Republic of the Philippines
SECURITIES AND EXCHANGE COMMISSION
SEC Building, EDSA, Greenhills, City of Mandaluyong

27 September 2007

Mr. Reynaldo G. David
President & Chief Executive Officer
Development Bank of the Philippines
Makati City

SEC Opinion No. 07-17
Control Test Rule

Sir:

This refers to your letter dated 19 September 2007 requesting confirmation that in determining the nationality of the proposed corporate bidder or buyer of PNOC –EDC shares, the "control test" is applicable.

It is alleged that Philippine National Oil Company ("PNOC") and PNOC EDC Retirement Fund ("PNOC-EDC RF") own 46.67% (consisting of 6,000,000,000 common shares and 4,500,000,000 preferred shares) and 13.33% (consisting of 3,000,000,000 preferred shares), respectively, of PNOC –Energy Development Corporation (PNOC-EDC).

The total combined shareholdings of PNOC and PNOC- EDC RF represent 60% of the entire outstanding capital stock of PNOC-EDC. The remaining 40% shares is held by the public of which 37.8% is foreign owned while 2.2% thereof is owned by Philippine nationals. PNOC-EDC's common shares are listed in the Philippine Stock Exchange ("PSE") while the preferred shares are not listed. Both common shares and preferred shares are voting.

It is further alleged that PNOC-EDC, a corporation duly organized under Philippine laws, owns land and is engaged in the business of exploring, developing and operating geothermal energy projects.

PNOC and PNOC-EDC RF intend to divest their shareholdings in PNOC-EDC through public bidding. In its bidding rules and regulations, the corporation proposes to incorporate as one of the qualifications for the potential bidder the hereunder quoted proviso:

(49)

" x x x the bidder must be a Filipino citizen, or a partnership with at least sixty percent (60%) of its total capital contribution and controlling interest held by Philippine Nationals, or a corporation or association at least sixty percent (60%) of whose issued and outstanding shares of stock is owned legally and beneficially by Philippine Nationals.'

xxx xxx xxx

'Philippine National' is defined as 'a citizen of the Philippines; or domestic partnership or association wholly owned by citizens of the Philippines; or a corporation organized under the laws of the Philippines of which at least sixty percent (60%) of the capital stock outstanding and entitled to vote is owned and held by citizens of the Philippines; or a corporation organized abroad and registered as doing business in the Philippines under the Corporation Code of which one hundred percent (100%) of the capital stock outstanding and entitled to vote is wholly owned by Filipinos ; or a trustee of funds for pension or other employee retirement or separation benefits, where the trustee is a Philippine national and at least sixty percent (60%) of the fund will accrue to the benefit of Philippine nationals: Provided, That where a corporation and its non-Filipino stockholders own stocks in a SEC-registered enterprise, at least sixty percent (60%) of the capital stock outstanding and entitled to vote of each of both corporations must be owned and held by citizens of the Philippines and at least sixty percent (60%) of the members of the Board of Directors of each of both corporations must be citizens of the Philippines in order that the corporation shall be considered a Philippine National."

In reply, please be informed that while the 1987 Constitution of the Philippines [1] imposes a mandatory restriction that 60% of the outstanding capital stock of PNOC-

[1]**Section 2. Article XII.** All lands of the public domain, waters, minerals, coal, petroleum, and other mineral oils, all forces of potential energy, fisheries, forests or timber, wildlife, flora and fauna, and other natural resources are owned by the State. With the exception of agricultural lands, all other natural resources shall not be alienated. The exploration, development, and utilization of natural resources shall be under the full control and supervision of the State. The State may directly undertake such activities, or it may enter into co-production, joint venture, or production-sharing agreements with Filipino citizens or corporations or associations at least sixty per centum of whose capital is owned by such citizens. Such agreements may be for a period not exceeding twenty-five years, renewable for not more than twenty-five

(48)

EDC must be held by Philippine nationals since it owns real estate in this jurisdiction and is engaged in a partly nationalized activity, nonetheless, the law squarely applicable in the presented factual scenario is R.A. 7042, otherwise known as the Foreign Investment Act (FIA) as amended by R.A. 8179, and its Amended Implementing Rules and Regulations.

Section 3 of R.A. 7042, as amended, reads thus:

> "a) the term *Philippine national* shall mean a citizen of the Philippines; or a domestic partnership or association wholly owned by citizens of the Philippines; or a corporation organized under the laws of the Philippines of which at least sixty percent (60%) of the capital stock outstanding and entitled to vote is owned and held by citizens of the Philippines; or a corporation organized abroad and registered as doing business in the Philippines under the Corporation Code of which one hundred percent (100%) of the capital stock outstanding and entitled to vote is wholly owned by Filipinos or a trustee of funds for pension or other employee retirement or separation benefits, where the trustee is a Philippine national and at least sixty percent (60%) of the fund will accrue to the benefit of Philippine nationals: *Provided*, That where a corporation and its non-Filipino stockholders own stocks in a Securities and Exchange Commission (SEC) registered enterprise, at least sixty percent (60%) of the capital stock outstanding and entitled to vote of each of both corporations must be owned and held by citizens of the Philippines and at least sixty percent (60%) of the members of the Board of Directors of each of both corporations must be citizens of the Philippines, in order

---

years, and under such terms and conditions as may be provided by law. In cases of water rights for irrigation, water supply, fisheries or industrial uses other than development of water power, beneficial use may be the measure and limit of the grant.

xxx xxx xxx

Section 11. No franchise, certificate, or any other form of authorization for the operation of a public utility shall be granted except to citizens of the Philippines or to corporations or association organized under the laws of the Philippines, at least sixty per centum of whose capital is owned by such citizens, nor shall such franchise, certificate, or authorization be exclusive in character or for a longer period than fifty years. Neither shall any such franchise or right be granted except under the condition that it shall be subject to amendment, alteration, or repeal by Congress when common good requires. The State shall encourage equity participation in public utilities by the general public. The participation of foreign investors in the governing body of any public utility enterprise shall be limited to their proportionate share in its capital, and the executive and managing officers of such corporation or association must be citizens of the Philippines. (Article XII, 1987 Constitution of the Philippines).

(47)

> that the corporation shall be considered a Philippine national."

In the same vein, **Section 1(b) of the Amendments to the Implementing Rules and Regulations of R.A. 7042 (Foreign Investments Act of 1991) as amended by R.A. 8179** provides:

> (b) Philippine National shall mean a citizen of the Philippines or a domestic partnership or association wholly owned by citizens of the Philippines; or a corporation organized under the laws of the Philippines of which at least sixty percent (60%) of the capital stock outstanding and entitled to vote is owned and held by citizens of the Philippines; or a corporation organized abroad and registered as doing business in the Philippines under the Corporation Code of which 100% of the capital stock outstanding and entitled to vote is wholly owned by Filipinos; or a trustee of funds for pension or other employee retirement or separation benefits, where the trustee is a Philippine national and at least sixty percent (60%) of the fund will accrue to the benefits of Philippine nationals; Provided, that where a corporation and its non-Filipino stockholders own stocks in Securities and Exchange Commission (SEC) registered enterprise, at least sixty percent (60%) of the capital stock outstanding and entitled to vote of each of both corporations must be owned and held by citizens of the Philippines and at least sixty percent (60%) of the members of the Board of Directors of each of both corporations must be citizens of the Philippines, in order that the corporation shall be considered a Philippine national. **The control test shall be applied for this purpose.** (Underlining supplied)

The foregoing adopts the well-entrenched ruling in the **Far Southeast Gold Resources** case[2] which laid down the "control test" rule stating:

> It further appears that on February 28, 1967, the SEC promulgated rules and regulations on the implementation of the constitutional and statutory requirements that the controlling interests of enterprises engaged in the exploitation of the natural resources should be held by citizens of the Philippines or by corporations or by associations at least 60% of the capital of which is owned by such citizens, and which provide for the

[2] DOJ Opinion No. 18 s.1989, dated January 19, 1989.

46

following rule in the determination of citizenship of corporations with alien equity, to wit:

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

Said rule was substantially reiterated on September 7, 1972 and approved by the Secretary of Commerce and Industry on September 12, 1972; and this rule has been followed up to the time as basis for determining the nationality of corporate stockholders.

With due respect, it is believed that the said query should be resolved by that Office by applying its aforecited rule.

Opinion No. 84, s. 1988 cited in your query is not meant to overrule the aforesaid SEC rule. There is nothing in said Opinion that precludes the application of the said SEC rule in appropriate cases. It is quite clear from said SEC rule that **the 'Grandfather Rule'**, which evolved and applied by the SEC in several cases, **will not apply in cases where the 60-40 Filipino alien equity ownership** in a particular natural resource corporation **is not in doubt.**

Verily, the PNOC-EDC proposed equity structure reflects that the 60-40% rule shall be adhered to by the adoption of the suggested provision in the Bidding Rules and Regulations. In the process, the "control test" rule as enunciated in the Far Southeast Gold case and not the "grandfather rule" shall be applicable.

Under the control test rule mandated by the aforequoted Amendments to the IRR of FIA, dissection or further inquiry on the ownership of the shareholders both in the investing and investee corporation shall be dispensed with once it is clearly established that the participating corporations are 60% owned by Filipino citizens. In the absence of

(45)

any doubt that the bidding corporation is 60% Filipino owned, the entity shall be deemed as "Philippine national" and may thus be allowed to bid or invest in legally permissible areas of investment as in the instant case.

It should be emphasized, however, the PNOC-EDC should always maintain its 60% Filipino equity ownership or holdings at all times in order not to contravene the mandatory restriction of the fundamental law.

Very truly yours,

VERNETTE G. UMALI-PACO
General Counsel

Copy furnished: Chairperson Fe B. Barin
Dir. Justina F. Callangan, CFD

Opinions 07 pnoc edc per.

(44)