

LEGAL OPINION ON WHETHER THE CONTRACTS IN THE PA-IWI GOAT RAISING PROJECT ARE REGISTRABLE SECURITIES

I. Definition of Securities under the Securities Regulation Code

The first step in analyzing and understanding whether the Pa-Iwi contracts are “securities” falling within the coverage of the provisions of the Securities Regulation Code, is being able to define what is a security under the said law.

Section 3 of the Securities Regulation Code, particularly item 3.1 thereof provides:

“SEC. 3. Definition of Terms. –

3.1. “Securities” are 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, 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 incorporations; and

(g) Other instruments as may in the future be determined by the Commission."

As can be observed from this provision, the law neither gave a rigid definition nor an exclusive enumeration of securities. It did not confine itself to those enumerated but instead provided for items to cover future unknown securities and all other securities that may fall under the definition provided by jurisprudence.

II. Definition of "Securities" as provided by Supreme Court Jurisprudence

Supreme Court decisions or jurisprudence form part of the law of the land. As such, Supreme Court pronouncements have the force and effect of law and are controlling with respect to matters put under discussion in its decisions.

The Supreme Court in *SEC vs. Santos, G.R. No. 195542, March 19, 2014*, citing the SRC Amended Implementing Rules and Regulations, provided for a more detailed definition of "securities", thus:

"Securities have been defined as shares, participation or interest 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 among others, investment contracts, certificates of interest or participation in a profit sharing agreement, certificates of deposit for a future subscription.

Under the SRC's Amended Implementing Rules and Regulations, specifically Rule 3, par. 1 subpar. G, an investment contract has been defined as a contract, transaction or scheme (collectively "contract"), whereby a person invests his money in a common enterprise and is led to expect profits primarily from the efforts of others. It is likewise provided in the said provision that an investment contract is presumed to exist whenever a person seeks to use the money or property of others on the promise of profits and a common enterprise is deemed created when two (2) or more investors "pool" their resources creating a common enterprise, even if the promoter receives nothing more than a broker's commission." [Underscoring and Stress Supplied]

Another in-depth discussion for a better understanding of the concept of "securities" was pronounced by the Supreme Court in *Power Homes Unlimited Corporation vs. SEC*. G.R. No. 164182, February 6, 2008, thus:

*"An investment contract is defined in the Amended Implementing Rules and Regulations of R.A. No. 8799 as a contract, transaction or scheme (collectively contract) whereby a person **invests his money in a common enterprise and is led to expect profits primarily from the efforts of others.***

*It behooves us to trace the history of the concept of an investment contract under R.A. No. 8799. Our definition of an investment contract traces its roots from the 1946 United States (US) case of **SEC v. W.J. Howey Co.***

In this case, the US Supreme Court was confronted with the issue of whether

the **Howey** transaction constituted an investment contract under the Securities Acts definition of security. The US Supreme Court, recognizing that the term investment contract was not defined by the Act or illumined by any legislative report, held that Congress was using a term whose meaning had been crystallized under the states blue sky laws in existence prior to the adoption of the Securities Act. Thus, it ruled that **the use of the catch-all term investment contract indicated a congressional intent to cover a wide range of investment transactions.** It established a test to determine whether a transaction falls within the scope of an investment contract. Known as the **Howey Test**, it requires a transaction, contract, or scheme whereby a person **(1) makes an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) to be derived solely from the efforts of others.** Although the proponents must establish all four elements, the US Supreme Court stressed that the **Howey Test** embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. Needless to state, any investment contract covered by the **Howey Test** must be registered under the Securities Act, regardless of whether its issuer was engaged in fraudulent practices.

After *Howey* came the 1973 US case of **SEC v. Glenn W. Turner Enterprises, Inc. et al.** In this case, the 9th Circuit of the US Court of Appeals ruled that the element that

*profits must come solely from the efforts of others should not be given a strict interpretation. It held that a literal reading of the requirement solely would lead to unrealistic results. It reasoned out that its flexible reading is in accord with the statutory policy of affording broad protection to the public. Our R.A. No. 8799 appears to follow this flexible concept for it defines an investment contract as a contract, transaction or scheme (collectively contract) whereby a person invests his money in a common enterprise and is **led to expect profits not solely but primarily from the efforts of others**. Thus, to be a security subject to regulation by the SEC, an investment contract in our jurisdiction must be proved to be:*

- (1) an investment of money,*
- (2) in a common enterprise,*
- (3) with expectation of profits, and*
- (4) **primarily** from efforts of others."*

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III. Requirement of Registration under the SRC and Penalties for Violating this Requirement

It is important to know whether a transaction/investment falls under the definition of "securities" under the Securities Regulation Code because under the same code, any person, whether natural or juridical may not offer for sale or distribution any security unless it had been duly registered with the SRC first. Section 8 of the SRC provides:

"Section 8. Requirement of Registration of Securities. 8.1. Securities **shall not be sold**

or offered for sale or distribution within the Philippines, without a registration statement duly filed with and approved by the Commission. Prior to such sale, information on the securities, in such form and with such substance as the Commission may prescribe, shall be made available to each prospective purchaser."

Failure to comply with the provisions of the aforesaid Section carries with it stiff penalties consisting of fines and imprisonment as enunciated under Art. 73 of the SRC, to wit:

"SEC. 73. Penalties. - Any person who violates any of the provisions of this Code, or the rules and regulations promulgated by the Commission under authority thereof, or any person who, in a registration statement filed under this Code, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall, **upon conviction, suffer a fine of not less than Fifty thousand pesos (P50,000.00) nor more than Five million pesos (P5,000,000.00) or imprisonment of not less than seven (7) years nor more than twenty- one (21) years, or both in the discretion of the court.** If the offender is a corporation, partnership or association or other juridical entity, the penalty may in the discretion of the court be imposed upon such juridical entity and upon the officer or officers of the corporation, partnership, association or entity responsible for the violation, and if such officer is an alien, he shall in addition to the penalties prescribed, be deported without further proceedings after service of sentence."
(Underscoring and Stress Supplied)

IV. Objective of the SEC in Requiring Registration:

An investment contract that is security under R.A. No. 8799, must be registered with 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. As such, the public's belief in the integrity of securities is of paramount importance and is in need of preservation.

V. Whether the Pa-Iwi Contracts are "securities" within the meaning of Philippine Law and Jurisprudence

Armed with the knowledge of the definition of "securities" under the law and an understanding of the nature of the Pa-Iwi Contracts, we can conclude that the said contracts are not securities but merely a lease of services or service contracts.

Under the New Civil Code of the Philippines, Art. 1642 and 1644, a lease may be made for any service rendered, to wit:

"Art. 1642. The contract of lease may be of things, or of work and service.

Art. 1644. In the lease of work or service, one of the parties binds himself to execute a piece of work or to render to the other some service for a price certain, but the relation of principal and agent does not exist between them."

An examination of a sample Pa-Iwi Contracts provides as follows:

"A. UNDERTAKINGS OF THE FIRST PARTY:

*1. The FIRST PARTY shall make available for sale to the SECOND PARTY thirty (30) healthy upgraded does that shall constitute the initial livestock assets of the latter **to be taken cared and be in custody of the FIRST PARTY right after 3 months of farm system preparation** (including the projection and possible construction of additional breeding space accommodation and the standardized process of breeding does selection) following the signing of this agreement.*

*2. The FIRST PARTY shall **shoulder all expenses incurred during the entire process of goat raising and breeding in its own farm including veterinary services, manpower requirements for procedural feeding, cleaning and safekeeping to ensure protection and wellbeing of does procured and owned by the SECOND PARTY.**"*

[Underscoring and Stress Supplied]

It is clear from the language of the agreement that the second party, or the purchaser of the goats, merely engages and leases the services of the farm (first party) to take care and custody of the goats purchased which includes their raising, breeding and safekeeping. Therefore, it can be concluded that the Pa-Iwi contract is only a service contract and not a security. It is important to note that the payment made by the second party is not an investment but the price paid to purchase the goats and the payment for the services of the farm in taking care of them, thus the pertinent clause of the Pa-Iwi Contract provides:

*"WHEREAS, the SECOND PARTY desires to venture into agri-business of goat raising and in so doing **intends to avail of the services and farm facilities** of the FIRST PARTY as provided for under its Profitable Goat Raising Livelihood Program" [Underscoring and Stress Supplied]*

Why the Power Homes Case and the definition of "Securities" therein does not apply.

Supreme Court case pronouncements only apply if the facts provided for in the case decided by the high court is similar to the or "on all fours" with our case. The Supreme Court ruling in the case of *Power Homes Unlimited Corporation vs. SEC. G.R. No. 164182, February 6, 2008* therefore does not apply to the Pa-Iwi contracts because the Power Homes case dealt with a networking scheme, which is totally different from our business, to wit:

"The scheme of the [petitioner] corporation requires an investor to become a Business Center Owner (BCO) who must fill-up and sign its application form. The Terms and Conditions printed at the back of the application form indicate that the BCO shall mean an independent representative of Power Homes, who is enrolled in the company's referral program and who will ultimately purchase real property from any accredited real estate developers and as such he is entitled to a referral bonus/commission. Paragraph 5 of the same indicates that there exists no employer/employee relationship between the BCO and the Power Homes Unlimited, Corp.

The BCO is required to pay US\$234 as his enrollment fee. His enrollment entitles him to recruit two investors who should pay US\$234 each and out of which amount he shall receive US\$92. In case the two referrals/enrollees would recruit a minimum of

four (4) persons each recruiting two (2) persons who become his/her own down lines, the BCO will receive a total amount of US\$147.20 after deducting the amount of US\$36.80 as property fund from the gross amount of US\$184. After recruiting 128 persons in a period of eight (8) months for each Left and Right business groups or a total of 256 enrollees whether directly referred by the BCO or through his down lines, the BCO who receives a total amount of US\$11,412.80 after deducting the amount of US\$363.20 as property fund from the gross amount of US\$11,776, has now an accumulated amount of US\$2,700 constituting as his Property Fund placed in a Property Fund account with the Chinabank. This accumulated amount of US\$2,700 is used as partial/full down payment for the real property chosen by the BCO from any of [petitioners] accredited real estate developers.

An example that comes to mind would be the long-term commercial papers that large companies, like San Miguel Corporation (SMC), offer to the public for raising funds that it needs for expansion. When an investor buys these papers or securities, he invests his money, together with others, in SMC with an expectation of profits arising from the efforts of those who manage and operate that company. SMC has to register these commercial papers with the SEC before offering them to investors.” [Underscoring and Stress Supplied]

We don't derive profit out of new recruits. We derive profits because goats reproduce. Thus, the application of the definition of securities under the Power Homes case is not pertinent to our case and the latter should have an entirely separate determination.

Also noteworthy, it is quite clear from the SMC example given by the Supreme Court that there is a huge difference between it and our Pa-Iwi contract. What the investor acquires

in the purchase of securities is the security itself, as he invests his money together with others and expects to earn profits from the efforts of those who run the company. The Pa-Iwi contracts contemplate an entirely different factual setting from this. In the Pa-Iwi engagement, what the Pa-Iwi partner obtains is not a paper security but the readily identifiable and tangible animals he could visit in the farm.

This premise gives rise to the application of the Supreme Court decision in *SEC vs. Prosperity.com, Inc.*, G.R. No. 164197, January 25, 2012. In this case, the Supreme Court pointed out that if money is given to a company, not as an investment but as payment for the obtention or procurement of tangible assets or a product of value, such transaction will not be considered a sale of a security, thus:

*"Here, PCI's clients do not make such investments. **They buy a product of some value to them: an Internet website of a 15-MB capacity.** The client can use this website to enable people to have internet access to what he has to offer to them, say, some skin cream. **The buyers of the website do not invest money in PCI that it could use for running some business that would generate profits for the investors.** The price of US\$234.00 is what the buyer pays for the use of the website, **a tangible asset that PCI creates**, using its computer facilities and technical skills. x x x*

*The CA is right in ruling that the last requisite in the Howey test is lacking in the marketing scheme that PCI has adopted. Evidently, it is PCI that expects profit from the network marketing of its products. PCI is correct in saying that the US\$234 it gets from its clients is **merely a consideration for the sale of the websites that it provides.**"*
[Underscoring and Stress Supplied]

Existence of the Four (4) Elements

We must now analyze whether the elements found in the *Howey Test* are present in the case of the Pa-Iwi contracts. The 4 elements are not really precise as they tend to include our contract which is, as previously discussed, are simple service contracts rather than securities.

Again, the four elements are:

(1) 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.

1. Investment of Money – To reiterate, the Pa-Iwi partners are not investors. This is because their money will be used for buying 30 goats and not to buy-in an investment in the company. The excess of the price paid will be the payment for the lease of services of the farm who will in turn take care of the goats. There is clearly no corporate investment in this scenario since the money will be used by the company to purchase the goats on behalf of the Pa-iwi partner and not for any corporate purpose that will enable the company to report profits to the Pa-iwi partner.

2. In a Common Enterprise – Pa-iwi partners are not investors in our business/enterprise. They merely entrust their goats to the care and safekeeping of the farm to ensure that the purchased goats are given the best treatment conducive to growth, development, and reproduction.

3. With expectation of profit – It is true that there is an expectation of profit. However, this expectation of profit does

not come primarily from the efforts of others as will be discussed hereinbelow.

4. Derived Primarily from efforts of another – As appearing in the miscellaneous provisions of the Pa-Iwi contract, profit will be realised by the Pa-Iwi partner when he sells the goats to the farm, thus:

"C. MISCELLANEOUS PROVISIONS:

1. The FIRST PARTY reserves the right to buy every single upgraded offspring of the 30 does of the SECOND PARTY upon reaching the age of four months at a price of Php 3,000.00 per head or a total of P90,000 for 30 offspring which shall represent the first payout to the SECOND PARTY on or before the 11th month after signing of this contract. The SECOND PARTY is further entitled to three (3) more payouts every 8 months thereafter at the rate of P135,000.00 every payout."

It bears to emphasize that it is the animals who reproduce under the supervision and care of the subfarm owners whose services are being leased by the Pa-Iwi partners. Sexual reproduction of the goats are primarily the nature of the goats, with or without the help of humans. The profits are therefore derived not "primarily" from the efforts of the subfarm owners but from the natural efforts of the goats/animals.

In conclusion, the Pa-Iwi contracts are not securities that should be registered with the SEC under the provisions of the Securities Regulation Code.

VI. The Remedy of Declaratory Relief:

Despite the fact that we have firm conclusion at hand that the Pa-Iwi contracts are not securities, we cannot solely rely on our judgment without any official pronouncement declaring that the same contracts are not securities.

The main legal remedy we can avail at this time is to file a Petition for Declaratory Relief with the Regional Trial court to dismiss any doubts as to the correctness of our conclusion.

Rule 63, Section 1 of the Rules of Court provides:

*Who may file petition. **Any person interested under** a deed, will, contract or other written instrument, or **whose rights are affected by a statute, executive order or regulation,** ordinance, or any other governmental regulation may, before breach or violation thereof, bring an action in the appropriate Regional Trial Court to **determine any question of construction or validity arising, and for a declaration of his rights or duties, thereunder.** [Underscoring and Stress Supplied]*

The requirements of an action for declaratory relief are as follows: (1) there must be a justiciable controversy; (2) the controversy must be between persons whose interests are adverse; (3) the party seeking declaratory relief must have a legal interest in the controversy; and (4) the issue involved must be ripe for judicial determination.

Indeed, under Section 1, Rule 63, **a person must file a petition for declaratory relief before breach or violation of a deed, will, contract, other written instrument, statute, executive order, regulation, ordinance or any other governmental regulation.** (Martelino vs. National Home Mortgage Finance Corporation, G.R. No. 160208, June 30, 2008)

1) Justiceable Controversy - The justiceable controversy in this case is whether or not the Pa-Iwi contracts are securities that need to be registered with the SEC;

2) Controversy Must Be Between Persons Whose Interests Are Adverse - In this case it will be the

Petitioner and the State who is regulating the sale of securities;

3) The Party Seeking Declaratory Relief Must Have A Legal Interest In The Controversy – the company definitely has legal interest in the controversy;

4) Issue involved must be ripe for Judicial Determination - an court case may arise should a ruling be handed down declaring as securities the Pa-Iwi Contracts. It is ripe for judicial determination notwithstanding the fact that there still had been no violation yet. This is the main purpose of the Petition for Declaratory Relief.

This petition will be filed in order for us to obtain a definitive court ruling which will serve as our basis to say that the Pa-iwi contracts are not securities and there is no requirement to register them with the SEC.