and a fine of not less than Five Hundred Thousand Pesos (PhP 500,000.00) at the discretion of the court, without prejudice to the administrative sanctions that the AMLC may impose on the erring covered Institution.

Duty to Freeze and Preserve All Related Accounts

Immediately upon receipt of the notice of the freeze order, the covered persons shall likewise preserve related accounts and serve a copy of the notice of the freeze order upon the owner/s or holder/s thereof.

Within twenty-four (24) hours from receipt of the notice of freeze order, the covered institutions shall submit to the AMLC, by personal delivery, a detailed, written return, specifying all the pertinent and relevant information which shall include, but not be limited to, the following:

1. The account number(s);
2. The name(s) of the account owner(s) or holder(s);
3. The time of freezing of all subject accounts;
4. The balance of the account as of the time of freezing;
5. The related accounts, if any, including the balance thereof as of the time of freezing; and
6. Explanation as to the ground for the identification of related accounts.

[300] Rule 16 of RA 1068 IRR

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Duty to Report All Attempted Dealings

Covered persons shall report to the AMLC any and all attempted dealings with regard to the frozen property or funds within twenty four (24) hours from such attempt.

G. Targeted Financial Sanctions[301]

Targeted Financial Sanctions" (TFS) refers to:

1. For TFS related to terrorism and TF: both asset freezing and prohibition to prevent funds or other assets from being made available, directly or indirectly, for the benefit of designated persons and those proscribed under Section 26 of the Anti-Terrorism Act of 2020 (RA 11479 and its IRR).

2. For TFS related to PF: both asset freezing and prohibition to prevent funds or other assets from being made available, directly or indirectly, for the benefit of any individual, natural or legal persons or entity designated pursuant to UNSC resolutions and its designation process.

Part VII. The Compliance Office

A. Duties and Responsibilities of the Compliance Officer[302]

Covered persons shall appoint a senior officer as the Compliance Officer who will be in charge of the following:

1. Implementation of its Operating Manual

2. Application of the internal programs and procedures, including:

   a. customer identification policies and procedures,
   b. proper maintenance of records,
   c. reporting of covered and suspicious transactions to the AMLC; and
   d. training of employees.

Unless otherwise provided in its Operating Manual, the registered Associated Person shall also be the Compliance Officer. A Compliance Officer shall be responsible for the following, among others:

1. Ensuring compliance by the staff of the covered person with the provisions of the AMLA, as amended, its IRR, and the manual of compliance procedures
2. Organizing training sessions for the staff on issues related to AML compliance
3. Preparing STRs and ensuring their timely filing with the AMLC
4. Keeping records of internally and externally reported suspicious transactions

The Compliance Officer should not simply be a passive recipient of ad hoc reports of suspicious transactions, but should play an active role in the identification and reporting of suspicious

[301] Section 2 (r) ARI no. 2, s. 2021
[302] Sec. 8.1 of the 2018 AML/CFT Guidelines

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transactions. To fulfill these functions, covered persons must ensure that the Compliance Officer receives full co-operation from all staff and full access to all relevant documentation.[303]

Notwithstanding the duties of the Compliance Officer, the ultimate responsibility for proper supervision, reporting and compliance under the AMLA, as amended, its RIRR shall rest with the covered person and its board of directors.[304]

B. Internal Control

Covered persons are required to establish and implement internal control and procedures aimed at preventing and impeding money laundering. Such procedures shall, among other things, ensure that such covered persons and their employees are aware of the provisions of the AMLA, its implementing rules and regulations, as well as all reportorial and compliance control and procedures that shall be established by the AMLC, the Supervising Authority and each covered person. These internal control procedures should be clearly set out and reflected in their Operating Manual.[305]

Policies and procedures should cover, among others:[306]

1. Communications of firm policies relating to money laundering, including timely disclosure of information and internal audits to ensure compliance with policies, procedures and controls relating to money laundering
2. Account opening and customer identification, including requirements for proper identification
3. Maintenance of records
4. Compliance with the requirement of the AMLA, its RIRR and all Circulars issued by the SEC and the AMLC
5. Cooperation with the SEC and other relevant Authorities

Covered persons shall establish written internal reporting procedures which shall:[307]

1. enable all its directors, officers, employees, and all key staff to know to whom they should report any knowledge or suspicion of money laundering activity;
2. ensure that there is a clear reporting chain under which suspicions of money laundering activity will be passed to the Compliance Officer, in accordance with the reporting procedures of the covered person; and
3. maintain a register of all reports filed pursuant to the 2018 AML/CFT Guidelines.

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[303] Sec. 8.1 of 2018 AML/CFT Guidelines
[304] Sec. 8.3 of 2018 AML/CFT Guidelines
[305] Sec. 9.1 of 2018 AML/CFT Guidelines
[306] Sec. 9.2 of 2018 AML/CFT Guidelines
[307] Sec. 9.3 of 2018 AML/CFT Guidelines.

C. Internal Audit

The internal audit shall be responsible for the periodic (not less frequently than once every 2 years) and independent evaluation of the covered persons:[308]

1. Risk management
2. Degree of adherence to internal control mechanisms related to the customer identification process
3. CT and ST reporting and record keeping and retention
4. The adequacy and effectiveness of other existing internal controls associated with money laundering and terrorist financing

The results of the internal audit shall be timely communicated to the board of directors and shall be open for scrutiny by SEC examiners in the course of the regular or special examination without prejudice to the conduct of its own evaluation whenever necessary.[309]

Q & A

You are the Compliance Officer of a regulated firm. A staff member informs you that a long-standing client has requested that the firm urgently undertakes an unusually large transaction, the size and type of which are out of line with the client's known profile. You advise the staff member to seek further information. The client refuses to provide this, and no other enquiries elicit any more facts. The employee remains suspicious and submits a suspicious activity report (SAR) to you. What should you do?

Refuse to do the transaction, but make no report.

Report to the AMLC and seek consent to proceed with the transaction. (CORRECT)

Do nothing - the client is a long-standing one.

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[308] Sec. 10.2 of 2018 AML/CFT Guidelines.

[309] Sec. 10.4 of 2018 AML/CFT Guidelines.

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