*A Strategic Vision:*

# Strengthening Philippine Mutual Funds

# and

# Improving the Public's Perception of Them

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A

# A Strategic Vision: Strengthening Philippine Mutual Funds And Improving The Public's Perception Of Them

## TABLE OF CONTENTS


| | Page |
|---|---|
| PREAMBLE | 1 |
| EXECUTIVE SUMMARY | 4 |
| Recommendations for Strengthening the Mutual Fund Industry | 8 |
| A. Legislation | 8 |
| 1. The Securities Act of 1999 ("SA99") | 8 |
| 2. The Revised Investment Company Act ("RICA") | 9 |
| 3. The Pre-Need Securities Code ("Code") | 9 |
| 4. The Personal Equity Retirement Account ("PERA") | 9 |
| B. Fiscal Policy | 10 |
| 1. The Documentary Stamp Tax on Share Issuance | 10 |
| 2. The Dividends Tax | 10 |
| 3. Other Taxes | 11 |
| C. Regulatory Reforms | 11 |
| 1. The Securities and Exchange Commission ("SEC") | 11 |
| 1. Mutual Fund Sales Agent Examinations | 12 |
| 2. SEC Investment Fund Unit | 12 |
| 3. SEC Pre-Need Unit | 12 |
| 2. Bangko Sentral ng Pilipinas ("BSP") | 12 |
| Permit Banks to Sell Fund Shares | 12 |
| Transfer BSP Regulation of Investment Advisers to the SEC | 13 |
| D. Strengthen the Investment Company Association of the Philippines ("ICAP") | 13 |
| 1. Influence the Legislative and Regulatory Environment | 13 |
| 2. Raise Professional Standards | 14 |
| 3. Create Investor Education and Media Relations Programs | 14 |
| 4. Develop an Economic and Marketing Analysis Capability | 14 |




B

I. THE PHILIPPINE INVESTMENT COMPANY INDUSTRY 16

A. Introduction 16

B. Relative to its Domestic Competitors, the Market and its Asian Neighbors 17

C. The Industry: Perceptions and Profile 19

1. Perceptions: A Few Pages of History 19
2. The Industry is New 19
3. A Respectable Track Record 20

D. The End of the Rainbow: Resources, Profits and Losses and Long Term Strategies of Fund Sponsors 27

1. Fund Distribution Channels 27
2. Management Company Human Resources 27
3. Financial Resources 29

E. Market Potential 32

F. Investment Opportunities for Mutual Funds 34

1. Analysis of Fund Portfolio Investments 34
2. The Equities Market 35
3. The Debt Market 40

G. Attracting Global Expertise and Resources 42

1. Expand Mutual Fund Investment Opportunities 42
2. Provide Satisfactory Answers to Fundamental Questions 44

H. Potential Fund Sponsors 44

II. DIFFERENTIAL REGULATION 46

A. Introduction 46

B. Regulation of Investment Companies 47

1. The Philippine Investment Company Act ("PICA"), Rule ICA 35-1 and The Revised Securities Act 47
2. The Revised Securities Act and SEC Rules and Forms 48
3. The Securities and Exchange Commission 49



C

C. Tax Policy Discriminates Against Funds and Their Shareholders and Inhibits the Growth and Development of the Fund Industry 50

1. The Dividends Tax 50
2. The Documentary Stamp Tax ("DST") on Issuance of Fund Shares 51
3. Other Taxes 52

D. Lack of Effective Regulation of Pre-Need Plans 53

E. Regulation of Common Trust Funds (CTF's) 56

F. The Costs to Investors, the Capital Market and Public Confidence 59

III. THE ROLE OF THE INVESTMENT COMPANY ASSOCIATION OF THE PHILIPPINES ("ICAP") 60

A. Establishment 60

B. Activities and Achievements 60

C. Current Projects and Plans 61

D. Financial Resources 62

IV. THE MUTUAL FUND AND UNIT TRUST INDUSTRIES OF NEIGHBORING ASIAN COUNTRIES 64

A. Pages From Another Book 64

B. "Best Practices" 64

1. India 64
2. Japan 66
3. Hong Kong 68
4. Republic of Korea 68
5. Malaysia 70
6. Singapore 71
7. Republic of China (Taiwan) 72

V. ANALYSES: STRATEGIES FOR REACHING LONG TERM GOALS 74

A. Why Aren't Funds More Popular in the Philippines 74

B. Working Professionals' Perceptions of Mutual Funds 74

C. The Best of All Possible Worlds 76

D. Keys to Change 77



d

1. Magic Wands 77
2. Second Thoughts 78
3. Legislation and Regulation 80

a. Securities Laws 80
b. Tax Laws 80
c. Regulation 81

4. Strengthen ICAP 82

VI. RECOMMENDATIONS: STRENGTHENING THE MUTUAL FUND INDUSTRY AND IMPROVING THE PUBLIC'S PERCEPTION OF MUTUAL FUNDS 84

A. Legislation 84

B. Fiscal Policy 85

C. Regulatory Reforms 86

1. The Securities and Exchange Commission ("SEC") 86
2. Bangko Sentral ng Pilipinas ("BSP") 87

D. ICAP's Comprehensive Strategic Plan 87

1. Influence the Legislative and Regulatory Environment 88
2. Raise Professional Standards Among Members, Investment Managers, Distributors and Sales Agents 88
3. Create Investor Education and Media Relations Programs 89
4. Develop an Economic and Marketing Analysis Capability 89

LIST OF TABLES i

LIST OF FIGURES ii

ABBREVIATIONS iii-iv

APPENDICES v-vii

# TABLES

| | | Page |
|---|---|---|
| Table 1 | Industry Players and Assets, 1998 | 17 |
| Table 2 | Mutual Fund Industry Market Capitalization Comparisons | 18 |
| Table 3 | Average Annual Returns of Philippine Mutual Funds, 1996-1998 | 20 |
| Table 4 | Portfolio Turnover | 24 |
| Table 5 | Fund Expense Ratios, 1996-1998 | 24 |
| Table 6 | Fund Sponsors by Industry, 1998 | 26 |
| Table 7 | Management Company Human Resources, 1998 | 27 |
| Table 8 | Sales Agent/Accountholder Comparisons, 1998 | 29 |
| Table 9 | Management Company Financial Resources, 1997 | 29 |
| Table 10 | Management Company Income/Expense Analysis, 1997 | 31 |
| Table 11 | Family Income, Expenditures and Savings, 1994 | 33 |
| Table 12 | Philippine Mutual Fund Investments, 1997 & 1998 | 35 |
| Table 13 | PSE Listed Companies and Market Capitalization, 1989-1998 | 36 |
| Table 14 | Volume of Treasury Bills Issued 1995-1998 | 40 |
| Table 15 | Volume of Fixed Rate Treasury Notes Issued, 1995-1998 | 40 |
| Table 16 | Commercial Paper Issued and Outstanding, 1989-1998 | 41 |
| Table 17 | Potential Investment Company Sponsors, November 1998 | 45 |
| Table 18 | Time of SEC Processing of Investment Fund Registration Statements | 49 |
| Table 19 | Summary of ICAP Financial Information | 62 |

# FIGURES

| | | Page |
|---|---|---|
| Figure 1 | Filipino Fund, Inc. - NAVPS vs. Stock Price | 23 |
| Figure 2 | Filipino Fund, Inc. - Premium (Discount) to NAVPS | 23 |
| Figure 3 | Philippine Stock Exchange Market Capitalization, 1989-1998 | 38 |
| Figure 4 | Philippine Stock Exchange Total Value Turnover, 1989-1998 | 38 |

# ABBREVIATIONS

| | |
|---|---|
| AIM | Asian Institute of Management |
| ALFIF | Ayala Life Fixed Income Fund |
| AMFI | Association of Mutual Funds in India |
| BED | Brokers and Exchanges Department |
| BIMI | BPI Investment Management Inc. |
| BNM | Bank Negara Malaysia |
| BPI | Bank of the Philippine Islands |
| BSP | Bangko Sentral ng Pilipinas |
| BTr | Bureau of Treasury |
| CARP | Comprehensive Agrarian Reform Program |
| CBI | Credit Information Bureau Inc. |
| CMDCI | Capital Markets Development Center, Inc. |
| CMI | Citisec Management Inc. |
| Code | Pre-Need Securities Code |
| CSTF | Contractual Savings Task Force |
| CTF | Common Trust Fund |
| CTGF | Clearing and Trade Guarantee Fund |
| DoF | Department of Finance |
| DST | Documentary Stamp Tax |
| FAIMI | First Abacus Investment Management, Inc. |
| FFI | Filipino Fund, Inc. |
| FIIs | Foreign Institutional Investors |
| FINEX | Financial Executives Institute of the Philippines |
| FMUTM | Federation of Malaysian Unit Trust Managers |
| FRTNs | Floating Rate Treasury Notes |
| FXTNs | Fixed Rate Treasury Notes |
| GSIS | Government Service Insurance System |
| HKIFA | Hong Kong Investment Funds Association |
| ICA | Investment Company Act |
| ICAP | Investment Company Association of the Philippines |
| IC | Insurance Commission |
| ICI | Investment Company Institute |
| IMA | Investment Management Activities |
| IOS | Investors Overseas Services |
| IRA | Individual Retirement Accounts |
| KITCA | Korea Investment Trust Companies Association |
| KLSE | Kuala Lumpur Stock Exchange |
| LGU | Local Government Unit |
| MFMCP | Mutual Fund Management Company of the Philippines, Inc. |
| MKSE | Makati Stock Exchange |
| MMOD | Money Market Operations Department |
| MOA | Memorandum of Agreement |
| MSE | Manila Stock Exchange |
| NAPOCOR | National Power Corporation |
| NAVPS | Net Asset Value Per Share |
| NRIs | Non-Resident Indians |

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|---|---|
| NRIs | Non-Resident Indians |
| PAMI | Philam Asset Management, Inc. |
| PDIC | Phlippine Deposit Insurance Corporation |
| PERA | Personal Equity Retirement Account |
| PICA | Philippine Investment Company Act |
| PLDT | Philippine Long Distance and Telephone Co. |
| PMI | Philequity Management, Inc. |
| PNB | Philippine National Bank |
| PNPs | Pre-Need Plans |
| PSE | Philippine Stock Exchange |
| RICA | Revised Investment Company Act |
| RSA | Revised Securities Act |
| RSIT | Regulation of the Securities Investment Trust |
| SA99 | Securities Act of 1999 |
| SC | Securities Commission |
| SCCP | Securities Clearing Corporation of the Philippines |
| SDT | Small Denomination Treasury |
| SFC | Securities Futures Commission |
| SEBI | Securities and Exchange Board of India |
| SEC | Securities and Exchange Commission |
| SEMS | Stock Exchange of Malaysia and Singapore |
| SET | Stock Exchange of Thailand |
| SIP | Small Investors Program |
| SRO | Self-Regulatory Organization |
| SITCA | Securities Investment Trust and Consulting Association of the R.O.C. |
| SITTA | Securities Investor Trust of Taipei Association |
| TFGFMC | The First Galleon Fund Management Corporation |
| US 64 | Unit Scheme 64 |
| UTI | Unit Trust of India |

# APPENDICES


| | | Page |
|---|---|---|
| APPENDIX 1 | Perceptions of Mutual Funds Among Working Professionals of Metro Manila, May 1999, ("Perception Survey") | 1-31 |
| APPENDIX 2 | IHAP Position Paper on the Mutual Fund Industry Study Submitted by AGILE | 32-42 |
| APPENDIX 3 | Comments of Lewis J. Mendelson, Capital Market Consultant, March 2, 1999, on the Revised Securities Act | 43-55 |
| APPENDIX 4 | Preliminary Comments of Lewis J. Mendelson, Capital Market Consultant, February 4, 1999, on The Revised Investment Company Act ("RICA") | 55-63 |
| APPENDIX 5 | Correspondence, Statements, Presentation and Comments of Lewis J. Mendelson, Capital Market Consultant on the Pre-Need Securities Code | 64-143 |
| A | Comments of Lewis J. Mendelson, Capital Market Consultant on the Pre-Need Securities Code | 64-79 |
| B | Distribution of Pre-Need Trust Fund Portfolio Assets: 1997 | 80-81 |
| C | Statement of Lewis J. Mendelson | 82-85 |
| D | Letter to Hon. Jose Macario L. Laurel | 86-88 |
| E | Level the Regulatory Playing Field | 89-93 |
| F | US SEC Scholarship Plan Findings, Opinions and Cases | 94-128 |
| G | United States Securities and Exchange Commission: Summary of Report on Face Amount Certificate Companies | 129-143 |

| | | |
|---|---|---|
| APPENDIX 6 | Extension of Comments (on "PERA") of Lewis J. Mendelson, Capital Market Specialist, Before the Senate Committee on Banks and Financial Intermediaries, February 5, 1999 | 144-146 |
| APPENDIX 7 | Excerpt from PricewaterhouseCoopers Monograph, "Building A Securities Market Regulator In An Emerging Market", The Division of Investment Management | 147-148 |
| APPENDIX 8 | Letter of Alberto V. Reyes, Deputy Governor, BSP, to Hon. Joel A. Bañares, Undersecretary, Department of Finance, June 9, 1999 | 149-151 |
| APPENDIX 9 | The Industry Players | 152-153 |
| APPENDIX 10 | BSP Regulation | 154-159 |
| A | SEC-BSP Memorandum of Agreement, February 11, 1999 | 154-157 |
| B | BSP Memorandum to All Banks and Other Financial Institutions Performing Trust, Other Fiduciary Business and Investment Management Activities, October 16, 1990 | 158-159 |
| APPENDIX 11 | Letter of Andre-Jacques Belanger, Director International Investment Products, Sun Life of Canada, May 17, 1999 | 160-162 |
| APPENDIX 12 | Letter of R.P. Lirio, Managing Director, Supervision and Examination Sector (SEII) and Officer-in-Charge, Supervisory Reports and Studies Office (SRSO) of the BSP, April 23, 1999 | 163-167 |
| APPENDIX 13 | Indian Mutual Funds: Sales, Redemptions and Net Assets, 1997-1998 | 168-169 |

| | | |
|---|---|---|
| APPENDIX 14 | Japanese Investment Trusts | 170-189 |
| A | Presentation of Mr. Hitoshi Tonomura, Chairman of Investment Trust Association of Japan, 4th Annual Asia-Oceania Conference, Hong Kong, April 28-30, 1999 | 170-173 |
| B | Japan Country Report, Oceania Conference | 174-189 |
| APPENDIX 15 | Report of the Hong Kong Investment Funds Association (HKIFA), Oceania Conference | 190-203 |
| APPENDIX 16 | Korean Investment Trusts and Mutual Funds | 204-210 |
| A | Country Report of the Korea Investment Trust Association, Oceania Conference | 204-209 |
| B | "Heard on the Street" Mutual Funds Offer Value in Jumping Korean Market, by Hae Won Choi, Asian Wall Street Journal, May 28-29, 1999 | 210 |
| APPENDIX 17 | Malaysia Country Report, Oceania Conference | 211-233 |
| APPENDIX 18 | Singapore: Unit Trusts and Mutual Funds | 234-241 |
| A | United States Embassy, Singapore's Securities Industry Report; Unit Trusts and Funds | 234 |
| B | Investment Management Association of Singapore, Organization, Objectives and Members | 235-241 |
| APPENDIX 19 | Taiwan, Country Report of the Securities Investment Trust and Consulting Association of the ROC, Oceania Conference | 242-253 |

# A STRATEGIC VISION:

# STRENGTHENING PHILIPPINE MUTUAL FUNDS AND IMPROVING THE PUBLIC'S PERCEPTION OF THEM

**July 1999**

## PREAMBLE

*Updates.* This report was prepared in two stages. The *Circulation Draft* was completed on March 10, 1999 and distributed for comment shortly thereafter. The Final Report was completed on July 31, 1999. While the Final Report bears a strong resemblance to the Circulation Draft, it also differs in several significant respects. These differences reflect not only the excellent comments received, but also take into account changes in the Philippine and Asian Capital Markets. The recommendations contained in the Circulation Draft remain. They have been sharpened and reinforced by:

- a heavier emphasis on "Best Practices" of the Mutual Fund Industries of Asia;
- a discussion of the need to broaden investment opportunities and protections, not only for mutual funds but for the entire market;
- a more focused discussion of how the modification or repeal of four taxes that hinder the development of the fund industry could not only benefit it, but also could lead, in three of the four cases, to an immediate increase in tax revenues;
- an analyses of a Market Survey of Working Professionals in Metro Manila ("Perception Survey") prepared by Professor Art Ilano; and
- updating through June 30, 1999, by co-author Noel Gamo, of some of the data contained in the Report.

***The Kaleidoscope effect.*** Preparing a report about the Philippine Mutual Fund Industry during the first six months of 1999 has been like looking at the industry through a kaleidoscope. Because of the accelerating pace of change in the Philippine capital market, reference to this as a "Final Report" may be a misnomer. If it were it to be written six months from now or next year, it could be very different. When this Report was first authorized late in 1998, Asia was still in the midst of a sweeping financial crisis. Now, it is in the midst of recovery. In January 1999, when this effort was begun, the Philippine Mutual Fund Industry was reporting total year-end 1998 assets of P3.3 billion and approximately 14,236 shareholder accounts, of which only 6,272 were accounted for by the 14 open-end funds. At June 30, it reported assets of P4.4 billion, a startling growth of P1.1 billion or 33%. Similarly, the number of open-end fund shareholder accounts jumped to 8,201, an increase of 1,929 accounts or nearly 31 percent. The industry's investment performance has improved from "notable" to, in some cases, "outstanding." What was the worst performing fund from 1996-98, had become the best performing fund for the first six months of 1999.

***Promising initiatives awaiting realization.*** Over this six month period, AGILE has designed and begun to implement a comprehensive program for the growth of the Philippine Capital Market. This report emphasizes the relationship of strengthened capital markets to the success of the fund industry. It borrows from AGILE's analyses of the need for market institutions to provide improved investor protections.

***Establishment of the CSTF.*** Among the more promising steps that have been initiated during this period was the establishment of the Contractual Savings Task Force ("CSTF") of the Department of Finance focused on reforming the national retirement system. While not its primary focus, that effort could open many opportunities for the development of the capital market and of the fund industry. It could also lead to rationalizing the tax system and making it fairer by treating all investment products equally.

***Listing T-Notes.*** Another promising step during this period was the signing of a Memorandum of Agreement on June 21, between the Department of Finance ("DoF") and the Philippine Stock Exchange ("PSE") to list and trade Small Denomination Treasury ("SDT") Notes within one year (by July 14, 2000) of the first SDT issue. Such trading could help to expand opportunities for investment, not only by helping to build a debt market, but also by providing a benchmark for valuation of long term debt by funds and by spurring a movement to "mark to the market" among other institutions, ultimately leading to more debt trading.

***Focus on enactment of SA'99 and RICA.*** The Congress has moved closer to adopting the long awaited Securities Act of 1999 with the much-needed reforms that it would bring. The Administration has restored enactment of the Revised Investment Company Act ("RICA") to its list of legislative priorities for this Congressional Session.

***The fund industry.*** The Investment Company Association of the Philippines ("ICAP") has also developed responsibly during this period. It has been actively involved in the CSTF; arranged on June 21, 1999, for the SEC to transfer its administration of the licensing examination for mutual fund salesmen to the Capital Market Development Center, Inc.("CMDCI"); participated in the 4th Annual Asia Oceania Regional Meeting of Investment Fund Associations; and determined to expand its membership and revenue sources to become better funded to enable it to become an even more effective representative of the fund industry. The fund industry also has attracted two new strong and knowledgeable domestic and international sponsors, Far East Bank and Trust Co., which in February registered, Far East Fund, Inc., and Sun Life Assurance Company of Canada, Inc. which is preparing to register several funds, including some that would invest substantially in securities of foreign issuers. Addition of such sponsors to the industry's ranks would help add to its credibility and its legitimization.

***A cautionary note.*** Although many positive initiatives have been undertaken and many symptoms of the Asian Financial Crisis appear to have lessened, the fundamental root causes have not yet been corrected. While there are many promising signs for the economy, the

capital market and the fund industry, they are only a beginning. There is much to be done to strengthen the fund industry.

# EXECUTIVE SUMMARY

A successful mutual fund industry can be an engine for the development of the Philippine capital market, driving its long term growth and development. By adding liquidity to the secondary market, mutual funds help to encourage new public offerings, improve intermediation, capital allocation and formation and, ultimately, can stimulate savings and help spur the development of the Philippine economy.

The Philippine Mutual Fund Industry by any standard is still too tiny, too unknown, too lacking in resources, too young and unprofitable, to be able to be a catalyst to market development. At December 31, 1998, it consisted of just 15 investment companies (14 were open-end or mutual funds) and 11 sponsors (12 investment managers). It had only ₱3.3 billion ($86 million) in total assets, less than 0.02 percent of total market capitalization. Its ₱3.3 billion total assets were dwarfed by those of bank common trust funds, ₱90 billion ($2.25 billion), and even by those of the Pre-Need Plan industry, ₱78.8 billion [$2 billion (1997)]. Moreover, the ₱3.3 billion asset figure overstated the mutual funds' market penetration. At December 31, 1998, the 14 mutual funds had 6,272 shareholders and the closed-end investment company almost 8,000 shareholders. At year-end 1997, approximately 70 percent of the total assets of the mutual funds were held by corporate shareholders, and much of those assets represented seed capital. However, the picture has begun to change dramatically over the first six months of 1999. Spurred by an increase of 1,929 open–end fund shareholder accounts, or more than 30 percent, and by portfolio appreciation, as the Philippines recovers from the Asian Financial Crisis, industry assets reached ₱4.4 billion and total shareholder accounts climbed to over 16,394 at June 30, 1999.

***Market potential.*** The tiny size of the mutual fund industry cannot be explained by a lack of market potential. That there is ample market potential for mutual funds may be inferred from family income data and savings rates. In 1994, the top family income strata of the Philippines, over 100,000 families, earned an average of ₱865,000 per year and were able to save approximately 40% of that amount, or ₱347,000 per family per year, a total of ₱35.8 billion. This well educated group should be open to investing in mutual funds. In the next tier of households are 419,000 families who earned some ₱327,000 and saved approximately 26 percent, or ₱85,000 per family per year. All should be prospects for investment in mutual funds. In the next tier are one million families who earned an average of ₱187,000 and saved 23 percent per year, or ₱43,000 per family. If those million families were able to save just an average of ₱5,000 each per year, it would represent a potential capital base of roughly ₱8 billion per year. Even the mass market of 6 million households with savings rates ranging from 19 to 8 percent could represent a target market. If each household could save ₱200 per month, perhaps through a savings plan, it would yield a total of ₱14 billion *per year.*

In the best of all imaginable circumstances, the total available pool of savings would amount to approximately ₱176 billion per annum, of which a significant portion could represent the market potential for mutual funds. Of course, others will continue to make strong claims to this savings pool. The Philippine Government's Small Investors Program ("SIP"), launched in November 1998, offers 91-, 182- and 364-day T-Bills for as low as ₱5,000; its

new Small Denominated Treasury Notes Program ("SDT"), launched July 14, 1999, offered ₱ 1.6 billion in 5-Year Treasury Notes paying 13 percent also in ₱ 5,000 minimum amounts. While potentially a great benefit to investors, as they become more and more available and accepted, the SIP and SDT could provide an enormous competitive challenge to the mutual fund industry, especially to bond and balanced mutual funds. They also represent an opportunity. Funds could use them to add liquidity to their portfolios and may be able to use the price of the T-Notes as the basis for valuation of other debt securities.

***Investment results.*** One reason for the lack of popular acceptance of the fund industry is lack of information about fund investment results, including the perception that the industry has not performed well. Actually, the industry has shown that it is capable of achieving respectable, and in some cases impressive, investment returns. For the three years 1996-98, the mutual funds (including the one closed-end investment company) posted a broad range of average annual returns from a top of 27.71 % for one of the equity funds; to an average annual loss of (-11.88 %) for one of the balanced funds. The equity mutual funds (average annual yield, +18.89%) measurably outperformed the benchmark Phisix (average annual yield,-4.50%) for 1996-98, although the balanced and bond mutual funds slightly lagged their benchmark rates over the same period.[1] When one considers that these returns were achieved over a three year period whose central economic reality was the Asian Financial Crisis and steep market declines throughout Asia, the performance of Philippine Fund industry is worthy of note.

More remarkable is how the funds have bounced back from the Asian Financial Crisis. During the first six months of 1999, the funds, with only a few exceptions, have posted even more impressive results. The five equity funds posted an average yield of 19.02% for the period; the seven balanced funds, 13.63%; and the three bond funds, 5.125%. The leading performer, the balanced fund that had averaged the lowest return for the 1996-98 period, posted a startling 32.47% yield over just the first six months of 1999. These results, achieved during both the crisis and the recovery, indicate that Philippine mutual funds, like their counterparts in other parts of the world, have the management and ability to meet or outperform the market. They can provide investors with an opportunity, in real terms, to preserve, if not enhance, the value of their money. For the industry to achieve broad popular acceptance, it will need to launch a powerful focused campaign that drives home that message.

***Troubled history.*** There are several other reasons that the industry is still tiny. To some extent it may still be a victim of its history of high front-end loads (now prohibited), scandals, disappointed investor expectations and a lack of investment opportunities.[2] This history discouraged potential sponsors from attempting to register funds with the Securities and Exchange Commission ("SEC") for eighteen years (1972-1990). During that period competing

[1] Benchmark indices, while useful indicators, are not perfectly comparable with funds. As indices they do not have expenses which funds do. In addition, they are not subject to the requirement, which funds must comply with to meet redemptions, that they maintain at least 10 percent of their assets in cash.

[2] This may no longer be the public perception of mutual funds. Our Survey, *"Perceptions of Mutual Funds among Working Professionals of Metro Manila," May 1999* ("Perception Survey") (attached as Appendix 1) concluded: "The industry need not worry about the troubled history of mutual funds in the Philippines, so there is no need for 'damage control' with regard to the industry's history." Nevertheless, the 18-year hiatus in the development of the industry resulting from its troubled history certainly has impeded its development.

products, common trust funds ("CTFs") and Pre-Need Plans (PNPs"), filled the vacuum in the market. When the industry started again in the 90's, it suffered from differential regulation vis-à-vis the CTFs and PNPs and from double taxation. It has been hampered by lack of a long-term performance track record, lack of a distribution network, lack of a media relations program, and lack of a well-funded group of sponsors.

***Regulatory obstacles.*** The policies of the Bangko Sentral ng Pilipinas ("BSP"), the Securities and Exchange Commission ("SEC") and the Department of Finance ("DoF") have not helped the fund industry to develop. The BSP needs to relax restrictions on fund distribution by banks and on its regulation of investment advisers of more than one fund. The SEC needs to develop greater expertise on the operation of the fund industry to permit broader product development and to devote adequate resources and personnel to the regulation of funds and of their competitors. The DoF needs to rationalize the tax laws so that they no longer inhibit development of more varied mutual funds or disproportionately effect on the ability of the industry to compete with like investment products.

***Investor perceptions.*** Our Survey, *"Perceptions of Mutual Funds among Working Professionals of Metro Manila," May 1999* ("Perception Survey") revealed three predominant misperceptions or lack of information about mutual funds among a key group of potential mutual fund investors. They are:

- ***Yields.*** A lack of information or a misperception about mutual fund yields. More than half (53.2%) of those surveyed did not know about, or had no opinion about, mutual fund yields and an additional 13.5 % thought they were not high yielding. In other words, more than two thirds of those surveyed lacked adequate information about mutual fund investment results.

- ***Accessibility.*** A lack of information or misperception about how accessible mutual funds are. Almost 40% (37.2%) did not know where or how to avail of mutual funds and another one-third (34%) thought they were accessible through banks. In other words, over 71% of those surveyed didn't know how to avail themselves of mutual funds.

- ***Minimum Investments.*** A lack of information or misperception about minimum investments. Half did not know the minimum amount required to invest in a mutual fund; 14.7% thought it was ₱100,000; and 2.6% assumed it was ₱1 million.

If the fund industry were able to correct this lack of information and those misconceptions, it could help to create much greater investor interest in mutual funds.

***"Best Practices."*** Although each country's fund or investment trust industry is unique, reflecting its own traditions, markets, institutions, culture and system of regulation, many of the challenges other countries face in strengthening their fund industries, especially those in Asian neighbors, are the same. The Philippine fund industry, Philippine policy makers, regulatory

bodies and leaders of the capital market can benefit from their neighbors' experience.[3] Among the lessons learned from them are:

- ***Enlightened government support is necessary.*** Government support can take many forms. It must provide an appropriate legislative framework. As we have seen in Hong Kong, an effective regulator can help to build public trust and confidence in the fairness and transparency of the industry. Tax incentives, as seen in India and Hong Kong, for example, can make an industry attractive to sponsors and investors. Government sponsored funds, such as the Unit Trust of India or those that provide the bulk of the assets of the Malaysian investment trust industry can help to gain broad public acceptance of the mutual fund concept and to lay the foundation for a private sector based industry. Compulsory savings programs such as in Singapore can also help to establish a pattern of savings and lay such a foundation.

- ***An effective professionally-staffed fund association makes a big difference.*** As evidenced by the associations of Hong Kong, Republic of China (Taiwan), Malaysia, Singapore, Japan, and Korea, a strong, effective broad-based, well-funded industry association with a full-time professional staff can make a significant difference, whether acting solely as a trade association or also as a Self-Regulatory Organization ("SRO"). Examples of Regulatory/Industry initiatives are: promoting corporate governance (Malaysian Government Special Committee) or promoting uniform reporting of fund investment results (Taiwan).

- ***Bank distribution of funds is necessary to establish a broad base of fund investors.*** Distribution of mutual funds through banks is one of the most effective ways to build a fund industry. Almost every neighboring country reviewed permits bank distribution of mutual funds or investment trusts. Both Korea and Japan permitted bank distribution as part of their reforms aimed at remedying the problems of the Asian Financial Crisis.

- ***The better the investment opportunities, the stronger the fund industry.*** Investment opportunities may be found in the domestic market, as in Korea, or offshore, as in Hong Kong where 98 percent of fund assets are off-shore and foreign currency-denominated funds.

***Legislative and regulatory changes.*** Implementation of five recommendations involving various degrees of legislative or regulatory changes could have an immediate positive impact on the fund industry. The industry would be strengthened and its public acceptance and credibility would grow if:

- ***banks*** could sell mutual funds on the floors of their branches throughout the country; or

[3] Descriptions of neighboring fund industries and the details and nuances of the broad lessons learned from them are contained in Part IV, p. 64 et seq., below, and in Appendices 13 to 19.

- ***pre-need plans*** couldn't be front-end loaded, had to make full risk disclosures and their sales agents could be retrained, upgraded and licensed to sell mutual funds; or

- ***foreign institutional investors*** found the Philippines an attractive place to sponsor mutual funds and invest; or

- ***investment opportunities*** for funds were broadened through the development of a long-term debt market, increased PSE listings and by permitting, among others, investments in securities of foreign issuers and in derivatives; or

- ***a coordinated series of tax incentives*** were enacted by the Philippine Government, such as those proposed in the 1999 Budget of the Government of India that would include measures to attract non-resident Filipinos, to stimulate the growth of mutual funds or to enact a government-sponsored savings program. [4]

Any of the above solutions would have a dramatic effect on the mutual fund industry, enlarging its potential to a greater or lesser degree, giving it many more outlets and opportunities to educate the public, and forever redefining it. Although each may strengthen the industry, each comes with a price. None can be ruled out. None offers a totally positive solution. However, only investment in securities of foreign issuers, increased PSE listings and possibly the establishment of a longer-term debt market, appear imminent.

## Recommendations for Strengthening the Mutual Fund Industry

Approximately one dozen concrete steps, primarily in the legislative and regulatory areas, could be taken over the next five months to facilitate the growth of the fund industry. [5]

### A. Legislation.

Enactment of four key Securities/Pension Reform Bills, currently under varying degrees of active consideration by Congress, could have significant direct and indirect beneficial effects on the fund industry. This Report strongly supports their enactment, with the amendments recommended. They are:

1. **The Securities Act of 1999 ("SA99"),** amended to include a broad definition of a statutory "underwriter" and to clarify the need for the application of traditional SEC "full disclosure" to Pre-Need Plans; SA99 is the foundation for reform of the regulatory framework of the capital market. It would authorize restructuring of the SEC and creation of SROs and

[4] A sixth suggestion, put forward by other commentators, is that the Philippine Government could authorize and sponsor a national investment fund ala The Unit Trust of India ("UTI") and have it distributed through Bank Branch Offices like its new ₱ 5,000 short-term T-Bill program. However, despite UTI's size, government sponsored and managed mutual funds generally have not fared well. We would limit the government's role to providing conditions and policies that favor the development of private sector funds.

[5] See "IHAP Position Paper on the Mutual Fund Industry Study Submitted by AGILE," attached as Appendix 2 to this Report, for the endorsement of the Report's major recommendations by the Investment Houses Association of the Philippines ("IHAP").

resolve issues that have been hanging over the market for five years. It has passed the Senate, and is currently under active consideration in the House. [See, Appendix 3, Comments of Lewis J. Mendelson, Capital Market Consultant, March 2, 1999, on The Revised Securities Act ("RSA"), House Bill __, Consolidating HB 297 and 3349, with SEC proposals, Eleventh Congress, First Regular Session, THE SECURITIES ACT OF 1999, (including Summary Statement)].

2. **The Revised Investment Company Act ("RICA")**; RICA, designated a priority Bill for enactment during the current Congressional Session, provides an updated law and guidelines for the operation of the fund industry. Several draft bills submitted in the Senate and House contain provisions that relieve funds of burdensome provisions, including limitations on management of more than one fund. H.B. 7294 needs to be amended to restore the existing broad definition of underwriter; to clarify the regulation of "investment advisers" and to omit from the registration requirements the power to limit registration of investment companies as investment opportunities permit or to allow registration only when conditions warrant. [See, Appendix 4, Preliminary Comments of Lewis J. Mendelson, Capital Market Consultant, on The Revised Investment Company Act ("RICA"), House Bill No. 85, Eleventh Congress, First Reg. Session, S.B. 152, Eleventh Congress, First Regular Session; and Separate Comments on Senate Bill].

3. **The Pre-Need Securities Code ("Code")**; The Code, no longer a priority Bill, offers an opportunity to provide for a more level playing field. It needs to provide for full disclosure (as required by Section 13 of H.B.8015, SA'99), valuation standards, prudential standards, protections against affiliated transactions, limitations on sales commissions and losses to investors and protections in the event of insolvency that could readjust the competitive balance vis-à-vis the fund industry. It should also provide means of easing the impact of an industry consolidation on pre-need certificate holders and surviving pre-need companies. [See Appendix 5, Correspondence, Statements, Presentation and Comments of Lewis J. Mendelson, Capital Market Consultant on The Pre-Need Securities Code ("Code"), H.B. Nos. 83, 5483, and 1611, Eleventh Congress, First Regular Session.]

4. **The Personal Equity Retirement Account ("PERA")**; PERA would create personal tax benefited retirement accounts. Such PERAs, like US Individual Retirement Accounts ("IRAs"), would encourage investment in tax deferred retirement plans, thus promoting long term savings and easing burdens on the social security system. With amendments to Bills pending in both the Senate and House, a PERA could be funded by shares, among others, of registered investment companies. Such changes could provide a big boost for the fund industry. Additional legislation that would provide for Plans similar to the US 401(k) and Keogh Plans for small businesses and strengthen the regulation of Occupational Pension Plans and the protections they offer participants could also boost the market for mutual funds and the services provided by fund managers. [See Appendix 6, Extension of Comments of Lewis J. Mendelson, Capital Market Specialist before the Senate Committee on Banks and Financial Intermediaries, February 5, 1999.]

## B. Fiscal Policy

Although The Tax Reform Act of 1997 provided fundamental relief to the mutual fund industry by reducing a great deal of the burden of double taxation of funds and their shareholders, there are a number of other tax provisions that discriminate directly and indirectly against funds and their shareholders. This Report recommends amendments to the tax laws to correct the prejudicial effects these taxes have on the mutual fund industry and its shareholders, as explained below.

### *1. The Documentary Stamp Tax on Share Issuance*

***Modify the Documentary Stamp Tax ("DST") on share issuance.*** The DST of ₱2.00 per ₱200.00 of the par value on issuance of fund shares is more prejudicial to an investment company than other enterprises because of the unique way mutual funds operate. The defining feature of an open-end fund is that it is required to redeem its shares at net asset value. Its redeemed shares then are cancelled and resold as original issues. Each time it does so, the fund again must pay the ₱2.00 DST.

***A practical solution.*** The fund industry has recommended that the DST on share issuance be levied on the entire authorized capital of an open-end fund upon its incorporation, but at lower rate, ₱1.00 per ₱200.00 of par value. The Report supports this proposal because it offers significant advantages to the Government and the fund industry. Tax collection should be quicker, more certain and more efficient, producing more immediate revenues for the Government than the DST currently in effect. The Government would not have to rely on a fund's ability to market its shares. Nor would it have to continually monitor payment (or non-payment) of the DST by the funds. Open-end funds would avoid taxation of reissued shares and over the longer-term the impact of the DST on open-end funds should be reduced.

### *2. The Dividends Tax*

***Repeal the Dividends Tax on individual fund shareholders.*** Individual (rather than corporate) fund shareholders are still required to pay taxes of 8% (10% after January 1, 2000) on declared fund dividends. Fund dividends are taxed even though the fund is required to pay a 20 percent withholding tax on interest income, transaction taxes on sales of PSE stocks and capital gains taxes on sales of non-PSE stocks. These kinds of taxes can inhibit investment choices by funds and shareholders and result in practices (funds not declaring dividends) that may inconvenience investors looking for regular income or make investing in funds less attractive to them.

***An unintended consequence.*** One, probably unintended, consequence of the tax on dividends is that it is an obstacle to the development of money market funds. Those funds, that in the U.S. attempt to maintain a $1.00 NAV by paying daily dividends and converting them to new fractional shares, became a major engine of the growth of the U.S. fund industry. Because Money Market Funds involve the appreciation of small differences, a difference of 8 or 10 basis points because of a tax on dividends could become an insurmountable obstacle to the

development of Philippine money market funds. The lack of money market funds continues to impede the growth of the fund industry here.

***To tax interest income to funds at 20 percent and then tax dividends to fund shareholders at 8 or 10 percent is excessive.*** The tax on dividends received by individual mutual fund shareholders should be repealed, as was the tax on dividends received by corporate fund shareholders. The 20 percent withholding tax paid by the funds on interest income is sufficient. To again tax dividends in the hands of individuals is excessive.

### *3. Other Taxes*

In addition to the modification or repeal of taxes that apply to mutual funds and their shareholders, as recommended above, other taxes also have a greater impact on the mutual fund industry than on other issuers. Because mutual funds invest and trade in securities, any tax on securities transactions or on capital gains, even though meant to apply equally to all investors, will take a larger toll on a mutual fund than on a non-professional investor. The Department of Finance ("DoF") is now conducting an ongoing review of financial sector taxation. As part of that review, in order to remove obstacles to the development of the fund industry; to raise additional tax revenues by encouraging additional investment; to rationalize the tax system; and to reduce the tax burden on the capital market; it is recommended that:

1. ***The IPO Tax should be repealed.*** To encourage listing on the PSE, the 4 percent IPO Tax should be repealed.

2. ***Capital gains on foreign securities of Philippine funds should be taxed like gains on securities not listed and traded on the PSE.*** In order not to discriminate against investments in foreign issuers; to broaden investment opportunities for all Philippine investors; and to provide an additional source of tax revenues from mutual funds: the corporate tax on capital gains of Philippine domiciled mutual funds or investment companies on securities of foreign issuers should be the same as the capital gains tax on net gains on sales of shares not listed and traded on the PSE: 5% on the first ₱100,000 of net gains and 10% on the excess; and

3. ***Equalize Tax Treatment of Similar Investment Products.*** Some policy makers have suggested that tax preferences be given to different kinds of investment products, (e.g. pre-need plans). Tax treatment should not favor one similar investment product over another. All should be treated equally.

## C. Regulatory Reforms

### 1. The Securities and Exchange Commission ("SEC")

This Report strongly recommends that the SEC initiate internal structural reforms and training programs as follows:

1. ***Mutual Fund Sales Agent Examinations.*** Transfer administration of Mutual Fund Sales Agent Examinations from the SEC's Brokers and Exchanges Department ("BED") to the Capital Market Development Center, Inc.("CMDCI"). This change, recommended in the Circulation Draft of this Report, dated March 10, 1999, was implemented on June 21, 1999. It should improve the relevance and the efficiency of the administration of the exam.

2. ***SEC Investment Fund Unit.*** To improve efficiency and develop greater expertise, establish and increase staffing of a separate SEC Investment Fund Unit within the SEC's Money Market Operations Department (MMOD). After enactment of RICA, draft rules to permit a wider variety of investment companies. [See Appendix 7, Excerpt from PricewaterhouseCoopers Monograph, "Building A Securities Market Regulator in An Emerging Market," The Division of Investment Management.]

3. ***SEC Pre-Need Unit.*** To transform the disclosures and regulation of the Pre-Need Industry, establish and adequately staff a separate Pre-Need Regulatory and Disclosure Unit within the SEC to fully regulate the activities and disclosures of the Pre-Need Industry. Include at least one Senior Level Actuary to supervise and train the staff. Draft Reporting Forms regarding Prospectuses and Annual Reports and a Pre-Need Advertising Code to standardize information disclosed to the public and assure that it is not misleading.

### 2. Bangko Sentral ng Pilipinas ("BSP")

***Permit Banks to Sell Fund Shares.*** Perhaps the single recommendation that could have the greatest effect on strengthening the Philippines investment company industry is to modify the BSP's inconsistent ad hoc policy that prevents banks from distributing fund shares. The BSP allows customers to sell Bank Common Trust Funds, risk investments, on the floor of Branch Banks throughout the Philippines. It also allows universal banking. But, it prevents banks from selling mutual funds for the announced reason that it "gives the impression that the investor is dealing with the parent bank." [6]

Notwithstanding the concerns of the BSP over possible confusion of funds with deposits that are insured with the PDIC, sales of fund shares could be properly and unmistakably identified as risk products that are not insured by the PDIC under the banking system. Banks in most of the Philippines' Asian neighbors, including most recently in Japan and Korea, are permitted to distribute fund shares. Appropriate fire-walls and other protections against transfer of information between bank departments and insulating depositors from underwriting risks can be established. If the Philippines is to have a vibrant mutual fund industry, one key would be to

[6] Letter of Alberto V. Reyes, Deputy Governor, BSP, to Hon. Joel A. Bañares, Undersecretary Dept. of Finance, June 9, 1999. (The "Reyes Letter" is included as Appendix 8 to this report.) The BSP has applied similar restrictive policies to investment houses with trust functions that have no quasi-banking functions. It required the investment house to staff its Trust Department with a separate set of officers and employees because its regulations prohibit a director, officer or employee who are managing a trust or other fiduciary accounts to perform duties in other departments. Id.

permit banks to distribute mutual funds. Specially trained and licensed bank employees could be allowed to distribute a broad variety of mutual funds, clearly identified as uninsured risk investments, through bank branch offices throughout the Philippines.

***Transfer BSP regulation of investment advisers to the SEC.*** BSP policies and regulations relating to Investment Management Activities ("IMA") also unnecessarily impede the growth of the fund industry. Currently, they prevent mutual fund investment managers from advising more than one fund. This prevents them from taking advantage of the benefits of scale that managing other mutual funds, pension funds or other private investment advisory clients would bring. This limits their efficiency and profit potential and discourages new entrants because it makes it uneconomical to enter the investment management profession. Discouraging or limiting fund investment advisers from providing such services deprives the securities market and pension and retirement fields of broader investment advisory resources, a more vigorous mutual fund industry, the benefits of greater competition and broader choices. The SEC should be the sole regulator of registered investment advisers and of the mutual fund industry.

### D. Strengthen the Investment Company Association of the Philippines ("ICAP")

***An ICAP Strategic Plan.*** For the Mutual Fund Industry to prosper and grow to begin to play a role as a catalyst to the development of the Philippine capital markets, it will need to mobilize an army of well-trained sales agents and support them with sales literature and a sustained media/public relations campaign. To optimize its chances for success it should be carried out on an industry-wide basis through ICAP. For ICAP to mount such a campaign on a wide scale the number of fund sponsors and ICAP member funds would have to expand dramatically. Alternatively, ICAP could expand its membership by permitting other kinds of members and/or increase the amount of its membership fees and special assessments.

ICAP will need to identify, prioritize and work toward change, prodding the legislature, training the regulators, educating the public and improving the funds and the markets. It must be the ignition key for change. This report recommends a comprehensive strategic plan that will help ICAP, given its limited resources, best perform that function. ICAP's Comprehensive Strategic Plan, would build upon its Charter and the kinds of individual member voluntary activities it has already initiated. It sets four goals and provides examples what can be achieved under each:

1. ***Influence the legislative and regulatory environment.*** This includes promoting passage of critical legislation and rationalizing the tax structure; training the SEC and its staff that regulates investment companies, including updating SEC [and BSP] rules to permit a wider variety of mutual funds.[7] It should also include promoting bills and rules to "level the

[7] Such new funds might include: money market funds; variable annuities; index funds; dollar denominated funds or cross border investments. Such rules also should help the funds to take advantage of changing technology such as facilitating telephonic and electronic share purchases and redemptions; check writing privileges for redeeming mutual fund shares; and comprehensive quarterly or monthly account statements to investors covering all of their securities holdings and transactions, including funds.

playing field" to correct, as much as possible, the discriminatory effects of differential regulation.

2. ***Raise professional standards***. This applies to Members, Investment Managers, Distributors and Sales Agents. It includes upgrading and standardizing Testing, Licensing, Registration and Monitoring of Sales Agents and Principals of Distributors of Funds, (possibly also of Insurance and Pre-Need Plans;) Training Investment Company Officers, Directors and Staff and the SEC; Adopting an ICAP Code of Ethics and ICAP Model Guidelines. At some future time, it could evolve into ICAP becoming a Self-Regulatory Organization ("SRO") as envisioned in Section 42 of the Senate RICA Bill.

3. ***Create investor education and media relations programs.*** This includes:

   - Adopting an ICAP Mission Statement that identifies ICAP with protecting investors, promoting professional standards, educating investors and strengthening the Philippine capital markets;
   - Developing sales literature and media campaigns aimed at investors;
   - Presenting a single powerful message that differentiates investment funds from competing products;
   - Designating a Training Officer; Developing Sales Literature, Training Materials and Courses for Sales Agents; and
   - Designing and executing a Media Relations Program, including an ICAP website.

4. ***Develop an economic and marketing analysis capability.*** This would include building an ICAP Data Base to enable it, among other things, to monitor markets; understand investor psychology; analyze comparative performance and expenses of funds and competing products; perform long and short term economic analyses.

***Implementation.*** Whether and to what degree ICAP will be able to accomplish these goals and turn this plan into a program will depend on its ability and willingness to: attract new members; raise additional funds; and accept continued international donor assistance, if offered. Raising additional funding and receiving technical assistance would help to carry ICAP through its organizational or "start up" years.

***An ICAP Business Plan.*** An indication of ICAP's willingness to help itself would be for it to adopt a business plan which identifies short (one year) and long term (five year) objectives and the resources and staffing necessary to achieve them. In this connection, mutual fund and investment adviser associations in neighboring Asian countries offer an example. Several have established associate memberships that permit them to include and receive membership fees from various organizations or entities that participate in or do business with investment companies and their advisers. Consideration also should be given, over the longer term, to defining and filling two ICAP staff positions: a full-time President who could act as an advocate/lobbyist and a Director of Education and Training.

***Capital market development.*** The success of the fund industry will not depend solely on ICAP. The concurrent development of other institutions of the capital market would also promote the development of the fund industry. Investors, the fund industry and all market institutions need a strong liquid market that provides a broad range of investor protections and investment opportunities and a strong, well-trained SEC to see that the markets are fair and transparent.

# A STRATEGIC VISION:

# STRENGTHENING PHILIPPINE MUTUAL FUNDS AND IMPROVING THE PUBLIC'S PERCEPTION OF THEM

**July 1999**

## I. THE PHILIPPINE INVESTMENT COMPANY INDUSTRY

### A. Introduction

*If the Philippines needs to develop its capital market, why start with a study the Philippine Mutual Fund industry?*

Mutual funds are a proven means of converting savers to long term investors, of introducing the public to the securities markets. Mutual funds, investment companies or investment trusts may take many forms. They may be open-end (redeemable at current net asset value) or closed-end (traded at market price) or may be known as unit trusts. Mutual funds, unlike bank savings deposits and Pre-Need Plans, offer the opportunity to preserve your assets against inflation, and enjoy many advantages over investing in individual securities or through competing investment vehicles such as bank common trust funds and pre-need contracts, to which they bear a strong resemblance, or insurance.

Mutual funds provide a means of participation in the securities market that allows the uninitiated investor to limit the degree of risk he or she wishes to take. The mutual fund is a relatively safer securities investment because its investment objectives are clearly stated, it permits the investor to own a share of a diversified portfolio of securities which is professionally managed at a relatively low cost. It provides many administrative conveniences, ease of purchase and redemption, regular account statements and transparency. Investors receive a prospectus and annual and quarterly reports and their fund is subject to regulation and oversight by the Securities and Exchange Commission ("SEC").

Mutual funds educate investors and marshal and channel investments into the securities markets. As disciplined, sophisticated investors mutual funds can exert a stabilizing influence on the market. A successful mutual fund industry can be a catalyst to the development of the Philippine capital market, an engine for its long term growth and development. By adding liquidity to the secondary market, mutual funds help to encourage new public offerings, improve intermediation, capital formation and allocation and, ultimately, can help to stimulate savings and spur the development of the Philippine economy.

## B. Relative to Its Domestic Competitors, the Market and Its Asian Neighbors

*How does the Philippines Mutual Fund Industry stand relative to its domestic competition and Asian neighbors' Mutual Fund Industries?*

***--A Faint Blinking Star, Barely discernable in the Cosmos - -***

When an international observer skims a listing of Philippines Mutual Funds for the first time, he may be struck immediately by the fact that:

**The industry is tiny.** By any standard, domestic or international, the Philippines Mutual Fund Industry is miniscule. Its total assets at year-end 1998, were ₱3.3 billion ($86 million). It is comprised of only 15 funds, including Filipino Fund, a closed end investment company, and only twelve investment management companies.[8] See Table 1, Industry Players and Assets, 1998, below. Its ₱3.3 billion total assets were dwarfed by those of bank common trust funds, ₱90 billion ($ 2.25 billion), and even by those of the Pre-Need Plan industry, ₱78.8 billion [$2 billion (1997)]. The funds, their net assets at year-end 1998, when they began commercial operations, and their investment advisers are presented in Table 1, Industry Players and Assets, 1998, below:

**Table 1. INDUSTRY PLAYERS AND ASSETS (₱), 1998**

| Name | Net Assets as of Year-end 1998 | Start of Operations | Investment Adviser |
|---|---|---|---|
| **EQUITY FUNDS** | | | |
| Abacus Growth Fund | 70,325,145 | Nov. 1997 | First Abacus Investment Mgt. Inc |
| Filipino Fund (Closed-end) | 767,780,211 | May 1991 | BPI Investment Mgt. Inc. |
| Philam Strategic Growth Fund | 81,957,210 | June 1998 | Philam Asset Management, Inc. |
| Philequity Fund | 267,112,224 | Feb. 1994 | Philequity Management, Inc. |
| United Fund | 77,267,224 | April 1995 | UCPB Trust Banking Division |
| *Sub-total* | *1,273,442,219* | | |
| | | | |
| **BALANCED FUNDS** | | | |
| All Asia Fund | 52,201,288 | Jan. 1999 | All Asia Asset Management, Inc. |
| Citisec Growth & Income Fund | 52,916,493 | July 1994 | Citisec Management, Inc. |
| ECC Growth & Income Fund | 55,043,221 | Oct. 1998 | ECC Asset Management, Inc. |
| First Galleon Family Fund | 8,362,525 | Feb. 1991 | First Galleon Fund Mgt., Inc. |
| GSIS Kinabukasan Fund | 833,678,418 | June 1998 | Winvest |
| MFCP Kabuhayan Fund | 293,172,752 | April 1996 | Mutual Fund Mgt. Co. of the Phil. |
| Philam Fund | 326,415,622 | Aug. 1993 | Philam Asset Management, Inc. |
| *Sub-total* | *1,621790,319* | | |
| | | | |
| **BOND FUNDS** | | | |
| All Asia Fixed Income Fund | 67,880,411 | Jan. 1998 | All Asia Asset Management, Inc. |
| Ayala Life Fixed Income Fund | 252,690,388 | Jan. 1999 | BPI Asset Mgt. & Trust Group |
| Philam Bond Fund | 94,829,323 | June 1997 | Philam Asset Management, Inc. |
| *Sub-total* | *415,400,122* | | |
| | | | |
| ***TOTAL*** | ***3,310,632,660*** | | |

*Source: Investment Company Association of the Philippines*

[8] Appendix 9, The Industry Players, describes the fund sponsors and their affiliations.

Although as recovery from the Asian Financial Crisis proceeded, total industry assets climbed rapidly to ₱4.4 billion at June 30, 1999, the industry remains relatively small and insignificant compared to its competitors and to other countries' fund industries.

- At December 31, 1998, the 14 open-end funds had 6,272 accounts, representing less than 0.001 percent of the total number of Philippine households. The closed-end investment company had nearly 8,000 shareholders, almost 2,000 more than all 14 mutual funds combined. By June 30, 1999, the number of industry shareholder accounts had climbed to 16,394, of which more than half, 8,201, were open-end fund accounts and 8,193 were closed-end.

- Even these puny numbers exaggerate the assets and market penetration of the mutual fund industry. Approximately 71% of total open-end fund assets at year-end 1997 were held by institutions and to a great extent represent seed capital.[9]

**By international market capitalization standards the Philippines Fund Industry is too tiny to notice.** The Philippines investment company industry's total market capitalization (per country industry net assets divided by total market capitalization) is far tinier than those of its Asian neighbors, save Indonesia. Mutual fund assets at year-end 1998, accounted for less than 0.02% the total market capitalization of the Philippines, compared to 14.65% in Japan, 10.34% in Malaysia, and 7.85 % in Thailand.

**Inconsequential.** When contrasted with the fund market capitalization ratios in neighbor Korea (a whopping 144%)[10] and in more mature markets such as the US (40.47 %), Australia, (an impressive 77.84%) and New Zealand (an equally impressive 72.55%), the inconsequential impact of the Philippines Mutual Fund Industry becomes even clearer. A selection of the latest available Mutual Fund Industry Market Capitalization Comparisons in US Dollars and as percentages is presented in Table 2, below.

**Table 2. MUTUAL FUND INDUSTRY MARKET CAPITALIZATION COMPARISONS**

| Country | Number of Funds | Total Net Assets (in US$ million) | Net Assets as a % of Local Stock Market |
|---|---|---|---|
| United States [1] | 7,351 | 5,525,200 | 40.47% |
| Japan [2] | 4,845 | 315,289 | 14.65% |
| Australia [2] | 3,787 | 233,460 | 77.84% |
| Korea [3] | 13,442 | 166,633 | 144% |
| Hong Kong [2] | 842 | 73,259 | n.a. |
| New Zealand [2] | 624 | 19,197 | 72.55% |
| Taiwan [2] | 174 | 19,448 | n.a. |

[9] The 1997 largest open-end fund, Kabuhayan Fund, which was originally partially government sponsored, had assets of ₱475 million, 98 percent of which was institutional seed capital. After the withdrawal of several major institutional shareholders, its total year-end 1998 assets were ₱ 294 million and it had fallen to third in size among open-end funds. By June 30, 1999, its assets had climbed back to ₱ 389 million, but it was still the third largest open-end fund.

[10] A market capitalization in excess of 100% is possible because bonds accounted for 64% of the assets of Korea's investment trusts and closed-end investment companies.

| Country | Number of Funds | Total Net Assets (in US$ million) | Net Assets as a % of Local Stock Market |
|---|---|---|---|
| Malaysia[4] | 95 | 10,191 | 10.34% |
| Thailand [2] | 168 | 1,722 | 7.85% |
| Philippines[5] | 15 | 86 | 0.02% |

[1] *As of year-end 1998. Local stock market included combined capitalization of NYSE, AMEX and NASDAQ. Data provided by Investment Company Institute, NYSE,NASDAQ-AMEX.*
[2] *As of June 30, 1998. Data compiled by Investment Trust Association of Japan.*
[3] *As of year-end 1998. Data provided by Korea Investment Trust Company Association.*
[4] *As of year-end 1998. Data provided by Federation of Malaysian Unit Trust Managers.*
[5] *As of year-end 1998.Data provided by Investment Company Association of the Philippines.*

## C. The Industry: Perceptions and Profile

### 1. Perceptions: A Few Pages Of History

Among the reasons that the Philippines mutual funds are so small is a history of abuse of investors, market disruptions and misguided regulatory policies. Mutual funds got a bad name from their beginning in the Philippines in the 1950s. Initially, in the late 50's their reputation was stained by misleading sales practices of the notorious European-based Investors Overseas Services ("IOS"). Soon after that, in the late '50s it was marred by heavy front-end load sales followed by heavy losses to unsuspecting redeeming shareholders. These mishaps were followed by the passage in June 1960 of Republic Act 2629, the Investment Company Act, ("PICA") patterned on the US Investment Company Act of 1940.

An attempt to revive the industry through the registration and sale of two funds, Trinity Shares Inc. in August 1969 and Pacific Fund, Inc. shortly thereafter, ended because the Philippines undeveloped financial markets could not withstand the political, economic and social unrest brought on by the *1st Quarter Storm of 1970*, a protest over the policies of then President Ferdinand Marcos. The ensuing political turmoil, social unrest, and deterioration of peace and order brought on a market collapse. Without alternative investment instruments the two funds soon became dormant. Entrepreneurs, potential fund sponsors did not attempt for at least 18 years, from 1972 to 1990, to register any new funds. During this hiatus bank common trust funds and Pre-Need Plans filled the void, not because of inherent differences in the products, but because of how they were packaged and sold, and most importantly, because of differences in how they were and continue to be regulated.

### 2. The Industry is New

Only one of the open-end funds, First Galleon Family Fund, which started operating in 1991, is more than six years old. Yet it remained the tiniest of all funds with total assets of only ₱8.4 million at December 31, 1998. The entire Philippine Mutual Fund Industry appears to have just gotten started. Three of the fifteen funds are so new that they are not yet able to post a one-year track record in the ICAP listed investment results in the daily newspaper.

## 3. A Respectable Track Record

Despite its newness and relatively small size, the industry has already proven itself capable of achieving respectable, even impressive, investment returns. Over the three-year period, 1996-98, the funds showed a broad range of average annual returns from a top of 27.69 % for Philequity (Equity); to an average annual loss of (-11.88 %) for MFCP Kabuhayan Fund (Balanced). Table 3. Average Annual Returns of Philippine Mutual Funds, 1996-1998, below, shows the average of annual[11] returns achieved by the 13 funds with performance records for at least one of the three years.

**Table 3. AVERAGE ANNUAL RETURNS OF PHILIPPINE MUTUAL FUNDS, 1996-1998.**

| Name of Fund | Percent Annual Returns | | | |
|---|---|---|---|---|
| | 1996 | 1997 | 1998 | Average |
| **EQUITY FUNDS** | | | | |
| Abacus Growth Fund | n.a. | n.a. | 19.20% | 19.20% |
| Filipino Fund (closed-end) | 16.41% | -27.86% | 10.58% | -0.29% |
| Philam Strategic Growth Fund | n.a. | n.a. | 19.21% | 19.21% |
| Philequity Fund | 58.35% | -5.30% | 30.09% | 27.71% |
| United Fund | 17.26% | -2.56% | 22.71% | 12.47% |
| *Average with closed-end fund* | *30.67%* | *-11.91%* | *20.35%* | *13.04%* |
| *Average w/o closed-end fund* | *37.81%* | *-3.93%* | *22.80%* | *18.89%* |
| *Benchmark: Phisix* | *22.22%* | *-41.04%* | *5.33%* | *-4.50%* |
| | | | | |
| **BALANCED FUNDS** | | | | |
| All Asia Fund | n.a. | n.a. | n.a. | n.a. |
| Citisec Growth & Income Fund | 17.82% | 1.73% | 22.51% | 14.02% |
| ECC Growth & Income Fund | n.a. | n.a. | 10.20% | 10.20% |
| First Galleon Family Fund | 6.32% | -39.51% | -1.06% | -11.42% |
| GSIS Kinabukasan Fund | n.a. | n.a. | 12.26% | 12.26% |
| MFCP Kabuhayan Fund | 2.54% | -27.70% | -10.89% | -11.88% |
| Philam Fund | 19.09% | -7.87% | 12.61% | 7.94% |
| *Average* | *11.54%* | *-18.34%* | *7.61%* | *0.27%* |
| *Benchmark: Phisix / T-bills* [1/] | *16.05%* | *-15.28%* | *8.66%* | *3.14%* |
| | | | | |
| **BOND FUNDS** | | | | |
| All Asia Fixed Income Fund | n.a. | n.a. | 11.70% | 11.70% |
| Ayala Life Fixed Income Fund | n.a. | n.a. | n.a. | n.a. |
| Philam Bond Fund | n.a. | n.a. | 10.37% | 10.37% |
| *Average* | *n.a.* | *n.a.* | *11.04%* | *11.04%* |
| *Benchmark: 91-day T-bill rate* [2/] | *n.a.* | *n.a.* | *11.99%* | *11.99%* |

[1/] A balanced fund is theoretically 50% invested in equities and 50% invested in fixed-income securities. The appropriate benchmark for balanced funds is therefore a similar proportion of both measures. Hence,

[11] Figures for 1998, for Philam Strategic Growth, ECC Growth & Income Fund, GSIS Kinabukasan Fund and All Asia Fixed Income Fund are annualized.

the benchmark was arrived at by getting 50% from the change in the Phisix and 50% from the average 91-day Treasury Bill rate (net of tax) for the year.

2/ The benchmark for bond funds is the average of the weekly auction results for the 91-day Treasury Bills (net of the 20% withholding tax).

*Source: Investment Company Association of the Philippines*

- **Equity Funds:** The four open-end equity funds scored three year average annual returns of 18.89%, significantly exceeding the Phisix benchmark of –4.50 %;
- **Balanced Funds:** The six balanced funds posted an average annual return of 0.27% versus 3.14% posted by combined Phisix/T-Bill benchmark; and
- **Bond Funds:** The two bond funds realized an average annual return for 1998 of 11.10% as against 11.88% the benchmark 91 day T-Bill rate for 1998.

When one considers that these returns were achieved over a three year period whose central economic reality was the Asian Financial Crisis and steep market declines throughout South East Asia, the performance of Philippine Fund industry deserves to be noted.

**1999: Six-month yields.** More remarkable is how the funds have bounced back from the Asian Financial Crisis. During the first six months of 1999, the funds, with only a few exceptions,[12] have posted even more impressive results. The five equity funds posted an average six-month yield of 19.02%; the seven balanced funds, 13.63%; and the three bond funds, 5.125%. These returns, achieved during both the crisis and the recovery, indicate that the Philippine mutual funds, like their counterparts in other parts of the world, have the management and ability to meet or outperform the market. They have shown that they can provide investors with an opportunity, in real terms, to preserve, if not enhance, the value of their money. For the industry to achieve broad popular acceptance, it will need to launch a powerful focused campaign that drives home that message.

**Perception of Performance: MFCP Kabuhayan Fund.** The perception of fund performance earlier may have fallen below reality. One of the largest funds, MFCP Kabuhayan Fund, which included the retirement funds of some of the largest Philippine corporations (San Miguel Corp., MERALCO, PLDT, PNB and AFP RSBS) had the lowest average (1996-98) annual return of all of the funds (-11.88 percent). In 1999, however, through June 30, MFCP Kabuhayan Fund, a balanced fund, has made a dramatic recovery. Over just the first six months of 1999, it outperformed all funds, including the equity funds, with a startling six-month investment return of 32.47%.

**Perception of Performance: Filipino Fund, Inc.** Of the fifteen funds, the closed-end, Filipino Fund, Inc. ("FFI"), having started operations in May of 1991, has a longer track record than all but First Galleon. FFI which represented almost one-fifth (19.5%) of the industry's assets (₱856 million) and about half (49%) of its shareholders at June 30, 1999, had a three-year average annual return of (-0.29%) for 1996-98 measured by changes in its net asset value

[12] The one, widely held, closed-end fund has consistently sold at a discount. Almost three years after its launch, it is thinly traded and still selling at less than its initial offering price. The longest established fund has recorded negative returns over the past two and one half years.

("NAV") per share. However, because it is a closed–end fund, evaluating its performance is more complicated than simply comparing changes in its NAV. It may help to explain, in part, the public's poor perception of investment companies. Unlike open-end investment companies (mutual funds) which are bought and sold at their NAV (plus commissions), closed-end investment companies when traded in the secondary market must be bought and sold at market price (plus or minus commissions). That price may be at a discount or premium from their NAV. Investors in a closed-end fund profit when its market price rises. That can result from either an increase in its NAV or the narrowing of its discount. Conversely, investors will suffer losses if its market price falls either because the discount widens or per share NAV decreases.

Few of FFI's over 8,000 shareholders would appear to have had a profitable experience. Figure 1, traces FFI's historical NAVPS vs. its closing prices on the PSE from listing Sept. 23, 1995, through June 30, 1999. FFI opened at its offering price of ₱1.08, but immediately traded at a discount to its NAVPS. Even as FFI's NAVPS climbed early in 1996 (peaking at ₱1.3461 on July 5, 1996), FFI never traded above ₱1.08. Its NAVPS fell below FFI's offering price on April 22, 1997, and dropped to its lowest value ₱0.8444 on November 18, 1997. FFI's market price per share closed as low as ₱0.44 on six days during August and September in the midst of the Asian Financial Crisis.

Figure 2 traces FFI's market price premium or discount to FFI's per share NAV. Except for four days in September 1997, when FFI closed at a premium (the highest at 1.17%), it has traded at a discount. From Sept. 23, 1995 to June 30, 1999, FFI's average discount was 27.32%. During the last quarter of 1998, its average discount was about 40%. With the stock market recovering during the second quarter of 1999, FFI's per share NAV reached a high of ₱1.1029. Its market price as of June 30, 1999, ₱ 0.72, was discounted by approximately 33% from its per share NAV of ₱1.0769. Although narrowing of the discount can present an opportunity for investors, FFI has not been actively traded. Its IPO subscribers may be waiting to sell their shares at a price higher than the initial offering price of ₱1.08. If FFI's average discount of 27.32% were considered the basis for arriving at market price, FFI's per share NAV would have to reach ₱1.49 for its market price to reach ₱1.08. Putting it another way, FFI's per share NAV would have to appreciate by 38% from its June 30, 1999, figure of ₱1.0769.

FFI or policy makers may wish to consider alternative means of narrowing discounts on the shares of closed-end companies based upon the practices in other countries described in Part IV. B. "Best Practices" at pages 64 to 73, below. In Korea, for example, closed-end funds are limited in duration to one or two years. (See page 68, below.) In Taiwan, the law requires a closed-end company to open and accept customer redemptions if its market price falls to 90 percent of its per share NAV. In other countries, the laws give more discretion to the funds' Boards of Directors. In India or the United States, a closed-end investment company is permitted to buy in a percentage (e.g. 10 percent) of its shares for a determined period if such buying program is announced.

**Figure 1. FILIPINO FUND, INC. – NAVPS VS. STOCK PRICE**

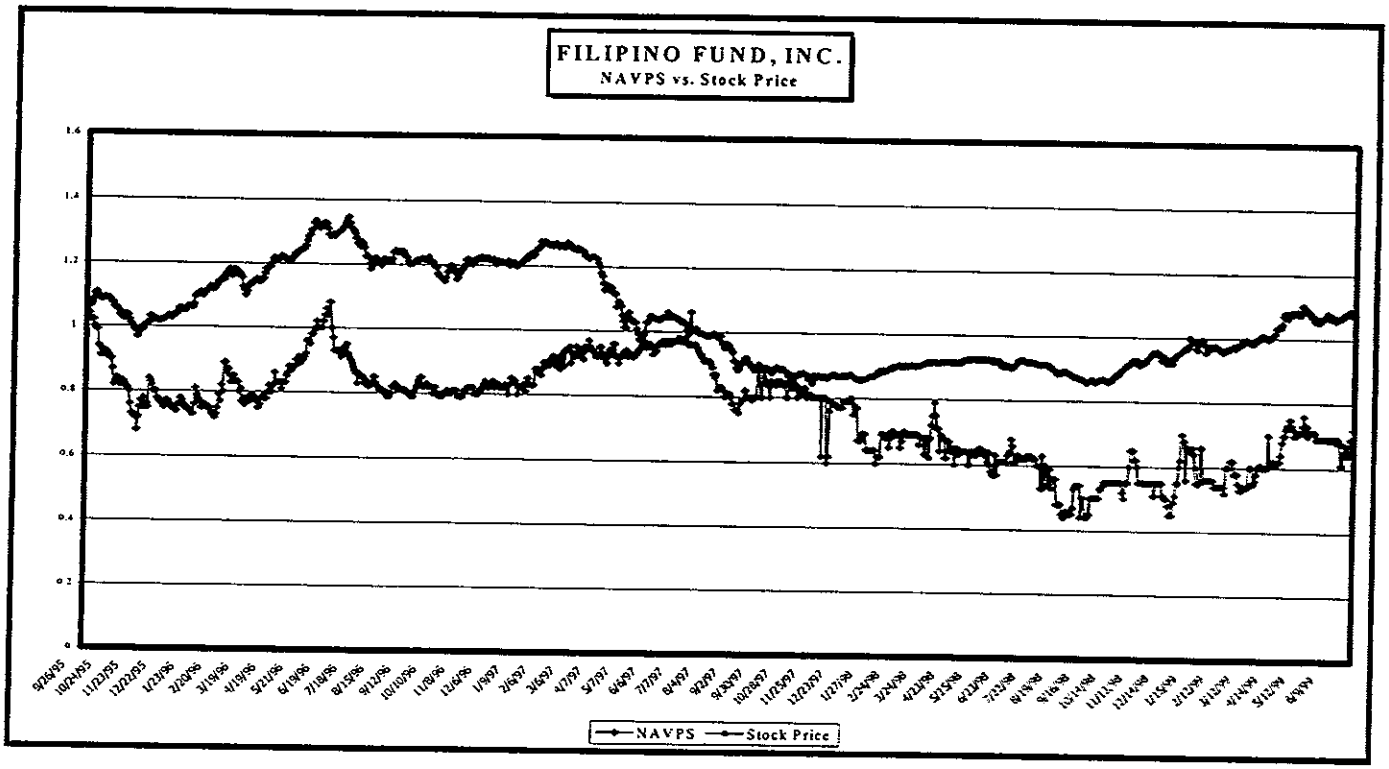
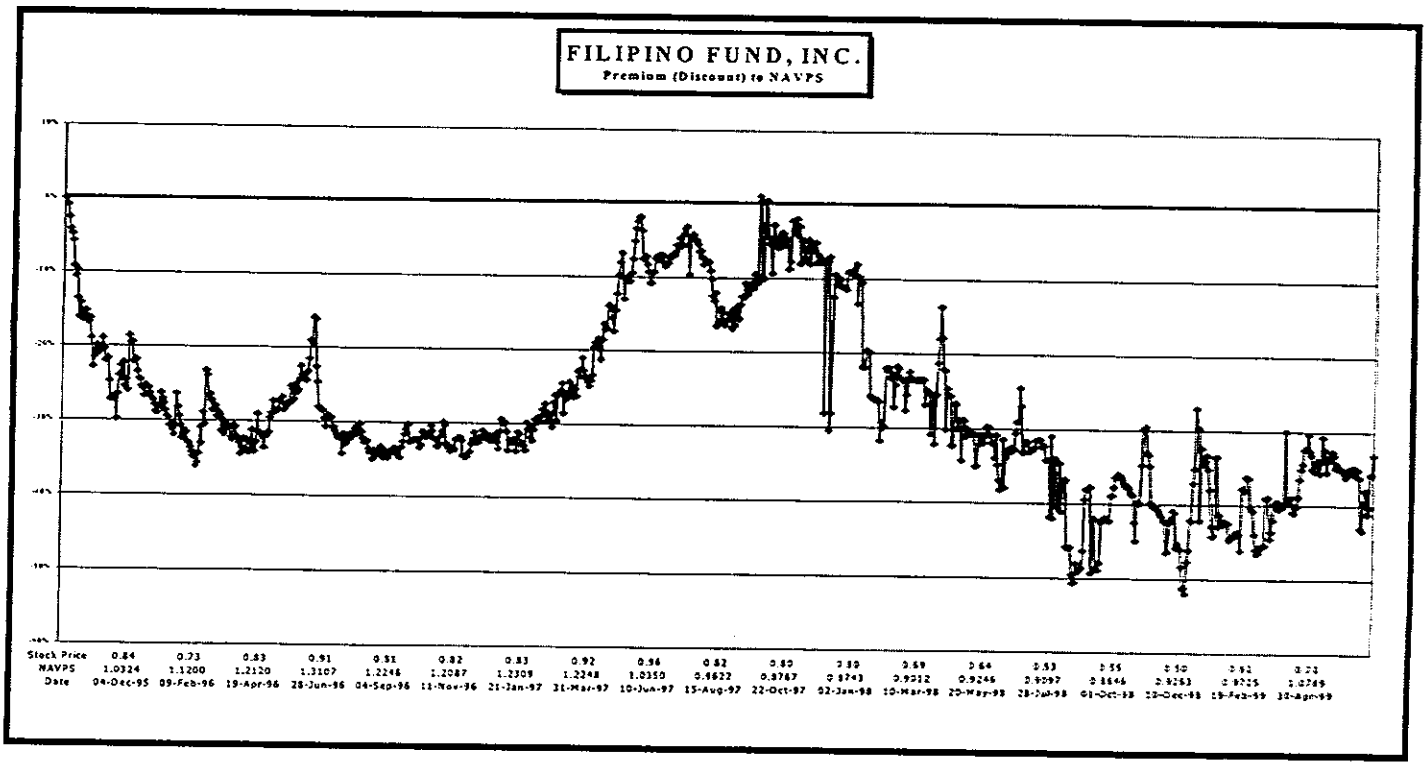



**Figure 2. FILIPINO FUND, INC. – PREMIUM (DISCOUNT) TO NAVPS**



**Portfolio Turnover**. The annual and three-year average portfolio turnover rates of the funds are set forth in Table 4, Portfolio Turnover, below. The three year averages for equity funds ranged from a high of 222% to a low of 108%. Surprisingly, there was little difference in the turnover rates of equity funds and balanced funds. For balanced funds the three-year averages ranged from 386% to 63%. The three highest average turnover rates were found in funds associated with broker/dealers. These rates, higher than those in more mature markets, may reflect the volatility of the Philippines stock market. It should also be noted that the higher turnover broker affiliated funds posted comparatively better average yields for the three year period than did non-broker affiliated funds.

**Table 4. PORTFOLIO TURNOVER**

| Name of Fund | Portfolio Turnover | | | |
|---|---|---|---|---|
| | 1996 | 1997 | 1998 | Average |
| **EQUITY FUNDS** | | | | |
| Abacus Growth Fund | n.a. | n.a. | 219% | 219% |
| Filipino Fund | 169% | 72% | 29% | 90% |
| Philam Strategic Growth Fund | n.a. | n.a. | n.a. | n.a. |
| Philequity Fund | 304% | 235% | 128% | 222% |
| United Fund | 148% | 158% | 19% | 108% |
| *Average* | *207%* | *155%* | *99%* | *154%* |
| | | | | |
| **BALANCED FUNDS** | | | | |
| Citisec Growth & Income Fund | 475% | 483% | 201% | 386% |
| ECC Growth & Income Fund | n.a. | n.a. | n.a. | n.a. |
| First Galleon Family Fund | 57% | 96% | 16% | 56% |
| GSIS Kinabukasan Fund | n.a. | n.a. | n.a. | n.a. |
| MFCP Kabuhayan Fund | 22% | 127% | 157% | 102% |
| Philam Fund | 69% | 80% | 41% | 63% |
| *Average* | *156%* | *196%* | *104%* | *152%* |

*Source: Investment Company Association of the Philippines*

**Expense Ratios.** As shown in Table 5, Fund Expense Ratios, 1996-98, below, three year average expense ratios ranged from a high of 4.55% for First Galleon, the smallest fund, to 1.82% for FFI, the largest fund. These expense ratios reflect the relatively small assets of the Philippine funds. The two funds with the highest expense ratios, First Galleon and MFCP Kabuhayan, also had the lowest annual investment returns over the three-year period.

**Table 5. FUND EXPENSE RATIOS, 1996-98**

| Name of Fund | Expense Ratios | | | |
|---|---|---|---|---|
| | 1996 | 1997 | 1998 | Average |
| **EQUITY FUNDS** | | | | |
| Abacus Growth Fund | n.a. | n.a. | 2.94% | 2.94% |
| Filipino Fund | 1.72% | 1.81% | 1.92% | 1.82% |
| Philam Strategic Growth Fund | n.a. | n.a. | n.a. | n.a. |
| Philequity Fund | 2.30% | 2.29% | 2.22% | 2.27% |
| United Fund | 2.49% | 2.17% | 2.26% | 2.31% |
| *Average* | *2.17%* | *2.09%* | *2.24%* | *2.20%* |
| | | | | |
| **BALANCED FUNDS** | | | | |
| Citisec Growth & Income Fund | 2.83% | 3.35% | 3.05% | 3.08% |

| Name of Fund | Expense Ratios | | | |
|---|---|---|---|---|
| | 1996 | 1997 | 1998 | Average |
| ECC Growth & Income Fund | n.a. | n.a. | n.a. | n.a. |
| First Galleon Family Fund | 3.02% | 3.91% | 6.73% | 4.55% |
| GSIS Kinabukasan Fund | n.a. | n.a. | n.a. | n.a. |
| MFCP Kabuhayan Fund | 3.76% | 4.30% | 4.17% | 4.08% |
| Philam Fund | 3.11% | 2.44% | 2.49% | 2.68% |
| *Average* | *3.18%* | *3.50%* | *4.11%* | *3.60%* |
| | | | | |
| **BOND FUNDS** | | | | |
| All Asia Fixed Income Fund | n.a. | n.a. | 1.74% | 1.74% |
| Ayala Life Fixed Income Fund | n.a. | n.a. | n.a. | n.a. |
| Philam Bond Fund | n.a. | n.a. | 2.24% | 2.24% |
| *Average* | *n.a.* | *n.a.* | *1.99%* | *1.99%* |

**The industry does not offer a wide variety of investment choices.** The fund objectives are pretty much "plain vanilla," fairly evenly divided by class among equity (5); balanced (7); and bond funds (3). There are no money market funds, no variable annuities, no municipal bond funds, no index funds or dollar denominated funds. There are few opportunities for portfolio managers to hedge against market volatility by investing, for example, in other markets or in put and call options.

**There are few (only three) multi-fund groups:** Philam (3 funds); All Asia (2 funds) and Filipino/Ayala (2 funds).

**And few big name international players.** A few fund industry sponsors have international parents or partners. Among those that do are: AIG's Philam Life Group and MFCP Kabuhayan Fund, which counts Daiwa Asset Management and National Investment Trust Company of Taiwan among its investment manager's joint venture partners. Standing in the wings at June 30, 1999, was Sun Life Assurance Company of Canada, Inc. ("Sun Life"), sponsor/owner of the MFS Group one of the stalwart's of the US mutual fund industry. Other than these, major international fund sponsors that bring the kind of expertise, resources and practices that can elevate the competitive environment, are absent. (See: Appendices 13, 15, and 18, for a sampling of India's, Hong Kong's and Singapore's global sponsors) (See also, discussion at Section I. G. Attracting Global Expertise and Resources, pages 42 to 44, below.)

**The Government Has Helped to Sponsor Two Funds.** The Philippine Government indirectly has backed two of the fifteen funds. Together those funds account for almost one-third of total industry assets at June 30, 1999:

- The Government Security Insurance System ("GSIS") sponsored **GSIS Kinabukasan Fund** was launched in June 1998, with the largest paid-up capital, ₱750 million, of any of the funds. At June 30, 1999, it had 1,948 shareholders and its assets had reached ₱986 million, making it the largest fund in the industry.

- The **The Mutual Fund Management Company of the Philippines, Inc., ("MFMCP") Kabuhayan Fund**, launched in April 1996, was the first government-sponsored fund. MFMCP, its management company, is a joint venture of the

Philippine National Bank, then a government-owned bank (now privatized), Clemente Fund Management (Asia) Ltd., Daiwa Asset Management, Inc. and National Investment Trust Company of Taiwan. At June 30, 1999, it had almost ₱389 million in total assets and 897 shareholder accounts.

**The Industry Sponsors are Banks, Insurance Companies and Securities Firms.** Other than the government sponsored GSIS, the fund industry unites sponsors from all segments of the private financial and capital markets: the banks, life insurance companies and the securities industry. Table 6, Fund Sponsors By Industry, 1998, below, is a snapshot of industry sponsorship at year-end 1998. By June 30, 1999, a different picture was emerging with the growth of Kabuhayan Fund by ₱95 million or about 33% to ₱389 million and of GSIS' Kinabukasan Fund by ₱153 million or approximately 18 % to ₱986 million. These changes and the eventual entry of two prestigious organizations Far East Bank and Trust Company ("FE Bank") and Sun Life into the industry will further adjust the balance among industry sponsors, but also evidence the industry's dynamism.

**Table 6. FUND SPONSORS BY INDUSTRY, 1998**

| Sponsor | No. of Funds | Net Assets | % of Total |
|---|---|---|---|
| Banks | 2 | 1,061,118,031 | 32.05% |
| Insurance | 5 | 833,105,307 | 25.16% |
| Securities Industry | 7 | 583,532,792 | 17.63% |
| GSIS | 1 | 832,913,949 | 25.16% |
| ***TOTAL*** | ***15*** | ***3,310,670,079*** | ***100.00%*** |

**Banks** sponsored by far the largest portion of fund assets, ₱1,061 billion at year-end 1998. They were anchored by FFI which had 1998 year-end net assets of ₱767 million. It is managed by BPI Investment Management Inc. ("BIMI"), a 100 percent owned subsidiary of the Bank of the Philippine Islands ("BPI"). PNB related MFMCP Kabuhayan Fund with ₱294 million in year-end assets rounded out the bank-sponsored funds.

**Three insurance related** sponsors accounted for ₱833 million in year-end assets distributed over five funds. Philam's three funds bring ₱503 million to the table; Ayala Life Assurance Co.'s Ayala Life Fixed Income Fund ("ALFIF") accounted for ₱253 million; and United Coconut Planters Life Assurance Corp's United Fund added another ₱77 million. By June 30,1999, the insurance related sponsors had added approximately ₱ 680 million in assets and together accounted for more than ₱ 1.4 billion: the three Philam funds had approximately ₱ 724 million; ALFIF ₱ 603 million; and United Fund almost ₱ 86 million.

**Five securities industry firms and one other**: First Abacus Financial Holdings, Inc.; Citisecurities, Inc; ECC Capital Corp.; All Asia Capital & Trust Co.; GT Corp.[13]; and Wealth Securities, Inc.; sponsored the remaining seven funds. Their total assets amounted to ₱583 million at year-end 1998, and approximately ₱741.5 million by June 30, 1999.

[13]GT Corp. is a holding company with interests in customs brokerage, a travel agency and insurance."

## D. The End of the Rainbow: Resources, Profits and Losses and Long Term Strategies of Fund Sponsors

### 1. Fund Distribution Channels

Almost all of the principal distributors of mutual fund shares rely solely on a direct sales team to market them. Some employ full-time salaried sales representatives, but the majority of salesmen are on a straight commission basis. They are usually marketing representatives of affiliated companies: insurance agents, securities brokers, and pre-need plan sales agents. Because of disparities in sales commissions, straight commission sales agents naturally tend to push the products that offer them higher commissions. Mutual funds are at a disadvantage because the commission rates (1.00% to 3.00%) they offer are much lower than those offered by insurance products and pre-need plans (10% to 15%). Securities brokers may resist recommending that their clients invest in mutual funds because they believe it would tend to lessen the amount of money that the clients would have available to invest directly in the stock market.

### 2. Management Company Human Resources

In other countries, mutual funds typically hire different (albeit usually related) companies to provide investment advisory, administrative and distribution services. In the Philippines, most management companies act as investment advisers, administrators and principal distributors of the funds that they manage. Table 7, Management Company Human Resources, 1998, presents the human resources of the twelve management companies in the Philippines as of year-end 1998.

**Table 7. MANAGEMENT COMPANY HUMAN RESOURCES, 1998**

| Management Company | Management [1] | Marketing [2] | Portfolio [3] | Operations [4] |
|---|---|---|---|---|
| All Asia Asset Mgt., Inc. | 1 | 1 | 1 | 1 |
| BPI Asset Mgt. & Trust Group | 1 | 0 | 5 | 0 |
| BPI Investment Mgt., Inc. | 1 | 0 | 1 | 2 |
| Citisec Management, Inc. | 1 | 0 | 1 | 2 |
| ECC Asset Mgt., Inc. | 1 | 0 | 1 | 2 |
| First Abacus Investment Mgt. | 2 | 1 | 2 | 2 |
| First Galleon Fund Mgt. Corp. | 1 | 1 | 1 | 3 |
| Mutual Fund Mgt. Co. | 2 | 2 | 1 | 8 |
| Philam Asset Mgt., Inc. | 2 | 11 | 1 | 6 |
| Philequity Management, Inc. | 1 | 0 | 1 | 3 |
| UCPB Trust Banking Division | 2 | 0 | 2 | 2 |
| Worldwide Investment | 1 | 3 | 1 | 5 |

*[1] Includes business development and corporate planning*
*[2] Includes sales and investor relations (straight commission salesmen excluded)*
*[3] Includes research and portfolio trading*
*[4] Includes accounting, information technology, personnel and other support services*
*Source: Investment Company Association of the Philippines*

What is immediately noticeable from Table 7, above, is that most management companies had very lean organizations. Only three had ten or more personnel. Perhaps, this is because most of the management companies are part of larger organizations. Their affiliates (such as banks, insurance companies, stockbrokerage firms, and investment houses) may provide assistance such as research, marketing and support services. BPI Asset Management & Trust Group did not have any marketing personnel. It provided only investment advisory services to ALFIF which is sold through Ayala Financial and Insurance, Inc., an affiliated company. The First Galleon Family Fund, despite the being the oldest operating mutual fund, had only 592 accountholders. Its principal distributor had only two licensed salesmen. Its marketing strategy relies mostly on print ads and direct mail.

It is also noteworthy that only Philam Asset Management, Inc. (PAMI) had more people in its marketing department than its investment and operations departments. Table 8, Sales Agent/Accountholder Comparisons, 1998, below, indicates that at year-end 1998, there were six distributors with more licensed salesmen than PAMI. What these figures do not reflect is that there were about 200 Philam Life insurance salesmen who referred accounts to PAMI. It is therefore not surprising that 2,500 accountholders or approximately 40% of the open-end segment of the industry's 6,272 accountholders at year-end 1998 were invested in funds sold by PAMI. On the other hand, it should be remembered that about half of Philam Fund's 2,011 accountholders were inherited from its predecessor, Trinity Shares, Inc.

Interviews with distributors also revealed that only a few of their licensed salesmen were actively soliciting accounts. Citisec Management Inc. (CMI), First Abacus Investment Management, Inc. (FAIMI) and Philequity Management, Inc. (PMI) had the largest numbers of licensed salesmen with 30, 22 and 20, respectively. They explained that most are agents of affiliated brokerage firms and only a handful actually sell mutual fund shares. The distributors of United Fund may be concentrating on institutional accounts and high net worth individuals. Although the fund has been in operation since 1996, it had only 75 accountholders at year-end 1998.

GSIS Kinabukasan Fund's distributor, Worldwide Investment, a newcomer in the industry with only 10 licensed salesmen, had produced 1,382 fund account holders at year-end 1998. That number leapt to 1,948 during the six months ended June 30, 1999. Its account holders are primarily GSIS members who were allowed an initial minimum investment of ₱1,000, instead of the ₱5,000 SEC minimum applicable to other funds. The fund's distribution strategy is based, in part, on a building a steady stream of small payments from GSIS members. The SEC's ₱5,000 restriction on minimum initial mutual fund investments is an example of "merit regulation." The SEC is substituting its judgment for that of the market. It should reconsider the restriction to allow the rest of the fund industry to have the same option as GSIS Kinabukasan Fund, as a matter of business judgment, to adopt a similar strategy to encourage regular investing, perhaps through payroll deduction plans.

**Table 8. SALES AGENT/ACCOUNTHOLDER COMPARISONS, 1998**

| Principal Distributor | No. of Licensed Salesmen | Funds Sold | No. of Accountholders |
|---|---|---|---|
| All Asia Asset Mgt., Inc. | 12 | All Asia Fund | 8 |
| | | All Asia Fixed Income | 9 |
| Ayala Finan'l & Insurance | 12 | Ayala Life Fixed Income | 16 |
| Citisec Management, Inc. | 30 | Citisec Growth & Income | 270 |
| ECC Asset Mgt., Inc. | 5 | ECC Growth & Income | 103 |
| First Abacus Investment Mgt. | 22 | Abacus Growth Fund | 184 |
| First Galleon Fund Mgt. Corp. | 2 | First Galleon Fund | 592 |
| Mutual Fund Mgt. Co. | 4 | MFCP Kabuhayan Fund | 745 |
| Philam Asset Mgt., Inc. | 9 | Philam Fund | 2,011 |
| | | Philam Bond Fund | 213 |
| | | Philam Strategic Growth | 288 |
| Philequity Management, Inc. | 20 | Philequity Fund | 376 |
| UCPB Trust Banking Division | 9 | United Fund | 75 |
| Worldwide Investment | 10 | GSIS Kinabukasan Fund | 1,382 |
| *TOTAL* | *135* | | *6,272* |

*Source: Investment Company Association of the Philippines*

### 3. Financial Resources

Table 9, Management Company Financial Resources, 1997; presents the financial highlights, based on the 1997 audited financial statements, of six management companies, or one-half of the current management companies. They are: Citisec Management, Inc. (CMI), The First Galleon Fund Management Corp. (TFGFMC), Philam Asset Management, Inc. (PAMI), Philequity Management, Inc. (PMI), Mutual Fund Management Company of the Philippines (MFMCP) and BPI Investment Management, Inc. (BIMI). [14] In reviewing this information, it should be recalled that 1997 was the first year of the Asian Financial Crisis and that, with only a few exceptions, individual fund assets under management, like industry assets, have grown.

**Table 9. MANAGEMENT COMPANY FINANCIAL RESOURCES, 1997**

| | CMI | TFGFMC | PAMI | PMI | MFMCP | BIMI |
|---|---|---|---|---|---|---|
| **BALANCE SHEET** | | | | | | |
| Total Assets | 13,393,376 | 40,172,493 | 17,509,988 | 20,242,980 | 16,307,168 | 26,272,631 |
| Total Liabilities | 583,752 | 956,941 | 1,032,910 | 2,015,749 | 1,062,277 | 3,736,825 |
| Stockholders' Equity | 12,809,624 | 39,215,552 | 16,477,078 | 18,227,231 | 15,244,891 | 22,535,806 |
| Paid-in Capital | 10,000,000 | 50,000,000 | 10,000,000 | 12,502,125 | 27,999,868 | 9,225,000 |
| Retained Earnings/ (Deficit) | 2,809,624 | (10,784,448) | 6,477,078 | 5,725,106 | (12,754,977) | 13,310,806 |
| *Debt-to-Equity Ratio* | *4.56%* | *2.44%* | *6.27%* | *11.06%* | *6.97%* | *16.58%* |

*Source: Investment Company Association of the Philippines*

[14] Four management companies were not included because they did not have full year operations in 1997, while the remaining two (UCPB Trust Division and BPI AMTG) are departments of their respective banks and therefore did not publish separate financial statements.

A quick glance at the major balance sheet items shows that all six management companies were adequately capitalized (at least with respect to meeting the ₱10 million minimum required net worth under SEC ICA Rule 35-1) and none was highly leveraged. In fact, most were practically debt-free, with D/E ratios ranging from 2.44% to 16.58%. Liabilities were mostly accounts payable and taxes payable.

A closer look at the composition of the Stockholders' Equity, however, reveals that two of the companies had incurred losses and had negative retained earnings. MFMCP, a relatively new player (1996), had a net worth of 54% of its paid-in capital. Industry pioneer, TFGFMC, also has negative retained earnings. Its position may be even worse than MFMCP's because Galleon Fund's net assets shrunk to ₱8.3 million at June 30, 1999, while Kabuhayan Funds rose to nearly ₱389 million during the same period.

The Income Statements and relevant financial ratios of the six management companies for the year 1997, are set forth in Table 10, Management Company Income Analysis, 1997, below. Again, the impact of the Asian Financial Crisis should be considered in reviewing 1997 data. It is presented because it is the most recent complete data available and provides insight, among other things, into relative expenses of fund management, sources of income, efficiency and profitability. The data shows that:

- Three management companies (half of those listed) incurred losses;
- Management fees were the main sources of income of three companies (PAMI, MFMCP and BIMI) representing 50% of more of the total income of each;
- Only one company, PMI, also relied on commissions as a major revenue source, while two, CMI and TFGFMC, depended on other sources of revenues to augment their income;
- Only one company, BIMI (which manages the lone closed-end fund), generated sufficient management fees to cover its entire operating expenses;
- For five of the six companies, (except PMI), salaries and occupancy costs were the two largest expense items;
- Commission expenses as a percentage of commission revenues ranged from 0% to 46.67%. This indicates that the companies are retaining the bulk of the sales loads and means either that:

  1) the salesmen were compensated some other way (such as salaries and allowances);
  2) the salesmen only got a small portion of the sales load; and/or
  3) management did most of the selling;

- 1997 operating expenses (excluding commissions, covered by commission revenues) of each company divided by its management fee rate would determine the fund size needed to generate enough management fees for it to cover expenses (assuming that such level of expenses are maintained). Comparing the computed break-even fund size level with the actual year-end 1998 net assets of the fund/s they were managing, three companies (PAMI, PMI and BIMI) were either close to or above their respective targets. CMI was about halfway while MFMCP and TFGFMC had a long way to go.
- The management companies that were losing money were those that managed the funds with the poorest investment results. There is a strong correlation between a solid record of fund investment performance and the profitability of the fund manager. The ability to attract and maintain investors will depend on how much or how little the value of their investments is enhanced.

**Table 10. MANAGEMENT COMPANY INCOME/EXPENSE ANALYSIS, 1997**

| | CMI | TFGFMC | PAMI | PMI | MFMCP | BIMI |
|---|---|---|---|---|---|---|
| **INCOME STATEMENT** | | | | | | |
| Management Fees | 1,142,179 | 840,617 | 7,726,242 | 3,651,954 | 8,575,239 | 13,243,334 |
| Commissions | 480,439 | 0 | 972,000 | 3,237,008 | 2,598,557 | 0 |
| Other Income | 1,837,171 | 2,760,752 | 1,935,716 | 2,114,280 | 1,100,767 | 371,994 |
| *Total Income* | *3,459,789* | *3,601,369* | *10,633,958* | *9,003,242* | *12,274,563* | *13,615,328* |
| Salaries, Wages & Benefits | 539,269 | 1,438,074 | 5,225,251 | 496,659 | 7,262,656 | 2,932,473 |
| Rent and Utilities | 653,899 | 474,865 | 2,064,893 | | 5,673,023 | 0 |
| Advertising & Promotions | 0 | 145,908 | 342,845 | 1,026,836 | 792,273 | 0 |
| Commissions | 125,892 | 0 | 453,634 | 956,099 | 0 | 0 |
| Depreciation & Amortization | 321,005 | 332,092 | 850,359 | 95,297 | 0 | 177,307 |
| Others | 505,820 | 2,282,374 | 2,694,312 | 2,178,337 | 2,981,363 | 7,796,099 |
| *Total Expenses* | *2,145,885* | *4,673,313* | *11,631,294* | *4,898,892* | *16,709,315* | *10,905,879* |
| Net Income Before Tax | 1,313,904 | (1,071,944) | (997,336) | 4,104,350 | (4,434,752) | 2,709,449 |
| Provision for Income Tax | 287,111 | - | 397,943 | 696,279 | - | 277,515 |
| *Net Income* | *1,026,793* | *(1,071,944)* | *(1,395,279)* | *3,408,071* | *(4,434,752)* | *2,431,934* |
| **RATIOS** | | | | | | |
| *Mgt. Fees as % of Tot. Income* | *33.01%* | *23.34%* | *72.66%* | *40.56%* | *69.86%* | *97.27%* |
| *Comm. As % of Total Income* | *13.89%* | *0.00%* | *9.14%* | *35.95%* | *21.17%* | *0.00%* |
| *Mgt. Fees as % of Tot. Expenses* | *53.23%* | *17.99%* | *66.43%* | *74.55%* | *51.32%* | *121.43%* |
| *Com. Exp. as % of Com. Income* | *26.20%* | *n.a.* | *46.67%* | *29.54%* | *0.00%* | *n.a.* |
| *Fund Size to Break-even* | *107,294,250* | *233,665,650* | *581,564,700* | *326,592,800* | *1,113,954,333* | *727,058,600* |
| *Assets of Fund/s Managed* | *52,916,493* | *8,362,526* | *503,127,755* | *276,480,745* | *293,511,465* | *767,606,566* |
| Assets Managed as % of B/E | *52.39%* | *3.58%* | *90.02%* | *105.18%* | *26.35%* | *105.58%* |

The limited profitability or lack of profitability of fund management companies may be explained by the narrow scope of their operations. Although subject primarily to SEC regulation, fund investment managers currently are inhibited by BSP Regulations on Trust and Other Fiduciary Business Activities from attempting to broaden their clientele. As interpreted by the BSP, managers of more than a single fund or investment company would fall under BSP jurisdiction as conducting investment management activities ("IMA"). The threat of dual regulation by the BSP and SEC has caused most fund advisers to limit themselves to managing

mutual funds, or perhaps only one mutual fund. Such dual regulation may also have discouraged potential sponsors or investment advisers from entering the mutual fund business because of the possible delays, expense and inefficiencies it could involve.

The bases for the continuing BSP jurisdiction over fund investment advisers, which subjects them to dual SEC-BSP regulation, are the SEC-BSP Memorandum of Agreement ("MOA") dated February 11, 1999, and Section 414 of the BSP Memorandum to All Banks and Other Financial Institutions Performing Trust, Other Fiduciary Business and Investment Management Activities dated October 16, 1990. Those documents are attached as Appendix 10 to this report. [15] Among other things, they require approval of entities performing investment management activities by the Monetary Board of the BSP and high paid-up capital. Delays and uncertainties are inevitable in obtaining the favorable recommendation of the Monetary Board since it has not established any procedures or guidelines for meeting its requirements. Uncertain BSP policies could require an investment adviser to register as a trust or other financial institution and to meet paid-up capital requirements that could exceed by far the current SEC requirement that fund investment managers maintain a net worth of ₱ 10 million.

The impact of BSP policies and regulation on the growth of the fund industry needs to be reviewed at a policy level. Currently, they prevent mutual fund investment managers from taking advantage of the benefits of scale that managing other mutual funds, pension funds or other private investment advisory clients would bring. This limits their efficiency and profit potential and discourages new entrants into the investment management profession. Discouraging or limiting fund investment advisers from providing such services deprives the securities market and pension and retirement fields of broader investment advisory resources, more vigorous mutual fund industry, the benefits of greater competition and broader choices. BSP restrictions on non-bank/non-investment house IMA should be high on the list of necessary changes to be worked out by the mutual fund industry, the SEC and the BSP.

### E. Market Potential

Despite the Philippines 16 percent savings rate (domestic savings as a percent of gross income product "GDP," 1991-98), the lowest of its immediate neighbors, there is a large untapped market potential for mutual funds. In the best of all imaginable circumstances, the total available pool of savings, based on an analysis of household savings, could amount to ₱176 billion per annum. Other analyses suggest an available pool in the range of ₱100 billion

[15] The MOA was entered in response to Section 130 of R.A. 7653 which required the BSP to phase out its regulatory powers over finance companies without quasi-banking functions [Non-Bank Financial Institutions ("NBFIs")] and other institutions performing similar functions within five years of its effective date, July 3, 1993. The MOA transferred six BSP functions to the SEC, but retained BSP jurisdiction over banking institutions, quasi-banks and certain other institutions, including NBFIs authorized to engage in quasi-banking functions or in trust or other fiduciary business/investment management operations. Each of the other institutions, except fund investment advisors, could either accept deposits or make loans or was otherwise required by law to be regulated by the BSP.

to ₱150 billion. [16] A significant portion of either figure could represent the market potential for mutual funds.

**Analysis of Household Savings.** As of 1994, some 103,305 families around the Philippines, representing the top echelon of income earners, earned on the average approximately ₱865,000 per year. Of this, they were able to save about 40% or some ₱347,000 per family per year. This represents a total annual savings of ₱35.8 billion per year. This income group would tend to be well educated and more open to investing in mutual funds. Considering that at present, there are only a few thousand clients for the entire mutual fund industry, there is a potential for the industry to grow five-fold through strategic targeting of this top income earning group alone.

**Table 11. FAMILY INCOME, EXPENDITURES AND SAVINGS, 1994**

| Income Class | Total Number of Families | Average Income | Average Expenditures | Average Savings | Average Savings Rate |
|---|---|---|---|---|---|
| | | | | | |
| Under P10,000 | 149,537 | 7,727.00 | 8,656.00 | (929.00) | -12.02% |
| 10,000-19,999 | 933,267 | 15,842.00 | 16,795.00 | (953.00) | -6.02% |
| 20,000-29,999 | 1,644,422 | 25,175.00 | 24,685.00 | 490.00 | 1.95% |
| 30,000-39,999 | 1,652,896 | 34,915.00 | 32,851.00 | 2,064.00 | 5.91% |
| 40,000-49,999 | 1,391,055 | 44,815.00 | 40,852.00 | 3,963.00 | 8.84% |
| 50,000-59,999 | 1,133,426 | 54,827.00 | 48,480.00 | 6,347.00 | 11.58% |
| 60,000-79,999 | 1,698,025 | 69,239.00 | 60,014.00 | 9,225.00 | 13.32% |
| 80,000-99,999 | 1,074,314 | 89,418.00 | 76,366.00 | 13,052.00 | 14.60% |
| 100,000-149,000 | 1,501,550 | 121,924.00 | 98,757.00 | 23,167.00 | 19.00% |
| 150,000-249,000 | 1,054,063 | 187,960.00 | 144,698.00 | 43,262.00 | 23.02% |
| 250,000-499,000 | 419,355 | 327,031.00 | 241,267.00 | 85,764.00 | 26.23% |
| 500,000 and over | 103,305 | 865,696.00 | 518,639.00 | 347,057.00 | 40.09% |

The top echelon is just the tip of the iceberg. In the next tier are 419,000 families, earning some ₱327,000 and saving ₱85,000 of this per annum (a savings rate of 26%). The total annual savings for this tier adds ₱35.9 billion.

The next tier represents a million families around the country that earn an average ₱187,000 and save ₱43,000, or 23%, per annum, a total annual savings of approximately ₱45.6 billion. Assuming that this potential number of clients invest only an average of ₱5,000 each (a conservative amount), this would still represent a potential capital base of almost ₱8 billion.

[16] The lower estimate was arrived at by targeting 10% of ₱1 trillion, the M3 money supply. The rationale for this is that mutual funds are supposed to convert savings to long term sources of funds. To validate this figure, it was divided by the stock market capitalization of ₱1.4 trillion and the result was 7.0%. This is lower than the figures for neighboring countries like Malaysia (11.52%) and Thailand (9.48%). Using the average of these two countries (10.5%) as the target for the Philippines, it yields the higher estimate of ₱150 billion.

These figures do not include the mass market of moderate wage earners, a potential 6 million households with savings rates ranging from 8 to 19 percent and representing a combined savings pool of approximately ₱70 billion per annum. It consists of families earning:

- ₱100,000 to ₱149,000 per annum, saving 19% or ₱23,000 per year, for a total annual savings of ₱34.7 billion;
- ₱80,000 to ₱99,000 per annum, saving 14.6% or ₱13,000 per family, for a total annual savings of ₱14 billion;
- ₱60,000 to ₱79,000 per annum, saving 13.3% or ₱9,300 per family, for a total annual savings of ₱15.6 billion; and
- ₱50,000 to ₱59,000 per annum, saving 11.6% or ₱6,300 per family, for a total savings of ₱7.1 billion.

The mass market, however, requires a different marketing strategy for distributing mutual funds. This market base resists the idea of investing ₱5,000 as a lump sum initial investment. A strategy involving the contribution of small monthly investments, especially in the form of wage deductions, may be more feasible. The most efficient way to accomplish this would be through the enactment of a government-sponsored savings program. Were these six million households to contribute some ₱200 each per month (a generally acceptable and conservative enough deduction for forced savings), the mass market would have the potential to yield capital infusions to the mutual fund industry of approximately ₱14 billion annually.

### F. Investment Opportunities for Mutual Funds

#### 1. Analysis of Fund Portfolio Investments

Investment companies, by converting savers to long-term investors and pooling their funds, make available much needed capital to sustain the country's economic growth. As discriminating, sophisticated investors, mutual funds help in the efficient allocation of scarce financial resources by investing in companies that have good growth potential, but are in need of funds.

Table 13, Philippine Mutual Fund Investments, 1997 and 1998, below, indicates that ₱486 million or 23.52% of total industry assets as of year-end 1997 was invested in equities (primarily stocks listed in the PSE). By year-end 1998, this figure had grown to ₱1.161 billion or 34.46% of total industry assets. In comparison, a 1993 survey conducted by the Financial Executives Institute of the Philippines (FINEX) revealed that only 2.7% of Common Trust Fund ("CTF") assets were then invested in equities.

Table 12. PHILIPPINE MUTUAL FUND INVESTMENTS, 1997 and 1998

| | BREAKDOWN OF INVESTMENTS IN PESOS | | | | | |
|---|---|---|---|---|---|---|
| | As of Dec. 31, 1997 | | | As of Dec. 31, 1998 | | |
| TYPE OF FUND | EQUITIES | CASH + FIXED | TOTAL ASSETS | EQUITIES | CASH + FIXED | TOTAL ASSETS |
| STOCK FUNDS | 285,195,583 | 811,805,906 | 1,097,001,489 | 728,302,578 | 573,957,242 | 1,302,259,820 |
| BALANCED FUNDS | 201,407,253 | 689,452,052 | 890,859,305 | 433,254,202 | 1,214,812,539 | 1,648,066,741 |
| BOND FUNDS | 0 | 80,958,265 | 80,958,265 | 0 | 420,105,736 | 420,105,736 |
| *TOTAL INDUSTRY* | *486,602,836* | *1,582,216,22* | *2,068,819,059* | *1,161,556,780* | *2,208,875,517* | *3,370,432,297* |

| | BREAKDOWN OF INVESTMENTS BY PERCENTAGE | | | | | |
|---|---|---|---|---|---|---|
| | As of Dec. 31, 1997 | | | As of Dec. 31, 1998 | | |
| TYPE OF FUND | EQUITIES | CASH + FIXED | TOTAL ASSETS | EQUITIES | CASH + FIXED | TOTAL ASSETS |
| STOCK FUNDS | 26.00% | 74.00% | 100.00% | 55.93% | 44.07% | 100.00% |
| BALANCED FUNDS | 22.61% | 77.39% | 100.00% | 26.29% | 73.71% | 100.00% |
| BOND FUNDS | 0.00% | 100.00% | 100.00% | 0.00% | 100.00% | 100.00% |
| *TOTAL INDUSTRY* | *23.52%* | *76.48%* | *100.00%* | *34.46%* | *65.54%* | *100.00%* |

The other assets of mutual funds were invested in various fixed-income securities such as Treasury Bills/Notes, commercial paper, bank deposits and deposit substitutes. Cash generally accounts for an insignificant portion of mutual fund assets (about 1% to 2%), but is necessary for meeting redemptions.

As shown in Table 12, almost 100% of mutual fund assets are put into productive use to enhance the value of shareholder investments. In contrast, Pre-Need Companies set aside only 44% (to 60%) of the total amount paid by their planholders for servicing their future obligations. Recent data indicated that 26.2% of pre-need trust funds are invested in real estate and another 10.4% in direct loans. (See Differential Regulation, Lack of Effective Regulation of Pre-Need Plans, at pages 53-56 below.) Mutual funds usually do not invest in real estate (except REITs) because of valuation and liquidity considerations. Nor do mutual funds typically engage in direct lending because it unnecessarily exposes the fund and its investors to added credit and liquidity risks.

## 2. The Equities Market

### a. Investment Opportunities

The PSE 1997 Fact Book, describes the PSE as one of the oldest stock exchanges in the Far East. The Manila Stock Exchange (MSE) was founded by five American businessmen in August 1927. It was used as a model for the Stock Exchange of Thailand (SET) and the Kuala Lumpur Stock Exchange (KLSE). At that time, trading revolved around a handful of issues mostly from the sugar milling and mining sectors.

The Makati Stock Exchange (MKSE) was established in May 1963 and commenced operations in November 1965. It earned the Philippines the dubious distinction of being the only country in the world with two exchanges trading the exact same issues. This created problems for investors and made the market very inefficient (the same issues could be trading at different prices at any given time). Talk of unifying the two began in 1992. In March 1994, then President Fidel Ramos ordered the SEC to revoke the licenses of both exchanges and issue a single license to the PSE.

**"Boom and Bust."** Table 13. PSE Listed Companies and Market Capitalization, 1989-1998, shows market capitalization for the years ended 1989 to 1998, and the total value turnover for those years. From 1990 to 1996, the number of PSE listed stocks increased by an average of 10 companies per year and its stock market capitalization rose 13 times from ₱161 million as of year-end 1990 to ₱2.1 trillion by year-end 1996. If one were to label those "boom" years, the period of the Asian financial crises that began in early 1997, certainly could be considered "bust" years. Only five companies' securities were listed in 1997 and none in 1998. Stock market capitalization had shrunk by 35% to ₱1.4 trillion (US$35 billion) by the end of 1998. Total value turnover also dropped dramatically from a high of ₱669 billion (US$17 billion) in 1996 to only ₱409 billion (US$10 billion) in 1998.

**Table 13. PSE LISTED COMPANIES AND MARKET CAPITALIZATION, 1989-1998**

| Year | No. of Listed Companies | Increase from Previous year | Stock Market Capitalization [1] | Total Value Turnover [1] |
|---|---|---|---|---|
| 1989 | 144 | 2 | 261.022 | 50.730 |
| 1990 | 153 | 9 | 161.219 | 28.569 |
| 1991 | 161 | 8 | 297.743 | 39.407 |
| 1992 | 169 | 8 | 391.231 | 77.032 |
| 1993 | 178 | 9 | 1,088.820 | 182.180 |
| 1994 | 189 | 11 | 1,386.464 | 364.297 |
| 1995 | 205 | 16 | 1,545.728 | 378.983 |
| 1996 | 216 | 11 | 2,121.763 | 668.817 |
| 1997 | 221 | 5 | 1,251.288 | 586.173 |
| 1998 | 221 | 0 | 1,373.701 | 408.679 |

[1] *In billions of Philippine Pesos. Source: Philippine Stock Exchange*

Despite boasting one of the oldest bourses in Asia, compared with its neighbors' the Philippine Stock Exchange ("PSE") has remained relatively small. Only 221 companies and 300 issues were listed in the PSE as of year-end 1998. Of this number, only 120 to 140 issues are actively traded. More importantly, most analysts believe that only 30 to 50 issues can be considered investment grade. The 50 largest issues account for almost 90% of the total stock market capitalization of ₱1.4 trillion. The 50 most traded securities account for over 80% of the total value turnover.

By comparison, the Stock Exchange of Thailand (SET) was established only in May 1974 and commenced trading in April 1975 with 21 listed companies. By the end of 1998, the number of listings had risen to 413 or nearly twice the number of companies listed in the PSE. The SET's year-end 1998 total market capitalization of 1.268 trillion baht (US$34 billion at recent exchange rates) is roughly the same as that of the PSE's US$35 billion. However, its 1998 total turnover value of 855.17 billion baht (US$23 billion) more than doubled that of the PSE's US$10 billion during the same period.

Malaysia is another Asian neighbor that has outpaced the Philippines stock market.. Although the history of the Malaysian Stock Exchange can be traced to the 1930s, the Kuala Lumpur Stock Exchange (KLSE) was established only in 1973 with the break-up of the Stock Exchange of Malaysia and Singapore (SEMS). At that time, the KLSE had 262 listed companies. By the end of its fiscal year (June 30) 1998, the number of listed companies has grown to 736 (450 in the main board and 286 in the second board). The KLSE's stock market capitalization as of June 30, 1998, and its total value turnover for the fiscal year then ended were RM 285.9 trillion (US$ 75 billion) and RM 253.5 trillion (US$66 billion).

Additional capital, wisely invested, can help to build the Philippines market. While a developing mutual fund industry can help that market to grow, the ability of the market to absorb the investments that mutual funds could bring to it would help the fund industry to succeed. However, with only a handful of investment grade securities, 30 to 50, too much money could be chasing too few securities. The market's inability to absorb new investments could impede fund industry growth. It could hamper the development of new products (such as sector funds) and deter foreign players from organizing funds. In a word, the fund industry and the market are "interdependent." Thus, the development of the Philippines stock market, or the lack of it, is a serious concern for the mutual fund industry.

**Figure 3. PHILIPPINE STOCK EXCHANGE MARKET CAPITALIZATION, 1989-98**

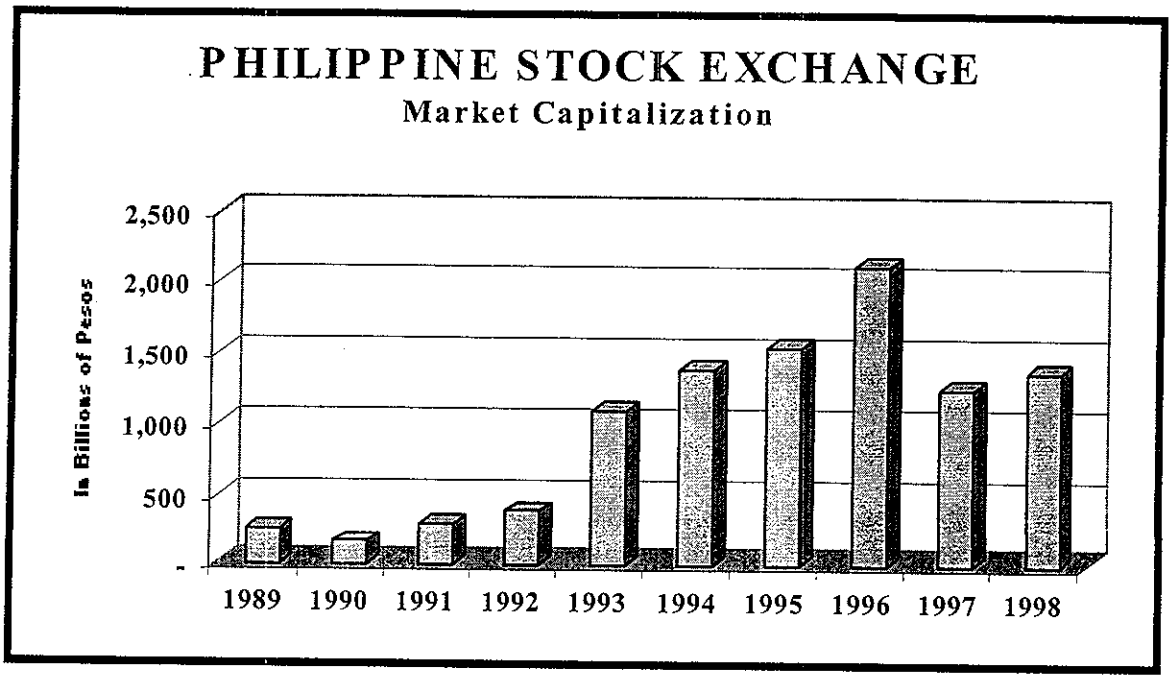
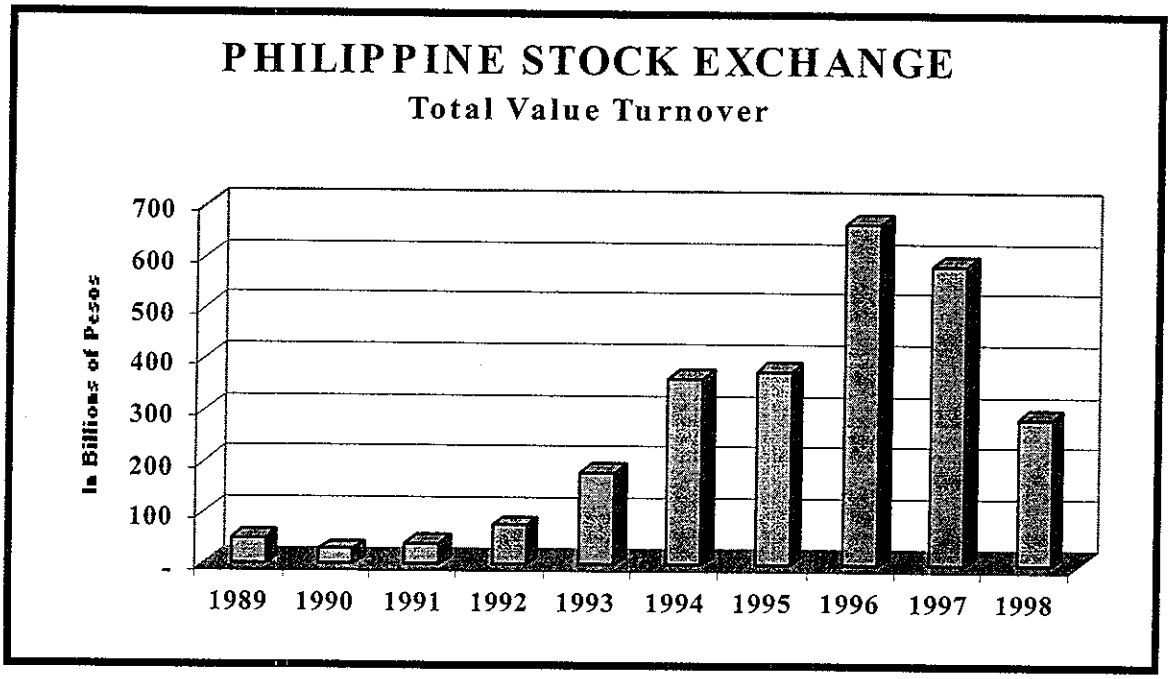



**Figure 4. PHILIPPINE STOCK EXCHANGE TOTAL VALUE TURNOVER, 1989-98**



### b. Investor Protections

Among the ways that the PSE and the Philippine securities markets can become more attractive and offer more investment opportunities to the fund industry, would be for the market to become more efficient and reduce systemic risk. The PSE and its related organizations, the Securities Clearing Corporation of the Philippines ("SCCP") and the Philippine Central Depository, Inc. ("PCDI"), have made great progress over the past few years in improving the efficiency and safety of the market. Nevertheless, they still need to put in place a number of vital protections that would reduce systemic risk and make the markets more efficient, not only for mutual funds, but for all investors. To provide for greater safety and re-enforce the integrity of the markets, a comprehensive risk management system to identify and contain risks to the settlement process must be established. It should include a broad-based Clearing and Trade Guarantee Fund ("CTGF"). To strengthen the SCCP's CTGF, at a minimum, every settling broker must contribute to the CTGF.

In late 1989, the Group of 30 published ten recommendations for creating world class securities markets ("G-30 Recommendations"). Markets were given two years to comply. The Philippines has met only one of the G-30 Recommendations, "Recommendation c." that it have an efficient and fully developed Central Securities Depository. Even here more is needed. For the PCDI to be fully successful a larger proportion of securities needs to be immobilized in it. Among the unmet G-30 Recommendations that would improve the Philippine market and thereby make it more hospitable to mutual funds and all investors are:

a. To eliminate delays on comparisons of trades outside the PSE system, compare all trades by T+1.
b. To reduce risk, inefficiencies and costs of settlement, institutions like mutual funds should be members of a trade comparison system which achieves positive affirmation of trade details.
c. The Philippines has an efficient depository, but a larger proportion of securities needs to be immobilized.
d. To reduce risk and promote efficiency, study market volumes to determine whether a trade netting system would be preferable to trade-for-trade clearance.
e. To minimize settlement risk for contra brokers, institute delivery vs. payment ("DvP"), delivery of securities and simultaneous receipt of funds.

In a rolling settlement environment, trades settle on every business day of the week on T+3. In the Philippines, trades settle every business day of the week at the SCCP, but on T+4 or later. Many trades fail to settle on T+4 because registrars fail to return scrip in a timely manner. Checks for all purposes, including those used to settle transactions take three days to clear.

f. All markets should adopt a convention of payment for settlement of securities.
g. To make payment for settlement of securities consistent, a "same day funds" convention should be adopted. For that to happen, the BSP or the banking system would need to develop an electronic cash/check clearing system.

h. A rolling settlement system should be adopted by all markets and final settlement achieved on T+3.
i. Securities lending and borrowing should be encouraged to expedite the settlement of securities transactions and avoid strings of fails.
j. To promote standardization, both domestically and worldwide, the International Organization for Standardization ("ISO") standard for securities messages and the ISN numbering system for securities issues should be adopted.

### 3. The Debt Market

**T-Bills and FXTNs.** The principal issuer of debt securities in the Philippines is the national government. Since 1986, the Bureau of Treasury ("BTr") has been conducting weekly auctions of 91-day, 182-day, and 364-day Treasury Bills (T-Bills). In 1995, the government also started issuing 2-year and 5-year Fixed Rate Treasury Notes (FXTNs), 7-year and 10-year notes in 1996, and 20-year notes in 1997. As shown in Table 14, Volume Of Treasury Bills Issued, 1995-98, and Table 15, Volume of Fixed Rate Treasury Notes Issued, 1995-98, below, the total amount of T-Bills and FXTNs issued from 1995 to 1998 was ₱872 billion and ₱215 billion, respectively. Although no details are available, an additional ₱146 billion worth of Floating Rate Treasury Notes (FRTNs) likewise had been issued by the government since 1995. As of February 28, 1999, the total amount of T-Bills and T-Notes outstanding was ₱818 billion.[17]

**Table 14. VOLUME OF TREASURY BILLS ISSUED, 1995-98[1/]**

| Year | 91-day | 182-day | 364-day | Total |
|---|---|---|---|---|
| 1995 | 62.355 | 57.727 | 59.357 | 179.439 |
| 1996 | 61.500 | 82.383 | 118.782 | 262.665 |
| 1997 | 58.340 | 63.455 | 85.293 | 207.088 |
| 1998 | 78.354 | 72.926 | 71.422 | 222.702 |
| ***Total*** | ***260.549*** | ***276.491*** | ***334.854*** | ***871.894*** |

*1/ In billions of Philippine Pesos*

*Source: Bureau of Treasury, Department of Finance*

**Table 15. VOLUME OF FIXED RATE TREASURY NOTES ISSUED, 1995-98[1/]**

| Year | 2-year | 5-year | 7-year | 10-year | 20-year | Total |
|---|---|---|---|---|---|---|
| 1995 | 23.430 | 21.000 | | | | 44.430 |
| 1996 | 38.530 | 19.680 | 19.585 | 7.000 | | 84.795 |
| 1997 | 23.200 | 7.500 | 5.327 | 5.259 | 2.000 | 43.286 |
| 1998 | 21.986 | 10.000 | 5.551 | 5.446 | | 42.983 |
| ***Total*** | ***107.146*** | ***58.180*** | ***30.463*** | ***17.705*** | ***2.000*** | ***215.494*** |

*1/ In billions of Philippine pesos*

*Source: Bureau of Treasury, Department of Finance*

[17] Aside from T-Bills and T-Notes, the government has also issued 10-year Agrarian Reform Bonds in substantial amounts through the Land Bank of the Philippines, basically as payment for landowners under the Comprehensive Agrarian Reform Program (CARP).

T-Bills and T-Notes are available from accredited government securities dealers, generally banks and some investment houses. The PSE has entered a Memorandum of Understanding with the Bureau of Treasury that by June 2000 it would list T-notes under the SDT Program with maturities of 5 years. It is hoped that listing and trading these notes on the PSE will not only help to expand the secondary market for them, but perhaps, more importantly, provide a better benchmark for their proper valuation by domestic funds and other investors.

**Municipal bonds** are virtually non-existent and are too small and too few to provide an investment opportunity for mutual funds. So far, only Cebu City and Legaspi City, Claveria, Sto. Domingo and Aklan have issued LGU (local government unit) bonds totaling only ₱ 96 million (excluding Cebu City). However, several LGU Bond issues: Palawan; Boracay; and Pangasinan are in the pipeline.

**Commercial Paper.** As in the equities market, there is a dearth of private companies issuing debt securities. According to the Credit Information Bureau, Inc. ("CIBI"), which rates commercial paper issues, only about 40 local companies are issuing such securities. As shown in Table 16, Commercial Paper Issued and Outstanding, 1989-98, below, a large percentage (69%) of the total of ₱206 billion worth of commercial paper issued from 1989 to 1998 was short-term paper. The total amount of commercial paper outstanding as of October 30, 1998 (₱48.3 billion) pales in comparison with the ₱767.8 billion total of T-Bills and T-Notes outstanding at December 31, 1998, and ₱818.3 billion outstanding at February 28, 1999.

**Table 16. COMMERCIAL PAPER ISSUED AND OUTSTANDING, 1989-98[1/]**

| Year | Issuance | | | Outstanding[4/] | | |
|---|---|---|---|---|---|---|
| | ST[2/] | LT[3/] | Total | ST[2/] | LT[3/] | Total |
| 1989 | 7.294 | 0.800 | 8.094 | 1.427 | 2.300 | 3.727 |
| 1990 | 14.954 | 0.925 | 15.879 | 3.107 | 9.675 | 6.782 |
| 1991 | 23.971 | 2.925 | 26.896 | 2.974 | 7.615 | 10.589 |
| 1992 | 13.328 | 8.402 | 21.730 | 2.543 | 6.828 | 9.372 |
| 1993 | 12.092 | 0.900 | 12.992 | 2.774 | 9.717 | 12.492 |
| 1994 | 18.056 | 6.200 | 24.256 | 3.907 | 22.165 | 26.072 |
| 1995 | 18.816 | 12.065 | 30.881 | 3.919 | 24.977 | 28.896 |
| 1996 | 15.135 | 20.250 | 35.385 | 5.930 | 45.556 | 51.485 |
| 1997 | 13.185 | 11.400 | 24.585 | 4.740 | 50.239 | 54.979 |
| 1998[4/] | 6.162 | 0.000 | 6.162 | 3.684 | 44.623 | 48.307 |
| ***Total*** | ***142.993*** | ***63.867*** | ***206.860*** | | | |

*1/ Figures are in millions of Philippine pesos.*
*2/ Short-term (one year of less) commercial paper.*
*3/ Long-term (more than one year) commercial paper.*
*4/ As of year-end, except for 1998 (as of October 30, 1998)*

*Source: Securities and Exchange Commission*

**US Dollar-denominated Eurobonds.** A handful of big corporations like Philippine Long Distance & Telephone Co. (PLDT), National Power Corporation (NAPOCOR), Ayala Corporation, San Miguel Corporation, and Benpres Corporation, issue US Dollar-denominated eurobonds, but these are traded by a few commercial banks and are not readily available locally. The minimum amounts are quite steep (usually US$1 million) making them

unaffordable even by medium-sized funds. The minimum transaction amount translates to about ₱38 million. Because a domestic mutual fund can invest only a maximum of 10% of its net assets in securities issued by any one issuer, a fund would have to have total net assets of at least ₱380 million before it could invest in such securities.

**Lack of a Broad Debt Market.** In conclusion, the Philippine debt market is still relatively undeveloped with a limited number of debt securities to choose from in terms of type of instrument, issuer and tenor. From a fund investment manager's perspective, the lack of a broad debt securities market constricts investment opportunities and makes managing a fund more difficult. It impedes the development of specialized products such as government bond funds, corporate bond funds, municipal bond funds, and money market funds that can be attractive to investors. It also makes valuation of bonds more difficult because there are still no benchmark prices to provide a reliable reference point to value such securities on a mark-to-market basis.

## G. Attracting Global Expertise and Resources

### 1. Expand Mutual Fund Investment Opportunities

Attractiveness of investment opportunities and the depth of the potential market for fund shares are the first things that a potential fund sponsor and good businessman will think about when he considers whether or not to commit capital and resources to the Philippines or to any other market. Those are the *sine qua non* of an investment. If the market can't pass those tests, he will say "forget about it" and stay home or go elsewhere.

***Critical Mass.*** As explained at pages 34 to 40, above, the jury may still be out on the question of whether the Philippines offers sufficient investment opportunities and reduced systemic risk to attract international fund sponsors. One such potential international fund sponsor provided a cogent analysis of the need to expand investment opportunities for Philippine based mutual funds and suggested an easy means of doing so. It urged allowing such Philippine based mutual funds to invest in securities of foreign issuers, including establishing mutual funds that could be fully invested in foreign securities ("foreign funds").[18] It explained that from a potential sponsor's perspective,

> "for a mutual fund operation to be profitable, a basic critical mass of capital under management is required. This critical mass is in excess of the size of the whole Philippine industry as it stands today. However, if this mass were to be achieved, it simply could not be invested in local (Philippine) securities markets alone, as these are simply too thin to support such volumes. Therefore, other outlets are required, and hence (investment in) foreign funds needs to be permitted."

***A competitive anomaly.*** It would be anomalous if Philippine investment companies were not also able to do what a Philippine bank, trust company, insurance company or shrewd

[18] See: May 17, 1999, letter of A. J. Belanger, Director International Investment Products, Sun Life of Canada, commenting on the March 10, 1999, *Circulation Draft,* attached as Appendix 11 to this report.

Philippine investor already can do. Banks and trust companies can and do organize common trust funds ("CTF's") that offer US dollar denominated foreign funds. The Insurance Commission ("IC") allows insurance companies to invest in foreign currency denominated investments, securities issued by foreign corporations and by foreign governments (IC Circular No. 9-97). The Social Security System has suggested that it should be able to invest P12 billion, or seven percent, of its P170 billion total investible funds in off-shore portfolio investments.

In the age of the internet and instant satellite communication, the Philippines, although composed of islands, can no longer operate with an island mentality. Philippine investors easily can find ways to invest directly in securities of foreign issuers and in offshore funds of well-known foreign investment managers with offices elsewhere in Asia. Hong Kong, for example, not only allows investment in securities of foreign issuers, including foreign funds, but encourages such investment through favorable tax treatment. (See, Part IV. B. 2 and 3, at pp. 66-68, below, and Appendices 14 and 15, regarding the significant role that foreign funds, securities of foreign issuers and foreign currency-denominated assets have played in the growth and development of Japan's and Hong Kong's Mutual Fund and Unit Trust Industries.

***A warning.*** The comment warns that if Philippine mutual fund sponsors are not permitted to organize "foreign funds", "potential mutual fund sponsors, whether local or foreign, will not see the Philippines' market as a viable one for their operations. This will deprive the market ...(of) the product legitimization that results from the entrance of important 'players' with credible names, well-established images, and large advertising and promotional budgets."

***The other shoe.*** Even if the securities laws and regulations permit investment in securities of foreign issuers and foreign funds, the tax laws may make such investments impractical or, at least, difficult. Not only is it important to expand available investment opportunities for mutual funds in order to attract strong sponsors and strengthen the industry, but also, if and when "foreign funds" and investment in securities of foreign issuers are permitted, it would be equally important that funds and other investors not be subjected to corporate taxes of 33 percent on realized capital gains on securities of foreign issuers as they currently would be. If forced to endure those high taxes, such "foreign funds" would suffer competitively vis-à-vis domestic funds. Most likely, they would have to adopt a "buy and hold" strategy to minimize realized gains. However, such a strategy could severely strain both their flexibility and marketability. They would be constrained in their portfolio management in that they probably would need to maintain a relatively larger portion of their assets in cash and near cash items to meet possible redemptions. They also would have to overcome potential investor resistance to buying into a portfolio with large unrealized capital gains that could be taxed at a 33 percent rate (or 32 percent effective January 1, 2000).

### 2. Provide Satisfactory Answers to Fundamental Questions

***Stability.*** Resolving issues regarding investment opportunities is just the beginning of the potential fund sponsor/good businessman's assessment. He will also ask some fundamental questions about stability: political and economic stability. When considering an overseas investment, a stable currency and control of inflation will help to hold his interest.

***Fairness of the marketplace.*** A potential mutual fund sponsor will also look at the efficiency, depth and liquidity of the capital market. He will want to know whether he will be treated fairly in the market place. He will ask whether the capital markets that are transparent and have as their primary objective the protection of investors. He will ask whether or not the rules are clear and, if he follows them, will he be treated fairly or arbitrarily. He will want to know how reliable, dependable and efficient the institutions of the capital market are. He will ask technical questions about controls on fraud, deception and manipulation, about delivery vs. payment and how long it takes for transactions in securities to clear and when they do, whether he will get clear title to the securities purchased.

***The regulatory environment.*** High on his list of factors that can make a difference will be his assessment of the regulatory environment. "How capable is the SEC?" he will ask. He will be pleased if high standards of professionalism are encouraged in the fund industry and in selling fund shares and other securities? He will also be happy if sound and reliable valuation, accounting and auditing practices are in place. He will look to the mutual fund regulatory structure to limit opportunities for affiliated transactions, self-dealing and misleading advertising. He will want to know whether the regulatory environment makes for a "level playing field" in which all similar products and investors in them are treated equally.

***Can we do business there?*** His bottom line will be "Can we do business there?" "How much will I have to risk?" "How long before we break even?" "How great is the upside potential and how soon can we reach it?" His lawyer will ask, "How hospitable is the legal system to foreign ownership? How reliable is the judicial system, if we are forced to use it? Can we enforce an agreement? What is the tax system like? Does it encourage investment? Will it allow a businessman to make a fair profit? Will we be frustrated by corruption and cronyism? Is it worth the hassle?"

## H. Potential Fund Sponsors

Two significant entities were poised to become fund sponsors during 1999. Far East Bank and Trust Company ("FE Bank") registered Far East Fund, Inc., an open-end investment fund with the SEC in February 1999 and Sun Life prepared applications for several new open-end funds, including some with novel features. Their entry into the industry will bring some degree of "product legitimization" to it: respected names, resources, expertise and distribution channels that will both benefit the entire industry and improve its public image and recognition. Waiting in the wings may be other significant fund sponsors from the banks, investment houses, stockbrokers and insurance companies.

ICAP conducted a seminar in November 1998, for companies that intended to establish their own mutual funds. The 25 companies listed in Table 17. Potential Investment Company Sponsors, November 1998, below, including FE Bank, Sun Life and Cocolife which is already a fund sponsor, were seminar participants.

**Table 17. POTENTIAL INVESTMENT COMPANY SPONSORS, NOVEMBER 1998**

| Name of Company | Industry |
|---|---|
| 1. Aetna Life Insurance | Insurance |
| 2. ATR Capital Partners | Investment House |
| 3. Banco de Oro | Banking |
| 4. Bancommerce Investment Corp. | Investment House |
| 5. Citibank, N.A. | Banking |
| 6. Cocolife | Insurance |
| 7. Diversified Securities | Stockbrokerage |
| 8. Equitable Banking Corp. | Banking |
| 9. FE Bank | Banking |
| 10. Fil-Credit Finance | Financing |
| 11. First Metro Investment Corp. | Investment House |
| 12. Global Business Bank | Banking |
| 13. Golden Tower Securities | Stockbrokerage |
| 14. ING Trust & Asset Management | Stockbrokerage |
| 15. Lippo Asia Investment Corp. | Investment House |
| 16. Multinational Investment Bancorp | Investment House |
| 17. PCI Bank | Banking |
| 18. Rizal Commercial Banking Corp. | Banking |
| 19. SB Capital | Investment House |
| 20. Securities 2000 | Stockbrokerage |
| 21. Fsecurity Bank | Banking |
| 22. Solid Bank | Banking |
| 23. Sumigin Metro | Investment House |
| 24. Sun Life | Insurance |
| 25. United Pacific Capital Corp. | Investment House |

Whether or how many of the other potential sponsors become players within the next year or two may depend on the changes in the industry and the capital market and upon the degree of implementation of the recommendations made in this and other studies of the capital market.

# II. DIFFERENTIAL REGULATION

*Are their differences in the regulatory environment and taxation of mutual funds, bank common trust funds, pre-need plans and insurance that help to explain the differences in their relative public acceptance?*

## A. Introduction

Investment companies or mutual funds issue shares that are securities. As issuers of securities they are subject to disclosure regulation by the SEC. The SEC is dedicated to the protection of investors. It requires adequate, accurate and current disclosure of all material information about securities sold to the public to enable investors to make informed investment decisions. It controls access to the market by professional participants in the market by testing, licensing and monitoring them. Because of the complex structures of investment companies, the Philippines Investment Company Act and the Rules under it provide a number of special protections to investment company shareholders against conflicts of interest and self-dealing.

The SEC has not applied these same principles to the regulation of Pre-Need Companies and the protection of their plan holders. Instead, it has focused primarily on the trust provisions of Pre-Need Plans and treated them somewhat like insurance. The primary concern of insurance regulation is to assure that the premises on which payment is based are sound and that the insured will receive the benefit of his bargain.

Common Trust Funds ("CTF's") were described in a 1993 ADB Consultant's Report, "*Developing a Bond Market in the Philippines*" as "surrogate mutual funds." In Visiting Professor of the Asian Institute of Management, Akira Tsusaka's "*Developing the Domestic Mutual Fund Industry in the Philippines,* Chapter III, of *The Philippine Mutual Fund Industry*,Edited by Francisco L. Roman, Jr. and Hazel C. Sangalang, (August 1996), Professor Tsusaka refers to CTFs as "quasi-mutual funds"

> "***because of the many similarities between CTFs and mutual funds in terms of their economic functions (pooled investment vehicle, professional fund management, diversification of investment portfolios), kinds of investment instruments permitted, no assurance of rate of return, etc." at p. 67.

The question might well be asked, "Why not regulate CTF's as investment companies, are they basically the same thing in substance with a different package and different regulatory protections? Banks and investment houses are permitted to solicit the public directly to invest through their CTFs. Indeed, in many, but not all banks, CTFs are sold at the same bank windows where tellers accept deposits. Like mutual funds, CTF's permit a bank to pool the funds of small investors in a diversified portfolio of securities that they could not otherwise invest in through individual trusts because they would be too small. Because they are a bank product and have been used to increase bank depositors, they are regulated by the BSP or ("Central Bank").

Like most Central Bank regulation, the BSP focuses on the solvency of the individual banks, on the sufficiency of the individual bank's reserves and on the payment of deposits, not directly on protection of investors or full disclosure. The BSP permits CTFs to invest in a wide range of securities from government and commercial paper (mostly short term, 30-60-90 day instruments) high and low grade fixed income paper, equities mortgages and real estate. In 1993, over 60% of their assets were invested in government securities, almost 30% in loans and discounted paper, and the rest in stocks.

A comparison of the regulation and taxation of investment companies or mutual funds and their nearest competitors, Pre-Need Plans and CTFs will make clear that funds have suffered from differential regulation. This regulatory pattern has hindered the growth and development of the fund industry. It has also denied opportunities and protections to investors, prevented them from making informed choices among similar products and has impeded the efficient allocation of capital that a level playing field and a more open, transparent and competitive market would encourage.

## B. Regulation of Investment Companies

### 1. The Philippine Investment Company Act ("PICA"), Rule ICA 35-1 and The Revised Securities Act

Investment companies present a unique regulatory challenge. They involve large amounts of liquid assets often managed by persons not personally known to the shareholders and who may also be associated with larger enterprises involved in other businesses. In view of the possible conflicts of interest, which their structure can engender, fund shareholders receive special protections. PICA sets requirements for the registration of investment companies and the licensing of mutual fund solicitors. It prohibits transactions with certain affiliated persons, specifies contracts of advisers and underwriters, the size and capital structure of investment companies, requires investment companies to keep records and submit reports, etc. And it prohibits investment company shares from being sold with a heavy front-end load.

Every phase of investment company regulation is guided by the broad general principle that investment company officers and directors, investment advisors and managers and the persons involved with them, like trustees, must observe the highest duty of loyalty to the shareholders who are essentially the beneficiaries of the trust. Investment companies must be administered solely in the interests of their shareholders, and any business practice that deviates from that basic fiduciary principle is not tolerated.

The regulatory system sets standards for the licensing and regulation of those who would market and operate an investment company. The regulatory system provides rules setting the legal form and structure of such companies and the segregation and protection of investment fund assets. The regulatory system requires disclosure by investment funds that is necessary to evaluate the suitability of the fund for a particular investor and the value of the investor's interest in the fund. The regulations ensure that there is a proper and disclosed basis for asset valuation and the pricing and redemption of shares.

The Rules and Regulations governing investment companies under PICA were originally promulgated in October 1989, and amended in May 1998, as ICA Rule 35-1. Every aspect of mutual fund operations currently is subject to the most stringent regulatory standards: disclosure; sales agent training and qualification; sales load and expense limitations; advertising; protections against self-dealing; director independence; portfolio diversification and valuation standards.

### 2. The Revised Securities Act and SEC Rules and Forms

Because investment companies or mutual funds issue shares to the public, they are likewise regulated by the Batas Pambansa Blg. 178 or the Revised Securities Act (RSA). This law basically provides for the registration and regulation of securities issued to the public.

The Rules and Regulations of the RSA that the SEC implemented in 1996 present a basic policy shift to a "full disclosure" approach from that of "merit regulation," although vestiges of merit regulation remain. Under a merit regulation approach the regulator decides whether a security may be sold. Under a "full disclosure" approach the regulator assures that all relevant information is disclosed and the market decides whether or not to purchase a security and what value to place on it. The fundamental concept of this approach is that investors must be able to make informed investment decisions about whether to buy, hold or sell securities. To that end, greater emphasis now has been placed on the submission of registration statements and regular reports by issuers, affiliated persons, brokers, dealers, transfer agents and other persons involved in the securities business.

Among the documents/reports which investment companies must file with the SEC under these rules are:

- ***SEC Form 8-1,*** **Registration Statement,** must be filed by an investment company before it can offer its shares to the public. It includes information required in the Prospectus: a description of the fund and the shares to be issued; investment guidelines and restrictions; the method and basis for computing the net asset value per share; risk factors; minimum investment amounts, sales loads etc.

- ***SEC Form 11-A,*** **Annual Report,** must be filed by all companies registered under the RSA. It includes audited financial statements.

- ***SEC Form 11-Q,*** **Quarterly Report,** includes management's discussion and analysis of financial condition and results of operations and submission of pro forma financial statements.

- ***SEC Form 11-C,*** **Event Report,** must be used to report any event (within 5 to 15 days from occurrence of the event) that materially affect the economic, financial or equity situation of the company (such as the resignation, removal or election of the fund's directors or officers, changes in certifying accountant, loss of a significant part of the company's net worth etc.)

- **Proxy Statement**
- **Information Statement**

### 3. The Securities and Exchange Commission

The SEC is responsible for registering, regulating and supervising investment companies and investment company managers. The Money Market Operations Department (MMOD) regulates investment companies while the Brokers and Exchanges Department (BED) supervises the investment advisers, distributors and investment solicitors of mutual funds.

**The Investment Management and Financial Services Division of the MMOD** consists of one supervisor and eight technical staff. At December 31, 1998, it oversaw the operations of 178 financing companies and (as of June 30, 1999) of 16 investment companies.[19] Only one person is assigned to audit and review the reports being submitted by the existing funds. The same person is responsible for reviewing the registration statements filed by new funds. As more funds are established, one person will find it increasingly difficult to properly monitor them. As shown in Table 18, Time of SEC Processing of Investment Fund Registration Statements, below, it has taken an average of 4.8 months since August 12, 1997, for the SEC to approve the registration statements of the last seven mutual fund applicants.

**TABLE 18. TIME OF SEC PROCESSING OF INVESTMENT FUND REGISTRATION STATEMENTS**

| Name of Fund | Date of Submission | Date of Approval | No. of Months |
|---|---|---|---|
| ECC Growth & Income Fund | Aug. 12, 1997 | Jan. 20, 1998 | 5.25 |
| Ayala Life Fixed Income Fund | Sep. 03, 1997 | May 08, 1998 | 8.25 |
| GSIS Kinabukasan Fund | April 20, 1998 | June 18, 1998 | 2.00 |
| All Asia Fixed Income Fund | April 20, 1998 | Aug. 22, 1998 | 4.00 |
| All Asia Fund | April 20, 1998 | Dec. 04, 1998 | 8.50 |
| Philam Strategic Growth Fund | May 15, 1998 | July 17, 1998 | 2.00 |
| Far East Fund | Nov. 3, 1998 | Feb. 23, 1999 | 3.75 |
| ***Average*** | | | ***4.80*** |

*Source: Money Market Operations Department, Securities and Exchange Commission*

**The Brokers and Dealers Division of the BED** in March 1999, consisted of 21 persons: one chief, three supervisors, and 17 technical staff. It was responsible for monitoring the activities of 167 PSE member brokers, 15 non-PSE member brokers, 49 government securities dealers, 59 investment houses and banks with underwriting licenses, and 13 mutual fund investment adviser/distributors. Aside from registering investment advisers and distributors of mutual funds, it administered mutual fund sales agent licensing examinations. During 1997-98, these exams were held every three to four months for from 70 to 120

[19] The registration of 16th fund, Far East Fund, Inc. was completed in February, but the fund had not yet been launched by July 31,1999.

candidates per exam. Because of the limited number of qualified people available to check exam papers, it took about one month for results to be released. As more funds are established, the number of persons who take the licensing exam may be expected to increase dramatically. For instance, it is reported that one prospective entrant to the industry is planning to have 1,500 of its insurance agents take the exam. At the request of ICAP, in accordance with the recommendation contained in the *Circulation Draft* of this Report, on June 21, 1999, the SEC agreed to transfer administration of the mutual fund sales agent licensing examination to the Capital Market Development Center, Inc. ("CMDCI").

### C. Tax Policy Discriminates Against Funds and Their Shareholders and Inhibits the Growth and Development of the Fund Industry

The Tax Reform Act of 1997 provided fundamental relief to mutual funds and closed-end investment companies by reducing a great deal of the burden of double taxation of funds and their shareholders.[20] Still, a number of other tax provisions discriminate directly and indirectly against funds and their shareholders, particularly the documentary stamp tax on issuance of fund shares and the tax on dividends declared by funds. They and some taxes of more general application, such as the corporate tax on net gains on investments in securities of foreign issuers and the IPO tax, present major, probably unintended, obstacles to the development of the fund industry. This Report recommends amendments to the tax laws to ameliorate the prejudicial effects that these four taxes have on the mutual fund industry and its shareholders.

#### 1. The Dividends Tax

***An excessive tax.*** Individuals who are fund shareholders (unlike corporate shareholders) still are required to pay a dividends tax of 8% (10% after January 1, 2000) on fund dividends declared. The tax on declared dividends is required even though funds already pay: a 20 percent withholding tax on interest income; transaction taxes of ½ of 1 percent on sales of PSE traded securities; and taxes on net gains on sales of non-PSE traded securities, as described below. Taxing fund shareholders on dividends, under these circumstances, is excessive. It can inhibit the industry in designing payment plans to accommodate shareholders and result in practices (funds not declaring dividends) that may inconvenience investors or make funds less attractive, especially to those investors who are looking for regular income.

***Unintended consequences.*** Retaining the tax on dividends paid by funds is an excellent example of a self-defeating regulation because it is a major obstacle to the growth of the financial markets and to broadening of the pool of taxable income. Fund managers generally are able legally to prevent imposition of the dividend tax by simply not declaring dividends. Thus, the government is not able to collect the tax on fund dividends. More troubling, is a probably unintended consequence of the tax on dividends. It is an obstacle to the

[20] Until December 31, 1997, although funds paid transaction taxes on their listed stocks, shareholders, upon redemption of their mutual fund shares, were required to pay a capital gains tax of 10% on the first ₱100,000 net gain and 20% on the excess, a form of double taxation which inhibited the growth of the fund industry. *On the other hand, CTFs were subject to a one time 20% final withholding tax on trust income based upon gross yields on the CTF's investments, while investors' income from CTFs was tax free.*

development of money market funds and through them to the growth of the fund industry in the Philippines.

***"For want of a nail..."*** In the U.S money market funds have attracted many new individual, as well as corporate, investors and are a major engine of the growth of the U.S. fund industry. They accounted for $1.352 trillion or 24.5% of the total U.S. mutual fund industry's net assets of $5.525 trillion at year-end 1998. Establishment of money market funds in the Philippines would provide a major boost to the fund industry. Money market funds earn higher than regular bank deposit rates because they are invested in money market instruments. Shareholders usually have check writing privileges. Philippine money market funds would help to introduce many more investors to the fund industry and would not only add to its assets under management, but also to public acceptance of the fund concept.

***Maintaining a stable NAV requires money market funds to declare daily dividends.*** A key feature of U.S. money market funds is their ability, with rare exceptions, to conveniently sell and redeem their shares at a $1.00 NAV. They are able to do this because all of their net earnings are distributed as dividends daily and converted into new fractional shares. Subjecting such dividends, paid to individuals, to an 8% tax (10% beginning January 1, 2000) will reduce the net earnings of money market funds and make them less attractive to individual investors. Because Money Market Funds involve the appreciation of small differences, a difference of 8 or 10 basis points because of a tax on dividends could make them less competitive and could be an insurmountable obstacle to the development of Philippine money market funds.

### 2. The Documentary Stamp Tax ("DST") On Issuance of Fund Shares

***Taxing the heart of fund operations.*** The DST of ₱2.00 per ₱200.00 of the par value, on issuance of fund shares, is more prejudicial to an investment company than other enterprises because of the unique way mutual funds operate. The defining feature of an open-end fund is that it is required to redeem its shares at net asset value. Its redeemed shares then are cancelled and resold as original issues. Each time it does so, the fund again must pay the ₱2.00 DST. The solution, proposed by the fund industry, would be more efficient and produce more immediate revenues for the Government, but would avoid taxation of reissued shares and, over the longer term, should reduce the impact of the DST on open-end funds.

***Pay more now, perhaps less over the longer term.*** The fund industry has recommended that the DST on issuance of fund shares be levied on the entire authorized capital of an open-end fund upon its incorporation, but at a lower rate, ₱1.00 per ₱200.00 of par value. This proposal would benefit the Government in that collections would be sooner, more certain and more efficient. The Government would not have to rely on a fund's ability to market its shares. Although a fund would pay more taxes upon organization, in the long run it would pay less because it would not have to pay the DST on redeemed shares that are re-issued and the rate would be lower. It could also amortize its payment over five years as a pre-operating expense.

### 3. Other Taxes

***A heavier toll.*** Other taxes also impact differently, and in fact harder, on investment companies and mutual funds than on other issuers because investment companies are in the business of investing, reinvesting and trading in securities. Thus, any tax on securities transactions or on capital gains, even though meant to apply equally to all investors, will take a heavier toll on an investment company than on a non-professional investor. For example:

- **The DST on purchases of shares in the secondary market.** Funds, like other investors, also pay a DST of ₱1.50 per ₱200 of par value of shares purchased on the PSE.

- **Stock Transaction Taxes** of 1/2 of 1% of the transaction amount must be paid by a fund, in lieu of capital gains, on the sale of all portfolio securities that are listed and traded on the PSE.

- **Capital gains taxes on shares not listed and traded on the PSE.** Funds also pay capital gains taxes of 5% on the first ₱100,000 of net gains and 10% on the excess on sales of shares not listed and traded on the PSE.

- **Withholding tax on interest income.** Funds and other investors, except tax exempt pension funds, must pay a 20% withholding tax on interest income on investments in fixed income instruments such as T-Bills, commercial paper, bank deposits and bonds. The uneven application of this tax is also detrimental to investment companies because it divides the market in such debt instruments between taxable and non-taxable instruments.

- **Corporate tax.** The SEC soon may be considering applications for registration of funds that would like to hold all (90 %) or a portion of their portfolios in U.S or non-Philippine stocks. If the SEC were to approve such funds, any realized gains on foreign portfolio securities would be taxed at corporate tax rates of approximately 33 percent (32 percent effective January I, 2000). Such a high tax imposes a heavy toll that inhibits the creation of new more varied investment funds. (See, *"The Other Shoe,"* Part I.G.1. on Attracting Global Expertise and Resources, p. 43, below) It would be more appropriate, provide greater opportunities for investment, diversification and profitability, and increased tax revenues if, instead of the 33 percent corporate tax, funds paid the same capital gains taxes on net realized gains on the sale of foreign securities as they would on shares not listed and traded on the PSE, 5% on the first ₱100,000 of net gains and 10% on the excess.

- **Initial Public Offerings Tax.** Another tax, a 4% Initial Public Offerings Tax, although paid by issuers, inhibits listing on the PSE and thus also tends to constrict the choices available to a fund and all other investors.

- **Special Benefits for Pre-Need Plans.** Pending legislation would provide additional tax benefits to the Pre-Need Plan industry and its plan holders. According to Reporter Norman P. Aquino, writing in Business World, February 24, 1999, "*Roco files bill....*"

> "Pre-need plan payments will be exempted from value-added tax (VAT) and documentary stamp tax. Benefits gained by plan holders will also be exempted from income tax. Meanwhile, corporate payments for pre-need plans will be considered expenses deductible from yearly income." Bus. World, Feb.24, at p. 13.

While it is important that fiscal policy not impede the growth of the financial sector, it is more important that similar investment product be treated similarly and one not receive tax- favored treatment that the others do not receive.

### D. Lack of Effective Regulation of Pre-Need Plans

**Similarities in Products/Differences in Regulation.** The casual observer will immediately notice how similar a Pre-Need Plan Company is to an investment company or mutual fund. Stripped to their essentials, both offer a security that entitles the holder to participation in a collective investment vehicle managed by a professional manager. Pre-Need Plans are marketed to many of the same investors as mutual funds could be sold. Both mutual funds and pre-need plans are for long-term investors. Their investment goals often are similar, providing for education or retirement. Both have been regulated by the SEC, but under different regulatory premises.[21] Their marketing programs and investor protections are very different.

**Popularity.** Pre-Need Plans are long-term investment or savings programs that have gained enormous popularity in the Philippines. As of 1997, there were 88 Pre-Need Plan Companies with total assets of ₱78.8 billion. They had sold 3.5 million plans for a gross contract price of ₱170 billion, with gross collections of ₱40 billion and total benefits paid of only ₱4 billion. Plan company paid-up capital was ₱1.8 billion and total trust funds were ₱20 billion. [Source: Philippine Federation of Pre-Need Plan Companies, Inc. ("Federation") Survey, Philippine Daily Inquirer, p.D.1, December 10, 1998.]

**Profitability.** The Issuer/Distributors of Pre-Need Plans, the Pre-Need companies have been remarkably profitable. According to SEC documents:

> " ***during the past five years, the industry grew by an average 20 percent per year. Total assets rose at an annual average of 30.2 percent, with net [*plan company.*] profit after tax posting an average increase of 28.2 percent per year." [Inquirer. Id.]

**The pre-need sales force** is over 200,000 strong and extremely well compensated on a per sale basis. Sales agents receive 50 percent of the full first two-year's payments. Generally,

[21] Chairman Yasay of the SEC testified before the House Committee on Banking and Finance on February 16, 1999, considering the Pre-Need Securities Code to the effect that if the SEC required Pre-Need Companies to make the kinds of disclosures for pre-need certificates that would be required for other kinds of securities, "No one would buy them."

they do not sell competing financial products. They are located throughout the Philippines. Few are full-time. Most have other jobs and sell almost exclusively to their friends and relatives. They receive front-end loaded commissions that are 50% of the payments made during the first two years on an installment plan. There is a high turnover among them. Once they have sold their friends and relatives, they remain sales agents in name only.

**Pre-Need Plan sales agents** may receive very little training. They are not subject to the more rigorous SEC testing and monitoring that are required of mutual fund and securities salesmen. The SEC Pre-Need Rules allow pre-need sales agents' licenses to be issued upon certification under oath *by the issuer/distributor* that the sales agent has been duly trained under a training program approved by the SEC. The SEC Rules do not specify training standards. Nor has the SEC required disclosure of sales agent turnover rates or the compensation structures.

**The plan guarantee** is its essential feature. Plans guarantee to pay a fixed sum five, ten, fifteen or other years in the future to meet a specific need of the plan holder. Three types of plans are sold: memorial plans: to be used for burial and memorial expenses; educational plans: to be used to pay some part of future educational expenses of a child; and "pension" plans: under which the proceeds are to be applied toward the plan holder's retirement.

**The market for the plans,** other than for memorial plans, typically is composed of newly-weds, young professionals, teachers, small entrepreneurs, shop owners and many other first time investors who are likely to have very little savings. They are risk averse. Therefore, the plans guaranteed payment is a strong determinant in their choice.

**Lapses.** When hard times come, plans lapse. Although lapse rate data is not readily available, lapses are essential to the "success" of the plan. It is estimated that at least 50 percent of installment plans lapse before becoming paid. When they do, because of the way the plan is structured, plan holders suffer steep losses (from 95% to 60% of their investments). The SEC has not required disclosure to investors in an offer document of lapse rates, actuarial assumptions or the degree and incidence of losses which plan holders have suffered.

**The rate of return** on a "typical plan" ranges between 3 and 7 percent per annum and averages approximately 5 percent. That is less than the 8 percent average rate of inflation over the past five years. Thus, the real rate of return on a such a plan would be negative. Under the plans only 40 percent of the total payments made by the plan holder must be placed in a trust to produce the guaranteed benefit, but actually only 5 percent of the first two years' payments is required to be placed in trust. The balance goes to the issuer/distributor to pay its administrative expenses, including high front-end load sales commissions. The SEC has not required disclosure to investors in an offer document of how much of their payments actually will be invested on their behalf or of what rates of return are on the total amounts invested.

**Only a Small Percentage of total Pre-Need gross collections are invested in stocks.** As of the end of 1997, of Trust Fund assets of ₱20 billion, just 26.9 percent, or ₱5 or ₱6 billion were invested in stocks industry-wide (based upon 24 companies accounting for 94% of

industry assets). Another 26.2 percent was invested in real estate. At year-end 1997, over 10 percent of the value of the real estate was accounted for by increment in the appraised value of the real estate. The next most significant assets accounted for 37.4 percent of total trust fund assets: government securities 17.0 percent; loans 10.4 percent; and cash/time deposits 10.0 percent. The SEC has not required disclosure to investors in an offer document or annual report of the portfolio holdings of Pre-Need Plan Trusts. Nor has it required valuations that would require real estate which is worth less than cost to be marked to market.

In the U.S. pre-need plans would qualify generally as investment companies under the U.S. "Investment Company Act of 1940" ("ICA"). They would qualify as "face amount certificate" investment companies if they promise to pay a fixed amount.[22]

Cases have held the U.S. Scholarship Plans were investment companies. The U.S. SEC, relied heavily on full disclosure to protect investors while acting flexibly to grant exemptions under the Investment Company Act ("ICA") to allow the Scholarship Plan to continue in business without altering its basic form. See, Findings and Opinion *In the Matter of The Trust Fund Sponsored by the Scholarship Club, Inc.*, ICA Rel. No. 5524, (1968 SEC LEXIS 563) (October 25, 1968).

For the protection of investors and to level the playing field, pre-need plans could properly be classified and regulated in the same manner as "investment companies" or at a minimum subject to concepts of investment company regulation. Among other things, in addition to providing the utmost transparency to assure that investors have complete information on which to base an investment decision, those protections would:

1. Prohibit various forms of self dealing;
2. Provide economic regulation of the remuneration of affiliates;
3. Restrict unsound capital structures;
4. Require clear disclosure of investment objectives and policies;
5. Protect the physical integrity of assets;
6. Assure fair valuation of investor purchases and redemptions; and

[22] Section 3(a) of the ICA defines an investment company as any issuer which - "(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of each such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.)

"Investment securities" includes "all securities except (A) government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries which are not investment companies. Section 3 (a) (2) defines it as any issuer which is engaged or proposes to engage in the business of issuing face –amount certificates of the installment type, or has been engaged in such business or has any such certificate outstanding."

Section (2) (a) (15) defines "face-amount" certificate to mean "any certificate, *investment contract*, or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face amount certificate of the installment type); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face amount certificate)."

7. Assure that investors receive accurate periodic reports about the funds and what the funds invest in.

**Insurance Industry Concerns.** The differential regulation of the pre-need industry has also alarmed the insurance industry. Asian Development Bank Report, R243-98, "*Technical Assistance to the Philippines for Technical Assistance to the Insurance Commission*" 31 December 1998, notes the similarity of pre-need products to insurance and states the following concerns:

> "***there is no actuarial supervision of the risks associated with pre-need products, and pre-need companies are not subject to the kind of prudential controls over investments, reserves and liability valuation that the (Insurance) Code imposes on insurance companies. ***Because of the advantages such as relative taxation, investment controls, and financial and operational aspects that pre-need companies have over the more regulated insurance companies, more domestic savings are placed in the shorter term products of pre-need companies than in long-term savings."*** (Emphasis added.) At p.2.

The reiteration of the ADB's concerns should not be viewed as an endorsement regulation of the pre-need industry by the Insurance Commission. It is included because it confirms the need for ending differential regulation, protecting plan holders and investors and better allocating long-term savings.

### E. Regulation of Common Trust Funds ("CTFs")

Like Pre-Need Plan Companies, CTFs can trace their growth, at least in part, to a continuing lack of effective regulation. [23] A 1980 Central Bank Study pointed out structural deficiencies in the trust business. Foremost was the failure to differentiate trust and investment management from other fund generating commercial bank activities which caused trusts to be used as funding sources for other bank commercial activities. Investors were not properly informed of the risks involved in CTFs. According to Sangalang and Norman Umali, "*Evolution of Finance Services in the Philippines,*" Chapter II, of *The Philippine Mutual Fund Industry*, supra,

> "*** many customers were of the idea that trust accounts were absolutely reserve-free, tax efficient, and an absolute source of high returns. Thus, investors were able to use trust and IMA (Investment Management Accounts) operations to evade the 35% net income tax as these were subjected only to the 20% final withholding tax." P.44.

[23] The analyses found in the studies cited is refuted by .R.P. Lirio, Managing Director, Supervision and Examination Sector (SE II) and Officer-in-Charge, Supervisory Reports and Studies Office (SRSO) of the BSP, in a letter dated April 23, 1999, commenting upon the *Circulation Draft* of this report. Mr. Lirio's letter is attached as Appendix 12 to this report. Essentially, it takes the position that CTF's have been more strictly regulated than mutual funds (describing protections) and that "the real reason for the (fund) industries' (sic) very slow development could be ...a. The industry itself failed to make its product acceptable to the public; b. The small investors' preference to relatively safe investments like CTFs over speculative ones like stocks and mutual funds."

The authors also cite a 1987 World Bank Review that noted that some commercial banks were using their CTF operations as another means of soliciting *de facto* deposits and deposit substitutes. In addition, they also note that a 1988 ADB Feasibility Study, *On Establishing a Mutual Fund in the Philippines,* stated that

> "...banks had no or inadequate capital to back their CTF operations. They also lacked supervision from regulating agencies. Investment guidelines and restrictions were overlooked. Fee and commission controls were inadequate. Investors were entitled to very few rights and transactions were not fully disclosed to them by their custodian banks. For almost a decade of rapid growth the industry lacked clear rules on licensing, capitalization, and nationality requirements for enterprising companies." At p. 44.

In October 1993, upon concluding that CTFs were being used to increase depositors, the BSP set a reserve requirement (adjusted from 10 % in 1993, to 15% in May 1995, 14 % in January 1997 and 13% July 1997) on all peso denominated CTFs. In the CTF industry of 1998, with assets of ₱90 billion, this 13 percent reserve requirement translates into a cash flow to the BSP of ₱11.7 billion. This could be a substantial inducement to the BSP to maintain the *status quo.* The 10 percent reserve requirement of October 1993, prompted a mini-stampede, as the assets of CTFs initially diminished markedly. Banks countered by launching dollar denominated CTF accounts. A few banks and others began to form mutual funds.

The BSP has been reluctant to permit banks to sponsor mutual funds. Ex-Governor Gabriel C. Singson of the BSP has recognized that

> "From a marketing standpoint, both CTF's and mutual funds are similar with respect to the basic concept of pooled savings under professional management. With the CTF subject to reserve requirements ..., a mutual fund has become increasingly competitive. Banks therefore look at it as an alternative financial product to offer customers looking for better investment yields.
>
> But customers will not necessarily regard mutual funds as a close substitute to bank deposits. The risk /return profiles are different.... Yet such a substitute for deposits, deposit substitutes and CTFs on a significant scale, bears potential implications on the effectiveness of the reserve requirement as a monetary tool, but not necessarily on the overall effectiveness of the monetary policy. The BSP should still be able to maintain monetary control but at an increasingly higher fiscal cost." Chapter VII, Government Perspective and Policy, *The Philippine Mutual Fund Industry*, supra, at p. 227

A cynic might view the BSP as one of the few true believers in the future of Philippine mutual fund industry. Ex-Governor Singson outlined the underlying principles and conditions under which commercial banks should be allowed to manage mutual funds. Foremost was that bank management not be perceived by the public to be a guarantee on investments nor as liabilities of banks. To ensure this distinction, he proposed:

- the management company of the fund should not share the name, logo, acronym of the parent bank and its subsidiaries;
- company personnel, facilities and premises should also be separate and distinct from those of the bank;
- all advertising materials, particularly to prospective investors promoting the sale of mutual funds shares and stock certificates, must clearly declare that such investments are not the liabilities of the bank and its subsidiaries, and that they do not guarantee either the principal or income; and
- state that mutual funds are not guaranteed by the PDIC.

His bottom line was that "Mutual funds must stand or fall on their own intrinsic merits." Chapter VII, Government Perspective and Policy, *The Philippine Mutual Fund Industry*, supra, at p. 228. Although not formally adopted by the Monetary Board, the BSP has continued to enforce these policies on an ad hoc basis one application at a time. As recently as June 9, 1999, BSP Deputy Governor Alberto V. Reyes, by letter to Undersecretary Joel Bañares of the DoF reconfirmed its view that "using the parent bank premises to sell mutual funds gives the impression that the investor is dealing with the parent bank." As indicated at page 12, footnote 6, above, the complete letter is included as Appendix 8 to this report.

Despite the efforts of the BSP, investors still are not properly informed of the risks of investing in CTF's. The CTF investor signs a Trust Agreement. It is required to contain language similar to the following:

> "Nothing in this agreement shall be construed as a guaranty of return or income nor does it entitle the TRUSTOR to a fixed rate of return on the money invested for him in the FUND by the TRUSTEE. The TRUSTEE shall not be liable for any loss or depreciation in the value of the FUND or in the value of the TRUSTOR's unitholdings unless attributable to its act of fraud, willful default, gross negligence or evident bad faith." [24]

However, it will be part of a long tightly printed small font document that is filled with technical legal language. The surrounding environment promotes the idea that the CTF is like a fixed rate instrument that is *guaranteed*. On the floor of the bank there may be a sign that indicates that the "gross yield" on the CTF for 60 or 90 days would be 13% or some other figure. Investors and bank branch managers may not understand unit pricing where "yields" are based on NAV. They may not understand or wish to explain to a prospect that the bank cannot state in advance the yield on an instrument that fluctuates in value. Yield can only refer to a yield that is already achieved, but may not be achieved in the future.

On the other hand, it has been suggested that some CTF's may "play with" asset values to be able to suggest a fixed rate in 30, 60, or 90-day terms. This is possible because, unlike

[24] Such a disclaimer, indicating that CTF returns are neither fixed nor guaranteed, appears to run counter to the conclusion of the BSP's R.P Lirio, fn. 22, above, that CTF's are relatively safer investments than mutual funds. Moreover, under the BSP Manual of Regulations, Subsec. X409.3.c., if fully disclosed to and authorized in writing by the client, the CTF could even invest in equities of or securities underwritten by, the trustee or fiduciary or a corporation in which the trustee or fiduciary owns 50% of the subscribed capital or voting stock.

mutual fund regulation which prevents playing around with valuation, CTF's have few rules on how they are valued and sold. Some may believe that because the CTF is based on the Trustee-Investor Relationship, the investment manager can actually do anything.

To the uninformed observer, BSP policies may appear inconsistent. The BSP requires strict dissociation of banks from sales of mutual funds in order not to confuse investors who are assuming investment risks. At the same time it allows CTFs to be sold to investors at deposit windows on the floor of the bank. It begs the question, "Does the BSP reserve requirement, make it safer to allow CTFs, but not mutual funds, to be sold on a bank floor?"

### F. The Costs to Investors, the Capital Market and Public Confidence

In part, because of these regulatory imbalances, the Philippines is losing out on the significant benefits that a strong mutual fund industry can bring to its capital markets and economy. The fund industry has remained too small to play its proper role as an engine of market growth. Mutual funds are one of the best ways to introduce Filipinos to the equity markets because at the same time that they offer investors professional management, liquidity, a variety of sound choices at relatively low prices, they also offer many opportunities to limit market risk. These regulatory imbalances have made it more difficult for Filipinos to share in the growth of Philippine industry and for mutual funds to stimulate more efficient capital allocation and capital creation. They also contribute to a lack of public trust and confidence in the fairness of the regulatory structure and its ability to protect investors in the capital markets.

# III. THE ROLE OF THE INVESTMENT COMPANY ASSOCIATION OF THE PHILIPPINES ("ICAP')

*What role does the Investment Company Association of the Philippines ("ICAP") play in the development of the Philippine Mutual Fund Industry and how does it compare with the role of Philippine Industry Associations and of neighboring countries' fund associations?*

## A. Establishment

The ADB-AIM sponsored Mutual Fund Seminar in 1995 was the first time representatives of the investment managers of the then operating investment companies came together to discuss the future of the mutual fund industry. The Seminar not only created renewed interest in mutual funds, but more importantly, it spawned ICAP. Six months later, in November 1995, ICAP was created. It had five charter investment company members whose total assets were ₱515 million. In just over four and one-half years, at June 30, 1999, it had fifteen investment company members with total assets of ₱4.4 billion.

ICAP is dedicated to four primary goals:

- influencing the regulatory environment (SEC Rules and legislation relating to investment companies);
- raising professional standards (assisting in examination and licensing of fund sales agents);
- promoting public awareness of investment companies; and
- providing information to its members. [25]

## B. Activities and Achievements

Considering that ICAP has no staff or business plan, that its members pay an initial membership fee of ₱10,000 and annual dues of ₱5,000 per fund per year and that it has spent

[25] ICAP's Charter defines its primary purposes as:

a. To formulate or assist in the formulation of rules, in cooperation with the Securities and Exchange Commission, for the purpose of increasing the efficiency and effectiveness of the services of investment companies;

b. To circulate information that would be of interest to its members;

c. To appear before any legislative body, committee, executive or regulatory authority, in the interest of investment companies and the general public;

d. To work in conjunction with any legal body or commission now appointed or to be appointed for the consideration, formulation, amendment or alteration of any law or regulation affecting and relating to investment companies;

e. To educate the public by conducting seminars, fora, and other related activities; and

f. To assist in the examination and registration of salesmen of securities issued by investment companies.

from ₱24,133 in 1996 to ₱225,362 in 1998, for its fiscal years 1996-1999, ICAP has had a remarkable record of achievements.

**In the legislative sphere**, one of ICAP's stellar achievements was to successfully lobby for the inclusion in the Tax Reform Act of 1997 of provisions which ended the imposition of capital gains taxes on fund shareholders when they redeemed their shares. Because the funds paid transaction taxes, the shareholder capital gains taxes amounted to double taxation. It had made it uneconomical to invest in fund shares and retarded the growth of the fund industry. ICAP is continuing to participate in committees to further revise the tax code. It has testified in favor of, and is promoting a bill to create the tax benefited Personal Equity Retirement Account, (the "PERA"). It would be similar to IRA's in the US that have been one of the mainsprings of US mutual fund growth.

ICAP is currently working for passage of the Revised Investment Company Act ("RICA"). and the Securities Act of 1999 ("SA99"). It has commented extensively on draft Bills, put forth suggested amendments, attended public hearings and participated in technical working groups organized by the Philippine Congress to review RICA and SA99. It continues to participate in various multi-sector committees, task forces and other groups and to study capital market related issues.

**On the regulatory side,** ICAP's work with the SEC has also yielded excellent results. It has opened a regular dialogue with SEC Commissioners and Directors on areas of mutual concern. Among other things, ICAP representatives have helped to shape amendments of rules and regulations governing investment companies. ICAP also has helped the SEC to review registration statements of at least eight companies applying to operate as investment companies since 1996. It has also contributed to the restyling of the mutual fund sales agent examinations, and has provided SEC with questions for mutual fund salesmen licensing exams that focus on knowledge of the product and professional selling practices.

**To promote public awareness of investment companies** in 1995 it persuaded Business World and The Manila Times to publish daily the Net Asset Value Per Share (NAVPS) of all funds. Fund NAVPS have also been posted on Bloomberg and Reuters since 1997 and Maktrade since 1998. ICAP furnishes the information to them. In November 1998, ICAP conducted a highly successful seminar for companies interested in establishing their own mutual funds.

**To provide member information,** ICAP representatives have regularly attended Asia Oceania Regional Meeting of mutual fund associations since 1996.

### C. Current Projects and Plans

ICAP's highest current priorities focus on:

- continued lobbying for enactment of legislation, specifically, SA99, RICA and PERA;

- improvement of the national retirement system, ICAP is participating in the DoF Contractual Savings Task Force and the Retirement Income Commission;
- improvement of regulation, specifically in the area of sales agent examinations and licensing by promoting the transfer of the administration of mutual fund sales agent licensing exam to the Capital Markets Development Center, Inc.("CMDCI"), a change that was recently approved;
- promoting higher professional standards by conducting workshops for fund administrators, auditors and the SEC on standardized accounting practices and procedures, and
- providing more information to members and the investing public through the establishment of an ICAP Web Page with links to member funds.

## D. Financial Resources

When ICAP was organized in 1995, each of the five original members paid a one-time membership fee of ₱10,000.00 and annual dues of ₱5,000. Members took turns hosting monthly meetings. Miscellaneous expenses were covered by special assessments. ICAP ended the year with a Members' Equity of ₱75,000.00. In the succeeding years, new members have been charged the same membership fee and annual dues. Members also were charged additional assessments, ₱5,000.00 for those who joined in 1996, and ₱10,000.00 for those who joined in 1997 and 1998. Costs of monthly meetings were subsequently charged to the Association, but members were assessed for special events (*e.g.*, attendance at the Asia Oceania Regional Meetings) and extraordinary expenses such as advertising. In November 1998, ICAP conducted a seminar for companies interested in establishing their own mutual funds which netted ICAP ₱278,000.00. At year end 1998, ICAP's total assets were ₱408,000.00.

Table 19, Summary of ICAP Financial Information, below includes comparative information from ICAP's balance sheets and income statements for 1995 to 1998.

**Table 19. SUMMARY OF ICAP FINANCIAL INFORMATION**

| | 1998 | 1997 | 1996 | 1995 |
|---|---|---|---|---|
| **BALANCE SHEET** | | | | |
| Cash in Bank | 358,705 | 124,608 | 97,489 | 40,000 |
| Due from Members | 50,000 | - | 25,000 | 41,895 |
| ***Total Assets*** | ***408,705*** | ***124,608*** | ***122,489*** | ***81,895*** |
| | | | | |
| Due to Members | - | - | - | 6,895 |
| Member's Equity | 408,705 | 124,608 | 122,489 | 75,000 |
| ***Total Liabilities and Equity*** | ***408,705*** | ***124,608*** | ***122,489*** | ***81,895*** |
| | | | | |
| | | | | |
| **INCOME STATEMENT** | | | | |
| Annual Dues | 57,500 | 45,000 | 35,000 | 25,000 |
| Membership Fees | 40,000 | 20,000 | 20,000 | 50,000 |
| Membership Assessments | 30,000 | 20,000 | 15,000 | - |
| Special Assessments | 45,000 | 70,000 | - | 28,159 |
| Seminar Fees | 260,000 | - | - | - |
| Sponsorship Fees | 75,000 | - | - | - |

| | 1998 | 1997 | 1996 | 1995 |
|---|---|---|---|---|
| Interest Income | 1,959 | 1,854 | 1,622 | - |
| ***Total Receipts*** | ***509,459*** | ***156,854*** | ***71,622*** | ***103,159*** |
| | | | | |
| Advertising & Promotions | 50,897 | 49,451 | 4,000 | 16,800 |
| Seminar Expenses | 56,538 | - | - | - |
| Representation | 47,773 | 37,261 | 7,839 | - |
| Transportation | 20,310 | 18,085 | 200 | - |
| Travelling | 28,464 | 28,859 | - | - |
| Professional Fees | 10,600 | 14,527 | 12,094 | 10,000 |
| Supplies | 3,050 | 1,552 | - | - |
| Taxes and Licenses | 1,527 | - | - | 1,359 |
| Miscellaneous | 6,203 | 5,000 | - | - |
| ***Total Disbursements*** | ***225,362*** | ***154,735*** | ***24,133*** | ***28,159*** |
| | | | | |
| *Net Income* | *284,097* | *2,119* | *47,489* | *75,000* |
| *Members' Equity, Beginning* | *124,608* | *122,489* | *75,000* | - |
| ***Members' Equity, End*** | ***408,705*** | ***124,608*** | ***122,489*** | ***75,000*** |

*Source: Investment Company Association of the Philippines*

It is clear that ICAP has come a long way in a short time. Like the parents of any three year old its members have much to be proud of and even more to look forward to. To meet the challenges that lie ahead and accomplish the ambitious program set forth in this report, ICAP will need to continue to find ways to materially augment its financial resources.

# IV. THE MUTUAL FUND AND UNIT TRUST INDUSTRIES OF NEIGHBORING ASIAN COUNTRIES

## A. Pages from Another Book

All securities markets are not the same. They vary depending upon their location and stage of development. A country's securities market regulator, like its market will reflect its history, culture and customs. Its physical and legal infrastructure will affect the design, construction and role of its regulator and the institutions of its capital market. One style will not fit every securities market. With this *caveat* it is helpful to consider briefly some of the distinctive aspects of the fund industries that are developing in neighboring countries of the Philippines in the context of their securities markets, economies and population demographics. These would include:

- the method and degree of government encouragement or discouragement of the fund industry;
- the regulatory structure and taxation of funds and their shareholders vs. treatment of competing products;
- the distribution channels available for merchandising fund shares;
- encouragement/discouragement of foreign ownership, participation, resources, know-how, leadership and responsibility; and
- the role of the mutual fund association as a self-regulator, proactive policy initiator, voice of the industry, unifying force; coordinator of investor education and designer of marketing strategies and the materials to implement them.

## B. "Best Practices"

### 1. India

One fund group, the Unit Trust of India ("UTI"), a government sponsored trust dominates the fund landscape and the capital market. Created by the government in 1964, and for 23 years a monopoly, UTI after 35 years in business, still has approximately 85 % of total industry assets and, with 85% of 1997 industry sales, of the market. When an Indian investor thinks of a unit trust or mutual fund, it is likely to be of UTI. (See **Appendix 13, Indian Mutual Funds: Sales, Redemptions and Net Assets, 1997-1998,** for a Indian mutual fund assets, sales and redemptions by UTI, Banks and other government sponsored institutions, and private sector sponsored funds.)

UTI and the Indian government are to be complemented on successfully introducing Indian savers to the Indian Capital markets and converting them into investors. However, the Indian mutual fund playing field is not level. UTI has its own statute and is only in part subject to standard investment company regulation by the Securities Exchange Board of India ("SEBI").

Direct government participation in the fund industry can be a mixed blessing. In 1987, the government allowed seven state-controlled banks and financial institutions (i.e. public sector institutions) to create mutual funds. That enabled them to dedicate their distribution networks to the sale of their mutual funds. By mid-1997, they accounted for approximately 10 % of fund industry assets. When they were organized, they too were virtually free of traditional Mutual Fund regulation. They created a series of "schemes" (equivalent of separate portfolios or corporate funds) which offered "guaranteed" returns and guaranteed redemption rates.

When the market turned down during the mid, and later, '90s, they were unable to meet their guarantees. After protracted litigation, the government reached a costly settlement with investors in one scheme. The asset manager of another voluntarily paid relatively smaller amount to meet one of its scheme's guarantees. Indian market prices continued at low rates, additional guaranteed schemes were about to mature over the next two years at less than their "guaranteed" prices. Their sponsoring banks and ultimately, the government, faced difficult decisions. Any failure to pay or delay, would have further detract from the credibility of the Indian fund industry. In fact, UTI's flagship scheme Unit Scheme 64 ("US 64") had run up a deficit of Rs.10.98 billion ($258 million) in June 1998. That led to large-scale redemptions that contributed to a stock market slump. The possibility of a further run on the funds, especially US 64, would have threatened the entire market.

The crisis triggered a dramatic rescue by the Government which was presented in the announcement of the Budget for 1999-2000.

- US 64 was restructured through the creation of a new fund and the issuance of Government Bonds worth Rs.48.1 billion ($1.13 billion) to it.[26] The new fund in turn was to buy an equivalent amount of holdings of US 64 with the bonds.

- A three-year exemption from the 10% dividend tax was granted for all income from UTI and all other open-end funds with more than 50% of their portfolios in equities.

- Capital gains taxes were reduced from 20% to 10%.

- To attract additional investments by non-resident Indians ("NRIs"), their ability to invest in mutual funds was extended and simplified. 1) A *post facto* reporting mechanism was adopted; and 2) NRIs were given access to broker terminals abroad to enable them to invest directly in all mutual funds, not just UTI funds, as was previously the case.

In response to the government's announcement of the rescue plan, the Bombay Stock Exchange's "Sensex" Index of 30 stocks, a leading market index, rose from a low of 3215.69 on February 27, 1999, to close at 3640.42, up more than 13 %, on March 3, a few days following the announcement. At July 30, 1999, the Sensex closed at 4542.34 (up 1326.65

[26] Rs. 1crore = Rs. 10 million. Exchange rate as of July 30, 1999, $1.00 = Rs. 43.230157.

points, or more than 41%, above its February 27, 1999 low). It reached its historic high close of 4728.78 on July 22, 1999.

India offers several innovations that are worthy of consideration and may qualify for a "Best Practices" list. In 1992, as part of a market liberalization program, the government permitted private sector-sponsored mutual funds. This opened the way for a number of large domestic companies and well-known foreign institutional investors ("FIIs") to sponsor funds. Although with one notable misstep, the FII's through their adherence to international standards, know-how, and resources tended to improve competition and up-grade professionalism in the fund industry.

India's fund association, the Association of Mutual Funds in India ("AMFI"), a trade association, has also begun to effectively represent the industry in regulatory matters, in up-grading the professionalism of its members, and implementing investor awareness and sales agent training programs. The Association has approximately 30 asset management company members, including UTI. AMFI, has a paid president, a business plan, a comprehensive strategic plan and a Code of Ethics. It has recognized the importance of good regulation and establishing a climate of compliance. To that end it has built a working partnership with SEBI which enables it to help to influence its regulatory framework by participating in the formulation of regulations, commenting on proposals and working closely with SEBI to improve regulation.

### 2. Japan

The Japanese mutual fund or investment trust industry reached approximately $369 billion in total assets at year end 1998, an increase of approximately $18 billion over 1997, but still not back to its 1996 size of $420 billion.[27] Over those three years, Japanese investment trusts increased the amount of foreign currency-denominated assets they held from Y2,888 Billion ($ 24.9 billion) in 1996 to Y5,228 billion ($45.1 billion) in 1998, an 81% increase. The ratio of foreign currency denominated assets to total investment trust net assets also increased from 5.9% to 12.2% over the same period. At the end of 1998, Japanese investment trusts held foreign stocks of 39 different countries and foreign bonds of 23. Offshore funds have been permitted to offer their shares in Japan since December 1972. At year-end 1998, there were 185 offshore funds with total net assets of Y2,783 billion ($24 billion).

The "Asian Financial Crisis" raised concerns that banks were not satisfactorily performing intermediation functions. Japan responded with its own version of the "big bang" in the financial markets. Mr. Hitoshi Tonomura, Chairman of the Investment Trust Association of Japan, described the purpose of the reform program as intended:

> "to make the Japanese Financial system more flexible and fairer, ...to promote competition and to establish the necessary conditions for such developments. In other words, the major purpose of these reforms is to provide a more reliable framework, which offers easier access for existing and potential users of the Japanese financial

[27] The conversion rate used throughout is $1.00 =Y115.70 at December 31, 1998.

system. The reforms are characterized by three key concepts of 'Global', 'Free', and 'Fair'.

Investment trusts are a priority within this reform program. The intention is to increase the convenience, clarity and reliability of these products so that everyone in Japan is encouraged to gain an understanding of the importance of savings and investments.....It is also important to foster the recognition that investment trusts are core products within an efficient investment portfolio of personal financial assets." Presentation of Mr. Tonomura, 4th Annual Asia-Oceania Conference, Hong Kong, April 28-30, 1999 ("Oceania Conference").[28]

As part of a reform program to develop more direct financing alternatives, in June 1998, the Japanese Government amended its Securities and Exchange Law. It put in place a number of broad reforms that affected its investment trust industry. Among other things, it removed restrictions that had prevented commercial banks from operating and distributing mutual funds. Supervision of such bank-sponsored mutual funds was placed in a new agency under the Ministry of Finance, rather than a bank regulatory agency and in December banks and insurance companies were allowed to distribute investment trusts.

Professor Akira Tsusaka, of the Asian Institute of Management ("AIM") and the University of Marketing and Distribution Sciences, in Japan, believes that "these events will bring about a new era in Japan's Mutual Fund industry." Commercial banks, including Mitsui Trust Company and the thirteen other major "City Banks," already have become active in the fund industry and have also contracted with local banks to distribute their funds. Because the banks were not accustomed to selling risk products and considering the depressed state of the Japanese securities market, the public's reception of the bank funds has not immediately met expectations. However, bankers and others in Japan believe that over the long term, mutual funds and deposits will become the two major elements of Japan's banking industry.

Among other significant reforms of Japan's fund industry, resulting from amendments in Japan's Investment Trust Law and Securities and Exchange Law, were the introduction of corporate-type investment trusts and privately placed investment trusts; permitting investment trust management companies to outsource management; applying the disclosure requirements of the Securities and Exchange Law to investment trusts; and requiring the financial statement of investment trusts to be audited by public accountants or accounting firms.

The Investment Trusts Association functions as both an SRO and the national association of the investment trust industry. As an SRO it makes rules regulating the business conduct of its members and settles investor complaints regarding its members business conduct. Among its activities as a national association, it promotes knowledge of investment trusts among investors and, taking a longer-term approach, advances education on securities and investment trusts in schools.

[28] The full text of Mr. Tonomura's presentation and of the Japan Country Report presented at the Oceania Conference are attached as Appendix 14 to this report.

### 3. Hong Kong

Hong Kong has an active and successful Unit Trust Association. In 1984, a small group of unit trust sponsors came together to persuade the government not to tax mutual funds. Their success was total. Funds now accumulate capital gains and income is tax free. Investors pay no personal tax on benefits received from funds. As a result Hong Kong has a thriving mutual fund/unit trust industry. As of March 1999, there were 1,475 authorized Hong Kong mutual funds and unit trusts with total assets approaching $183.09 billion. The 905 equity funds accounted for $124.8 billion or 68% of total fund assets. (See Appendix 15, Report of the Hong Kong Investment Funds Association ("HKIFA"), prepared for the Oceania Conference, including numbers of Authorized Mutual Funds and Unit Trusts, for a breakdown by type of funds of total fund assets.)

The Hong Kong Mutual Fund and Unit Trust industry, in terms of numbers of funds and total assets, is comprised overwhelmingly (98%) of funds that are domiciled offshore and that invest in foreign stocks, bonds or other foreign currency-denominated assets. In other words, authorized funds that are invested solely in Hong Kong equity or solely in Hong Kong money market instruments accounted for less than 2% of the industry total both in terms of asset size and numbers of funds. Hong Kong domiciled funds accounted for just 1.2% of total assets.

Another reason for the success of the mutual fund/unit trust industry in Hong Kong is that banks, especially retail banks, have assumed an increasingly important role as mutual fund and unit trust distribution channels. In fact, banks accounted for 48% of the industry's gross sales in 1998 up from 41% in 1997.

### 4. Republic of Korea

Korea's investment trust industry was among the first to begin its recovery from the Asian Financial Crisis. At year end 1998, assets held in investment trusts totaled 196 trillion won, an increase of 118.2% over 1997.[29] In dollar terms, perhaps because of currency fluctuations, the increase was an even more dramatic, 155.7%, from $63.6 billion at year-end 1997 to $162.6 billion at the end of 1998.[30] Assets of money market funds accounted for 47.3% of total investment trust assets at year-end 1998. The Korea Investment Trust Companies Association ("KITCA"), in April 1999, attributed the huge increase in assets of its investment trusts as

> "due to their characteristic of providing high, short-term returns compared with other financial products. Specifically, ...through the establishment of bond funds with high

[29] Unless otherwise stated, the source of the data about Korea's investment trust industry is the Country Report of the Republic of Korea to the Oceania Conference ("KITCA Country Report").

[30] The Asian Wall Street Journal in a front page "*Heard on the Street*" article, "*Mutual Funds Offer Value In Jumping Korean Market*" *by Hae Won Choi, May 28,29, 1999, p.1,* ("AWSJ") put the assets of the *Korean Investment Trust Industry at two trillion won on that date, citing Korea's Financial Supervisory Service as its source, but put the US dollar equivalent at ($1.68 billion) (actually $168 billion). The KITCA Country Report and the AWSJ article are attached as Appendix 16 to this report.*

credit ratings and high yields that were issued during the first half of 1998." Republic of Korea, Country Report to Oceania Conference.

The Asian Wall Street Journal, May 28-29, quoted Korean investment trust management companies that attributed the industry's performance to investments in Korean "blue chip" stocks which have led the stock market's rally.

Two regional investment trust companies and five investment trust management companies were shut down as a result of industry restructuring in the midst of the Asian Financial Crisis. KITCA reported that in April 1999, there were "four investment trust companies and 20 investment trust management companies in business." The Asian Wall Street Journal of May 28-29 referred to 22 "mutual funds listed in South Korea", six on the Korea Stock Exchange and 16 on the over-the-counter Kosdaq.

Korea has two kinds of foreign or international funds: Overseas Investment Funds-for domestic investors that invest in securities of foreign issuers (1998 year end assets $848 million); and Foreign domiciled funds, registered outside Korea, and permitted to be sold domestically since January 1, 1997.

Like Japan, during 1998, Korea adopted a number of significant legislative changes that should strengthen its fund industry. In September 1998, it revised its Securities Investment Trust Business Act and enacted the Securities Investment Company Act. Recognizing the importance of a strong distribution system, banks were permitted to distribute investment trusts. Minimum capital requirements for establishment of an investment trust company were lowered from 30 billion won to 10 billion won. Privately placed funds were also permitted and allowed to invest without diversification limitations. Investment Trusts were permitted to invest in futures (both domestic and foreign). Funds established after November 1998, were required to value bonds by "marking to the market," as distinguished from using the amortized cost method. "Mark to market" valuation for all funds is scheduled for July, 2000. KITCA was required to disclose the performance and unit prices of funds. Fund management companies were permitted to exercise the voting rights of equity stock held in trusted assets. Criteria for registering qualified fund managers were introduced.

Corporate type funds, as distinguished from investment trusts, were permitted, but only closed-end funds. Open-end funds will be allowed within five years per Presidential Decree. According to the AWSJ, the government plans to allow them as early as 2000. The AWSJ pointed out that like other closed-end funds, Korea's have a fixed number of shares, and trade either on the Korea Stock Exchange or in the over-the-counter Kosdaq market. As does the Philippines' closed-end FFI, the Korean closed end funds trade at a discount to their net asset value. The AWSJ identified one trading at a 14% discount from its NAV (considerably smaller than FFI's average 27.3 discount. Perhaps the explanation for the relatively modest discount is that, unlike closed-end funds in other countries, the law calls for Korean funds to expire just one year after they are listed, though they can be extended for another year. That means that investors who buy at a discount now will be able to redeem at the funds' full NAV per share in less than a year or less than two years at the most. Another reason for a modest discount is that

at least some of the funds have compiled significant gains in NAV, more than the rise in the Korean Stock Price Index.

### 5. Malaysia

The Malaysian unit trust (mutual fund) industry is dominated by 12 large government sponsored funds that accounted for 83.5 percent of total industry assets at year-end 1998.[31] The number of funds almost doubled in four years, from 47 at the end of 1994 to 89 at the end of 1998.[32] Of these, 77 were private sector sponsored, compared with only 39 at the end of 1994. There were 32 investment management companies at the end of 1998. Total year-end industry assets peaked at the end of 1996 at RM 59.96 billion, declined to RM 33.57 at year-end 1997 and had climbed back to RM 38.73 at the end of 1998. Perhaps, a more telling indicator of the relative growth of the Malaysian fund industry are the changes in the ratio of total fund assets to the market capitalization of the KLSE. That ratio has climbed from 7.0% at the end of 1994 to 10.3 at year-end 1998. (In the Philippines it was 0.02 percent on the same date, see p. 15, above.)

All of Malaysia's unit investment trusts are permitted to invest in securities of foreign issuers, subject to the specific approval of Bank Negara Malaysia ("BNM"), the Securities Commission ("SC") and other relevant authorities. No specific data is available on the extent of such investments, the FM**UTM** believes that most funds are largely invested in domestic securities. Privately placed investment funds are permitted, but domestic funds denominated in foreign currency and selling off-shore funds are not permitted.

The FM**UTM** is an industry trade association devoted to enhancing the professional standards and image of the unit trust industry. It emphasizes:

- improving the regulatory, fiscal and legal environment for unit trusts;
- formulating sound and ethical business practices to promote interest in the unit trust industry;
- providing information, assistance and other services to members; and
- promoting public awareness of the benefits and risks of investing in unit trusts.

It aspires to become an SRO, which it envisions as including 'regulating and licensing the various distribution channels in the marketing and distribution of unit trusts and implementing compliance and disciplinary procedures.

Among the regulatory initiatives taken by the BNM and SC with respect to maintaining confidence in the Malaysian capital markets were the release of a Corporate Governance Report by the Finance Committee on Corporate Governance that sets forth a comprehensive action plan, including: 1. Developing a Malaysian Corporate Governance Code containing principles

[31] Source: The data on the Malaysian fund industry is based upon the Malaysia Country Report to the Oceania Conference by the Federation of Malaysian Unit Trust Managers ("FM**UTM**"). That report is attached as Appendix 17 to this Report.

[32] The FM**UTM** also reported that there were 89 open-end funds and five closed-end funds at December 31, 1998.

and best practices for corporate governance; 2. Formulating effective enforcement mechanisms that involve reforming the laws, regulations and rules to strengthen the regulatory framework for public listed companies, including enforcement of good corporate conduct; and 3. Training and education to expand the pool of persons suitable for appointment as company directors.

### 6. Singapore

The unit trust or mutual fund industry of Singapore has changed dramatically in a few short years. In 1992, private fund managers entered the market. At year-end 1997, local and foreign financial institutions in Singapore offered 101 unit trusts with total assets of $125 billion in local and foreign funds, nearly double the value in 1994.[33] By year-end 1998, Singapore offered 116 unit trusts, including 23 global equity funds, 42 regional funds and 34 single country funds. There were also 12 bond funds, three balanced funds and two gold funds. Foreign firms managed 50, nearly half, of the unit trusts at year-end 1997. Over 90 percent of the funds managed in Singapore came from foreign investors, including perhaps 50 percent from Europe and the U.S. Although almost 70 percent of those funds were invested in equities, only about 10 percent were invested in Singapore.[34] Unit trusts and funds are regulated under the Singapore Companies Act by the Registry of companies and businesses of the Ministry of Finance which screens and approves trustees. There are no barriers to foreign-owned financial institutions offering Singapore based unit trusts and funds

In September 1997, The Investment Management Association of Singapore was established. As of January 8, 1999, it had 84 members and a very complete web site. The roster of its members reads like a "Who's Who" of the international banking and asset management companies. (See Appendix 18, IMAS Organization, Objectives and Members and United States Embassy, Singapore's Securities Industry Report, August 1998, Unit Trusts and Funds). It provides a model for a well-run association, addressing such maters as a code of Best Practices and Standards for the industry, investor education and training programs.

Singapore's fund industry is unique because of the government's Central Provident Fund. Although it siphons off considerable employee income through a hugely successful forced savings program, it has established a pattern of savings which is a necessary precondition for a fund industry. The public sector also provides support for fund managers. In 1998, the government announced that it would allocate $35 billion in public sector funds to Singapore-based private fund managers over the next three years.

[33] Source: United States Embassy, Singapore's Securities Industry Report, August 1998, Unit Trusts and Funds, pages 6 and 7, attached as part of Appendix 18 of this report.
[34] Id.

### 7. Republic of China (Taiwan)

Taiwan had 44 funds with total assets of $23.1 billion at year-end 1998, an increase of over $6 billion, or 35 percent over its 1997 total.[35] Of these 17 were closed-end funds which accounted for $1.9 billion of the 1998 total. During 1997, the number of closed-end funds decreased by four and total closed-end assets dropped by 41.09 percent. This is because Taiwan has a unique way of limiting the discount on closed-end funds. According to the Regulation of the Securities Investment Trust ("RSIT") Law, if the market price of a closed-end investment company falls below 90 percent of its per share NAV, it must open and accept customer redemptions.

Taiwan permits international investment funds that are sold there and invested abroad. At year-end 1998, there were 21 such international funds, an increase of four over 1997. Equity funds accounted for $1.272 billion of the almost $1.3 billion of international equity and bond funds. It does not permit privately placed investment funds or domestic funds denominated in foreign currencies. Offshore (foreign) funds are not permitted to offer, market or sell their shares in Taiwan. However, an investor with $5 million may invest directly in an offshore fund through a "non-discretionary trust account" with a bank in accordance with the regulation of the Central Bank of China.

The Securities Investment Trust & Consulting Association R.O.C. ("SITCA") succeeded the Securities Investor Trust of Taipei Association ("SITTA") on October 8, 1998. It is composed of officially licensed government and private organizations that are engaged in the securities trust and consulting businesses in Taiwan. Under amendments to the Law of Securities Transactions all securities investment trust companies will be required to become members of SITCA. As of April, 1999, SITCA had 177 members, 33 securities investment trusts and 144 securities investment consulting firms.

SITCA describes itself as a self-regulatory organization ("SRO"). It states that its most important function is to "enhance the notion of self-regulation among member firms, to take the initiative to set up a sound internal control system for the purpose of earning the trust of the investor and acquire broader business development." It believes that better protecting investor interests will boost the positive image of the industry. It collects information from its members and acts as a "show window" for the two industries it represents. It also describes its role as acting as "the bridge between government, society and our members." As a promoter of its industries SITCA focuses on "breaking down information and technical barriers, strengthening international exchange, bringing in professional know-how, assisting members in business development and breaking new ground that keeps in line with market trends." Finally, it offers professional training to its industries.

[35] Information about Taiwan's Mutual Fund Industry is based upon the Country Report of the Securities Investment Trust & Consulting Association of the R.O.C. ("SITCA") to the Oceania Conference which is attached as Appendix 19 of this report.

Banks play a major role in the sale of domestic funds, accounting for most fund share transactions. Some investment trust companies have initiated monthly savings programs through banks through which a fixed amount is transferred monthly from a bank account to a fund account. The Securities Futures Commission ("SFC") also permits distribution of mutual funds through the internet by individual companies with SFC approval.

Taiwan undertook a number of legislative reforms affecting the investment trust management business in 1998. One of the most important was to permit securities investment trusts and advisory companies to conduct discretionary investment businesses. SITCA, in its role as an SRO, will be authorized by the SFC under the amended RSIT to review initial applications for discretionary investment business. The SFC also revisited the regulation of fund portfolio turnover. It had previously removed its ceiling on stock fund turnover rates, however, it will now require the three funds with the highest turnover rates to disclose the reasons for such rates. Effective January 1, 1998, Taiwan combined its personal income tax and business income tax into what SITCA described as the "fair-taxed." Under it a company must set up a separate account for dividends and investors will not be double taxed.

# V. ANALYSES: STRATEGIES FOR REACHING LONG TERM GOALS

## A. Why Aren't Funds More Popular In the Philippines

*"Nowhere to go but up."*

From what we have seen above, funds started on the wrong foot and kept going. In short, the industry is to some extent still a victim of its history, scandals, disappointed investor expectations, the eighteen year hiatus in registering funds and the rise of competing products, (CTFs and Pre-Need Plans), during the hiatus. When the industry started again in the 90's, it suffered from double taxation, differential regulation, lack of a long-term track record, lack of a distribution network, lack of a media relations program, and of a well-funded group of sponsors.

## B. Working Professionals' Perceptions of Mutual Funds

The Perception Survey, conducted among working professionals based in Metro Manila, was designed to identify their perceptions about mutual funds, especially as compared to other investment options.[36]

Among its findings were the following:

- Fifty five percent (55%) of urban professionals claim to have heard about mutual funds. This awareness of their existence, however, does not necessarily translate into actual knowledge about what they are, but simply a familiarity with the term itself. Thirty two percent (32.2%) of urban professionals did not know what a mutual fund is;

- A majority (65.4%) of urban professionals perceived that mutual funds were already available in the country (even if they might not have known what exactly they were);

- A third (33.3%) of urban professionals perceived mutual funds to be high yielding investments, while 13.5% disagreed. More than half (53.2%) either did not know or had no opinion about yield;

- Almost forty percent (37.2%) of urban professionals did not know where or how to avail of mutual funds. A third of them (34%) assumed that mutual funds can be availed of via banks;

[36] N.B. Findings of this study are limited to urban professionals within the Metro Manila area, who are generally the primary target of mutual funds upon their introduction, and cannot be applied to a mass market base. The survey was conducted using purposive stratified sampling, whereby the researcher deliberately selected offices within the Metro Manila area to spread out the sample base. Stratification was done based on position in the company (i.e. top management, middle management, and staff). Of 300 questionnaires distributed, 156 valid and completed forms returned. This number was deemed large enough to generate reasonable conclusions at a 95% level of confidence. Frequency tables were generated and further analysis was performed using cross tabulations. The Chi-Square Test was used to establish the significance of the results.

- While half of urban professionals did not know what the minimum required amount was in order to invest in mutual fund, 14.7% thought that is was around ₱100,000 and 2.6% assumed it was a million pesos. Only 6.4% correctly expected the minimum required amount to be ₱5,000.

When asked to compare mutual funds with other investment options, urban professionals believed mutual funds…

- …offered an average level of risk, being riskier than pre-need plans but far less risky than stocks;
- …offered a rate of return that was at par with common trust funds, above bonds and pre-need plans, but below that of the stock market and of real estate;
- …were relatively less convenient to access than most forms of investment, even less than real estate;
- …provided a below-average level of liquidity to investors, well below that of common trust funds and the stock market, and far below that of time deposits;
- …are only about at par with stocks and pre-need plans and stocks as far as being recommendable to other people (most urban professionals say that they would most likely recommend time deposits as an investment of choice).

Most urban professionals generally prefer to invest in time deposits or real estate, and only four percent expressed a likelihood of investing in mutual funds.

***The expected rate of return on investment.*** The primary consideration for one-third of urban professionals in choosing an investment vehicle was the expected rate of return on investment. Another third prioritized the trustworthiness or credibility of the investment tool itself. Only fifteen percent prioritized the financial risk involved (i.e. whether performance will actually meet expectations) and only twelve percent were concerned with liquidity.

***Marketing strategy for urban professionals.*** The Perception Survey can help the fund industry to tailor its marketing strategy for urban professionals. It tells us that awareness about mutual funds exists, but that actual knowledge about the product is lacking. This means that any industry promotion can focus on clarifying the benefits that mutual funds offer, as opposed to promotions that focus on telling the market that mutual funds do exist in the first place.

***Emphasize a solid track record of investment results.*** This survey result reinforces the viability of a strategy of first building a solid performance track record. It could include: highlighting the performance history of a few "star" players in the mutual fund industry, or of industry average returns by types of funds, and then using this to emphasize the advantages of

mutual funds to establish mutual funds in the urban professional market, the most likely market during the introduction and growth stages of the fund industry.

***Low Minimum Investments.*** The Perception Survey also tells us that any industry-wide promotional effort should highlight the minimum investment amount for mutual funds. In light of the growing success of the GSIS fund and of some of the Philippines Asian neighbors with low minimum investment amounts, it also suggests the need to persuade the SEC that a fund's minimum investment amount should be a matter of business judgment for the directors of the mutual funds, their investment advisers and underwriters, and not a regulatory matter.

***Bank Distribution.*** The fact that a third of the urban professional market expects banks to carry mutual funds also emphasizes the opportunities available in opening up the banking sector as a means of distribution for mutual funds. In addition to the resistance of the BSP to distribution of mutual funds through banks (see pp. 53-56, above and Appendices 9 and 12), the market can also be expected to resist the idea of moving from traditional investment tools (such time deposits and "assured" returns) to mutual funds. This inertia will be difficult to break unless the industry is able to emphasize a powerful benefit, such as solid history of investment returns.

***Establish the trustworthiness of the mutual fund industry.*** Over the long term, building industry credibility will not only attract investors, but will help to keep them during difficult times. Product trustworthiness can be built by creating reasonable expectations and fulfilling them. Establishment of well-functioning higher yielding money market funds, as discussed at pages 50-51, above, offers an excellent opportunity to build trust and confidence in the product. Promoting and enforcing high professional standards through Codes of Ethics and Advertising Guidelines, continuous training emphasizing professionalism and fostering a climate of compliance, adherence to industry-wide standards and identifying the fund industry's interests with investors' interests can help to build confidence in the industry.

### C. The Best of All Possible Worlds

For the Mutual Fund Industry to prosper and grow to the point where it can play a role as a catalyst to the development of the Philippines capital markets, it will need to fashion a strategic plan and marshal the resources to educate the public, as outlined above, about what investment companies are and how Philippine investors and savers could benefit by investing in mutual funds.

A key element in such a plan is to develop a coordinated, industry-wide sales program and a broad based mutual fund distribution system to implement it. It will need to mobilize army of well-trained sales agents and support them with sales literature and a strong sustained media/public relations campaign. [37]

[37] Such a campaign could be based, among other things, upon an understanding of the market; the predilections of investors, their risk tolerances; their willingness to invest for long term goals. It should strive to differentiate mutual funds from their principal competitors' products: pre-need plans, CTF's, time deposits and the Government's new

Few of the eleven current industry players have the sales forces, resources and experience to devote to such a campaign. To optimize its chances for success it should be carried out through ICAP. For ICAP to mount such a campaign on a wide scale the number of fund sponsors and ICAP member funds would have to expand dramatically, and, depending upon the numbers, the fund sponsors might have to increase the amount of their membership fees or special assessments to ICAP.

In a sense, this suggestion begs the question, "What will bring more potential fund sponsors into the industry?" The answer, in one word, is "**opportunity**." Local and international sponsors will emphasize questions such as:

- Will we find sufficient investment opportunity?
- How much money will be at risk for how long?
- How soon might the operation expect to break even?
- What is the extent of upside potential? and
- When might it be reached?

They can be expected to go through some of the same analyses as described above in Section I.G, Attracting Global Resources and Expertise, which involves sufficiency of investment opportunities, improving the fairness and integrity of the market and ultimately turns on the availability of investment opportunities, the quality of the legislative and regulatory framework and the climate of compliance.

### D. Keys to Change

*"I am the opposite of a stage magician. He brings you illusion in the form of truth. I bring you truth in the form of illusion." Prologue to "The Glass Menagerie," Tennessee Williams*

#### 1. Magic Wands

At least five solutions, any one of which, if it didn't change the industry overnight, could have an immediate positive almost magical impact on it, might already have occurred to the reader.[38] "What if .....

91-day 13% Treasury Bills and could also identify funds with investors' interest, as investors who are working to improve the markets.

Mutual fund advantages such as limiting risk and higher long-term performance should be stressed; percentage fully invested on shareholder's behalf (Cf. Pre-Need Plans, only 40-44%; CTFs, 87% after reserve); tax advantages (PERA), if any, in addition to the basics, i.e. liquidity, professional management, low acquisition and maintenance costs.

[38] The Philippine Government were to authorize and sponsor a national investment fund ala The Unit Trust of India and have it distributed through Bank Offices like its new 13 percent short-term T-Bill program or to enact a government-sponsored savings program?

- ***banks could sell mutual funds on the floors of their branches throughout the country; or***

- ***pre-need plans couldn't be front-end loaded, had to make full risk disclosures and their sales agents could be retrained, upgraded and licensed to sell mutual funds; or***

- ***foreign institutional investors found the Philippines an attractive place to sponsor mutual funds and invest; or***

- ***the Philippine Government were to enact a coordinated series of tax incentives, such as those recently proposed in the 1999 Budget of the Government of India, including measures to attract non-resident Filipinos, to stimulate the growth of mutual funds or to enact a government-sponsored savings program; or***

- ***the Philippine Government were to authorize and sponsor a national investment fund ala The Unit Trust of India and have it distributed through Bank Branch Offices like its new 13 percent short-term T-Bill program or to enact a government-sponsored savings program?***

Wouldn't that immediately strengthen the investment company industry and improve its public image?

**2. Second Thoughts**

***"Beware of your wishes, they may come true." Confucius.***

Any of the above solutions could have a dramatic effect on the mutual fund industry, enlarging its potential to a greater or lesser degree, giving it many more outlets and opportunities to educate the public, and forever redefining it. Although each may strengthen the industry, each comes with a price. None can be ruled out. None offers a totally positive solution. However, none appears imminent.

**A fund industry dominated by banks.** Having banks sponsor and *distribute* mutual funds raises many of the concerns expressed by Ex-Gov. Singson (See, Part II, Differential Regulation, Regulation of CTFs, at pp. 56-57, above). Depositors must be shielded from underwriting losses; "fire walls" will be needed to prevent the flow of information between bank operations and fund managers; and precautions taken to avoid investors thinking that mutual fund investments are insured like bank deposits. In addition, it raises the spectre of funds being operated as an arm of the banking industry and a more complicated regulatory structure with funds subjected to a greater extent to BSP regulation as well as SEC regulation. These objections are not insurmountable. Serious attention should be paid to satisfying these concerns.

**Funds sold by Pre-Need sales agents.** Some have suggested that closer identification of the fund industry with the Pre-Need Industry, may not enhance the fund industry.

Nevertheless, the ability of the funds to reach the public would be increased if it were possible retrain and qualify pre-need sales agents, to develop them into a corps of professional "financial counselors" who would, among other things, sell fund shares. Of course, by the time the retraining and qualification was completed, there probably would be far fewer of them. Moreover, to increase impartiality, compensation for selling one or another product should not be disproportionate. Such sales agents, like any other securities sales agents, would need to be strictly monitored.

**Foreign Institutional Investors as fund sponsors.** Foreign institutional investors could bring resources, know-how and international standards and practices to the fund industry that would raise the level of competition and spearhead a promotional campaign. Would they also bring "hot money" that could leave as quickly as it comes? Or would they make the necessary commitment to hang-in for the long run? This can be a fruitful area for industry development.

**A government sponsored mutual fund distributed through branch banks.** The fund industry works best when it is run by the private sector. Where the government has run funds, those funds' operations and performance has not equaled that of the private sector. Even in India, perhaps because the legendary and mammoth UTI enjoyed a less regulated existence, it resulted in a lack of transparency, questionable practices, unfair competitive advantages and ultimately, a massive government bailout. UTI and several public sector bank managed funds have had to be bailed out by the government because of business losses.

**A government-sponsored forced savings program.** Singapore's forced savings program is the bulwark of its economy. It has succeeded beyond the country's greatest expectations. However, Singapore is a very disciplined country and has a small and fairly homogenous population. Savings invested through the Central Provident Fund, while benefiting the economy are not invested in mutual funds or uni-trusts. As the U.S. Embassy reported, more than 90 percent of the funds managed Singapore are from foreign sources. Whether such a program could work in the Philippines would depend on a number of cultural and political assessments. On the other hand, creating opportunities and savings consciousness can also help. The Philippine Government's new 13 percent, ₱10,000 minimum, 90, 180, 360 day T-Bills, provides such an opportunity. While a great benefit to investors, it could either provide an enormous competitive challenge to mutual funds, especially to bond and balanced funds, as T-Bills become more available and until a secondary bond market develops here or an investment opportunity for the funds, providing a new source of investment in the bond market and an index to permit better valuation of debt instruments.

**A government tax incentive program to encourage investment in mutual funds, including measures to attract non-resident Filipinos.** This could be the best of all possible worlds in that it could stimulate investment in the fund industry and the capital market. Questions will be raised as to discrimination against other financial products, favoritism to the affluent and the overall benefit to the economy. Nevertheless, such a proposal merits serious consideration. At the very least, tax laws that discriminate against funds and their shareholders, specifically the DST on issuance of fund shares, the tax on fund dividends and the corporate tax

on net gains on sales of foreign securities, should be reconsidered. Nor should the tax laws favor one or another form of investment.

### 3. Legislation and Regulation

#### a. Securities Laws

Many things can and should be done to promote some of the benefits of the more dramatic changes described above. However, with the exception of requiring disclosure to Pre-Need Plan investors under "SA99," they are unlikely to happen in the near term. Immediate "here and now" fund industry priorities for effecting change lie in legislative and regulatory reforms and in educating sales agents and the investing public.

At least four pieces of pending legislation are of vital importance to the development of the fund industry. Two which relate to regulation of securities: SA99; and the Code; have been designated as "priority legislation" by President Estrada.

- **SA99** is the foundation for reform of the regulatory framework of the capital market. It would authorize restructuring of the SEC and creation of SROs and resolve issues that have been hanging over the market for five years. It has passed the Senate, is currently under consideration in the House and is expected to pass early in the Second Congressional Session.

- **The Code** offers the opportunity to provide for a more level playing field. It should provide for full disclosure, valuation standards, prudential standards, protections against affiliated transactions, limitations on sales commissions and losses to investors that could readjust the competitive balance vis-à-vis the fund industry. The House has held an initial hearing and is considering alternative proposals. However, it has been removed from the category of "priority legislation."

- **RICA** provides an updated law and guidelines for the operation of the fund industry. Several draft bills have been submitted in the Senate and House and ICAP has already commented on, and is closely following, House and Senate drafts. RICA has been designated priority legislation and is expected to be enacted by year-end.

#### b. Tax Laws

Other ICAP legislative concerns cluster around fiscal policy, promoting a retirement or pension program through tax incentives to benefit investors in certain funding vehicles, including investment company shares, and relief from provisions which discriminate against funds and their shareholders or hinder the development of the capital markets. (See pages 10-11 and 50-53, above, for a discussion of those provisions.)

**The PERA.** A fourth Bill, denominated the "Personal Equity Retirement Account" or "PERA" would create personal tax benefited retirement accounts. PERAs, like the US's

Individual Retirement Accounts ("IRAs"), would encourage investment in tax deferred retirement plans, thus promoting long term savings and easing burdens on the social security system. With an amendment to the pending Bill, a PERA could be funded, among other things, by mutual fund shares. If that were done, the PERA could provide an enormous shot in the arm for the mutual fund industry, as retirement investments, including Individual Retirement Accounts ("IRAs"), have in the United States.

A 1998 Retirement Survey of the Investment Company Institute (ICI) indicated that $1.86 trillion or 17% of the $10.9 trillion U.S. retirement market was held in mutual funds. This figure represents 34% of the total U.S. mutual fund industry's year-end 1998 net assets of $5.25 trillion. Almost half of the $1.86 trillion, $930 billion, was accounted for by Individual Retirement Accounts ("IRAs"). The $930 billion in mutual fund IRAs was 44% of the total $2.1 trillion IRA market.

The Senate held an initial hearing in February and a comparable Bill was introduced in the House in July 1999 by Majority Leader Mar Roxas. Enactment of the PERA Bill was initially among President Estrada's priorities, but has not remained near the top of the list. The Bill needs to be broadened, or companion legislation enacted, to provide for employer contributory plans such as the US 401(k) and H.R.10 plans. The PERA should be considered in the broader context of reform of the national retirement system in order that issues such as the balance between public and private sector retirement programs and regulatory protections may be resolved. Enactment of such legislation, with mutual funds as a funding vehicle, should be a high priority for the fund industry.

### c. Regulation

ICAP's goals in the regulatory arena revolve around:

- upgrading professional standards
- providing a regulatory environment that fits the fund industry better by helping the SEC to:
  - better understand the operations of investment companies
  - become more efficient and knowledgeable, and
- "leveling the regulatory playing field."

**Upgrading Professional Standards.** ICAP saw the administration of fund sales agent **licensing examinations** as an impediment to the growth of the industry. ICAP found that often the questions were heavily legally oriented and at odds with the practical standards, understanding of investors and fairness that a sales agent must have. As a result its value was limited. Only a relatively few applicants were able to pass the exam (seven out of 42 in 1996).[39] Second, processing the exam appeared to overburden the SEC's resources. Therefore, ICAP

[39] Following this exam, industry representatives consulted with the SEC and provided sample questions that they believed would be more appropriate. The SEC adopted certain of ICAP's suggestions. However, subsequently, according to industry sources, the exam has not been as relevant as ICAP would like.

has worked successfully to transfer its administration from the SEC's BED Division to the Capital Market Development Center, Inc.("CMDCI").

**Training the SEC Staff.** In addition to helping the SEC and, now the CMDCI, to prepare a more meaningful sales agent's exam, ICAP representatives have assisted the SEC in writing rules and reviewing registration statements. To develop greater SEC expertise, it would like to provide regular training programs to the SEC on the operation of investment companies and of the fund industry, such as the planned program on accounting standards. It would also like to see the SEC organize a separate unit to regulate funds.

**Bangko Sentral ng Pilipinas ("BSP" of the "Central Bank").** ICAP has also recognized that it will need to reach some policy accommodation with the BSP if it is to improve the chances of bringing banks more actively into the fund industry. However, it has not actively pursued the matter because Governor Singson and others at the BSP have taken a strong position. ICAP is considering alternative strategies.

Market forces may soon begin to play a stronger role in bringing the banks further into the fund management business, even in a way that is already permitted under the BSP's policies. As the Government's new small denominated Treasury Bills, SIPs and Treasury Notes, SDT's, minimum ~~₱5,~~000, become more broadly available, their attractive rates, including the initial SDT T-Note launch at 13 percent, may begin to draw investors out of competing vehicles such as CTF's and may also start to draw from bank deposits. To maintain their competitive positions, banks may be forced to establish mutual funds under the BSP's current policy restrictions or may bring pressure on the BSP to modify its policy in order to strengthen the financial condition of the banks.

**Leveling the Playing Field.** ICAP has not taken a position on the **regulation of the Pre-Need Industry.** It has limited its regulatory and legislative goals to those that relate directly to the regulation of funds and their management companies. Several ICAP fund sponsors are part of organizations that also sell pre-need plans or act as trustees for pre-need plans. However, as indicated above, just as the Pre-Need industry has benefited, the fund industry has suffered, from differential regulation. ICAP must remain aware of the impact of the regulation of the Pre-Need industry on the fund industry, in order that pre-need not pre-empt the market for mutual funds.

### 4. Strengthen ICAP

As the Fund Industry Association, ICAP is the only organization that is solely devoted to promoting the interests of the fund industry as an industry. It has close ties to the regulatory structure, understands the needs of its members and of all arms of the securities industry. The stronger ICAP can become, the better able it will be to move the levers of change. On the other hand, real change will not come from outside the industry, It will be up to ICAP to prod the government, help to train the SEC, lobby the Congress, promote higher professional standards and deliver the message that mutual funds can help investors reach their goals.

The dramatic, industry transforming, goals envisioned by this report will be possible over the long term if at least one entity can identify, prioritize and work toward them. That entity must constantly oil and tend the engines of change, prodding the legislature, training the regulators, educating the public and improving the funds and the markets. That is the role of ICAP. It must be the starter, the spark plug of change. The recommendations that follow, though not restricted to ICAP, depend in large measure on ICAP's ability and potential. They are a practical approach to suggestions for ICAP to more fully realize that ability and potential.

# VI. RECOMMENDATIONS: STRENGTHENING THE MUTUAL FUND INDUSTRY AND IMPROVING THE PUBLIC'S PERCEPTION OF MUTUAL FUNDS

Approximately one dozen concrete steps, primarily in the legislative and regulatory areas, could be taken over the next nine months to facilitate the growth of the fund industry.

## A. Legislation

Enactment of four key Securities/Pension Reform Bills, currently under varying degrees of active consideration by Congress, could have significant direct and indirect beneficial effects on the fund industry. This Report strongly supports their enactment, with the amendments recommended. They are:

- **The Securities Act of 1999, ("SA99")**; amended to include a broad definition of a statutory "underwriter;" to clarify the need for the application of traditional SEC disclosure" to Pre-Need Plans; and to assure better financing of the SEC; SA99 is the foundation for reform of the regulatory framework of the capital market. It would authorize restructuring of the SEC and creation of SROs and resolve issues that have been hanging over the market for five years. It has passed the Senate, is currently under consideration in the House.

- **The Revised Investment Company Act ("RICA")**; RICA provides an updated law and guidelines for the operation of the fund industry. Several draft bills submitted in the Senate and House contain provisions that relieve funds of burdensome provisions, including limitations on management of more than one fund.

- **The Pre-Need Securities Code ("Code")**; The Code offers the opportunity to provide for a more level playing field. It needs to provide for full disclosure, valuation standards, prudential standards, protections against affiliated transactions, limitations on sales commissions and losses to investors that could readjust the competitive balance vis-à-vis the fund industry. It should also provide means of easing the impact of an industry consolidation on pre-need certificate holders and surviving pre-need companies.

- **The Personal Equity Retirement Account ("PERA")**; PERA would create personal tax benefited retirement accounts. Such PERAs, like US Individual Retirement Accounts ("IRAs"), would encourage investment in tax deferred retirement plans, thus promoting long term savings and easing burdens on the social security system. Among other things an amendment to the pending Bill is necessary to permit a PERA to be funded by shares of registered investment companies (mutual funds). That could provide a big boost for the fund industry. An ICAP representative is already deeply involved as a member of the DoF Contractual Savings Task Force. It is shaping recommendations to the Retirement Income Commission that ultimately will help to

determine the kind of PERA legislation that will be recommended, the kind of retirement system the Philippines will have, and the role of the fund industry in it.

## B. Fiscal Policy

Although The Tax Reform Act of 1997 provided fundamental relief to the mutual fund industry by reducing a great deal of the burden of double taxation of funds and their shareholders, there are a number of other tax provisions that discriminate directly and indirectly against funds and their shareholders. The Report recommends amendments to the tax laws to correct the prejudicial effects these taxes have on the mutual fund industry and its shareholders, as explained below.

- ***The Documentary Stamp Tax ("DST") on issuance of fund shares should be modified.*** The DST is ₱2.00 per ₱200.00 of the par value on issuance of fund shares. It is more prejudicial to an open-end mutual fund than other enterprises because of the unique way mutual funds operate. They redeem and then reissue their shares. The DST attaches to each re-issuance. The solution, proposed by the fund industry, would be more efficient and produce more immediate revenues for the Government, but would avoid taxation of reissued shares and, over the longer term, should reduce the impact of the DST on open-end funds.

- ***Specifically,*** the fund industry has recommended that the DST on issuance of fund shares be levied on the entire authorized capital of an open-end fund upon its incorporation, but at a lower rate, ₱1.00 per ₱200.00 of par value. This proposal would benefit the Government in that collections would be sooner, more certain and more efficient. The Government would not have to rely on a fund's ability to market its shares. Although a fund would pay more taxes upon organization, in the long run it would pay less because it would not have to pay the DST on redeemed shares that are re-issued and the rate would be lower. It could also amortize its payment over five years as a pre-operating expense.

- ***The tax on fund dividends should be repealed as excessive.*** Although funds pay a 20 percent withholding tax on interest income, transaction taxes on sales of PSE traded securities and capital gains taxes on non-PSE securities, fund shareholders still must pay taxes of 8% (10% after January 1, 2000) on fund dividends declared. The tax on dividends received by individual mutual fund shareholders should be repealed, as was the tax on dividends received by corporate fund shareholders in 1997. The withholding taxes funds pay on interest income, transaction taxes on PSE traded securities and the capital gains taxes on non-PSE transactions are sufficient. To again tax dividends in the hands of individuals is excessive. Moreover, because of its impact on the operation of money market funds, it is impeding the development of the fund industry.

***Other taxes*** also have a greater impact on the mutual fund industry than on other issuers. Because mutual funds invest and trade in securities, any tax on securities transactions or on capital gains, even though meant to apply equally to all investors, will take a larger toll on an investment company than on a non-professional investor. The DoF is conducting an ongoing review of financial sector taxation. As part of that review, in order to remove obstacles to the development of the fund industry; to raise additional tax revenues by encouraging additional investment; to rationalize the tax system; and to reduce the tax burden on the capital market; it is recommended that:

- ***The IPO Tax should be repealed.*** To encourage listing on the PSE, the IPO Tax should be repealed.

- ***Capital gains on foreign securities of Philippine funds should be taxed like gains on securities not listed and traded on the PSE.*** In order not to discriminate against investments in foreign issuers; to broaden investment opportunities for all Philippine investors; and to provide an additional source of tax revenues from mutual funds: the corporate tax on capital gains of Philippine domiciled mutual funds or investment companies on securities of foreign issuers should be the same as the capital gains tax on net gains on sales of shares not listed and traded on the PSE: 5% the first ₱100,000 of net gains and 10% on the excess.

- ***The tax treatment of similar investment products should be equalized.*** Some policy makers have suggested that tax preferences be given to different kinds of investment products, (e.g. pre-need plans). Tax treatment should not favor one similar investment product over another. All should be treated equally.

## C. Regulatory Reforms

### 1. The Securities and Exchange Commission ("SEC")

This Report strongly recommends that the SEC initiate internal structural reforms and training programs as follows:

- **SEC Investment Fund Unit.** To improve efficiency and develop greater expertise, establish and increase staffing of a separate SEC Investment Fund Unit within the SEC's Money Market Operations Department (MMOD). After enactment of RICA, draft rules to permit a wider variety of investment companies. [See Appendix 7, Excerpt from PricewaterhouseCoopers Monograph, "Building A Securities Market Regulator in An Emerging Market," The Division of Investment Management.]

- **SEC Pre-Need Unit.** To transform the disclosures and regulation of the Pre-Need Industry, establish and adequately staff a separate Pre-Need Regulatory and Disclosure Unit within the SEC to fully regulate the activities and disclosures of the Pre-Need Industry. Include at least one Senior Level Actuary to supervise and train the staff.

Draft Reporting Forms regarding Prospectuses and Annual Reports and a Pre-Need Advertising Code to standardize information disclosed to the public and assure that it is not misleading.[40]

### 2. Bangko Sentral ng Pilipinas ("BSP")

**Permit Banks to Sell Fund Shares.** Perhaps the single recommendation that could have the greatest effect on strengthening the Philippines investment company industry is to modify the BSP's inconsistent ad hoc policy that prevents banks from distributing fund shares. The BSP allows customers to sell risk investments, Bank CTFs, on the floor of Branch Banks throughout the Philippines. It prevents banks from selling funds for the announced reason that it could mislead investors. No doubt sales of fund shares could be properly and unmistakably identified as risk products. Banks throughout South East Asia, including most recently in Japan and Korea, are allowed to distribute fund shares. Appropriate fire-walls and other protections against transfer of information between bank departments and insulating depositors from underwriting risks can be established.

***Transfer BSP regulation of investment advisers to the SEC.*** BSP policies and regulations relating to Investment Management Activities ("IMA") also unnecessarily impede the growth of the fund industry. Currently, they prevent mutual fund investment managers from advising more than one fund. This prevents them from taking advantage of the benefits of scale that managing other mutual funds, pension funds or other private investment advisory clients would bring. This limits their efficiency and profit potential and discourages new entrants because it makes it uneconomical to enter the investment management profession. Discouraging or limiting fund investment advisers from providing such services deprives the securities market and pension and retirement fields of broader investment advisory resources, a more vigorous mutual fund industry, the benefits of greater competition and broader choices. The SEC should be the sole regulator of registered investment advisers and of the mutual fund industry.

## D. ICAP's Comprehensive Strategic Plan

The balance of the recommendations in this report focus, in large measure on a comprehensive strategic plan that will provide a vision for ICAP, given its limited resources, to help the investment company industry realize its potential as a catalyst for the development of the Philippines capital market.

ICAP's Comprehensive Strategic Plan, builds upon its Charter and the kinds of activities it has already initiated solely through the voluntary activities of its members. It sets four goals and provides examples what can be achieved under each:

[40] The recommendation contained in the *Circulation Draft* regarding transfer of mutual fund salesmen licensing exams to the CMDCI has been deleted because it has already been implemented.

1. **Influence the Legislative and Regulatory Environment.** This includes promoting passage of critical legislation:

   - The Securities Act of 1999, ("SA99");
   - The Revised Investment Company Act ("RICA");
   - The Personal Equity Retirement Account ("PERA") amended to include investment company shares as a funding vehicle for tax benefited PERA accounts; and
   - Rationalizing the tax structure; and

   Training the SEC and its staff that regulates investment companies, including updating SEC (and BSP) rules to permit a wider variety of mutual funds.[41] It should also include promoting bills and rules to "level the playing field" to correct, as much as possible, the discriminatory effects of differential regulation.

2. **Raise Professional Standards among Members, Investment Managers, Distributors and Sales Agents.** This includes:

   - Upgrading and Standardizing Testing, Licensing, Registration and Monitoring of Sales Agents and Principals of Distributors of Funds, Insurance and Pre-Need Plans

   - Providing Continuing Education Programs for Portfolio Managers and Traders

   - Training Investment Company Independent Directors

   - Adopting an ICAP Code of Ethics

   - Adopting ICAP Model Guidelines, including:
     i. A Compliance Manual
     ii. Advertising Code; and
     iii. Accounting and Valuation Guidelines

   - Becoming a Self-Regulatory Organization as envisioned in Section 42 of RICA (Senate Bill).[42]

[41] Such new funds might include: money market funds; variable annuities; index funds; dollar-denominated funds or cross border investments. Such rules should also help the funds to take advantage of changing technology such as facilitating telephone and electronic share purchases and redemptions; check-writing privileges for redeeming mutual fund shares; and comprehensive quarterly or monthly account statements to investors covering all of their securities holdings and transactions, including funds.

[42] Such SRO activities could include: initial review of investment company registration statements, including prospectuses; training, testing, licensing and monitoring sales agents, brokers and dealers in securities not sold on the PSE; setting standards for and reviewing all mutual fund advertising; setting rules for the operation of mutual funds, and conducting joint inspections of mutual funds and their advisors with the SEC.

3. **Create Investor Education and Media Relations Programs.** This includes

   - Adopting an ICAP Mission Statement which identifies ICAP with: protecting investors, promoting professional standards, educating investors and strengthening the Philippines capital markets.

   - Developing sales literature and media campaigns aimed at investors
     i. Advantages of funding a PERA with mutual funds
     ii. Tax Benefit related sales
     iii. Understanding investment risk
     iv. Goal related campaigns: education; new home retirement
     v. Long term performance
     vi. Product differentiation

   - Designating a Training Officer; Develop Sales Literature, Training Materials and Courses for Sales Agents

   - Designing and executing a Media Relations Program, including providing ICAP:
     i. press and media releases
     ii. comments on capital market developments
     iii. annual journalist awards
     iv. a website

   - Publishing an ICAP Membership Directory
   - Setting up an ICAP Speakers Bureau
   - Creating Educational Programs for Students
   - Focusing media campaigns on the track records of "star" performers in the industry. This would help emphasize the most attractive benefit of mutual funds, which is its potential to provide better than average rates of return on investments.
   - Educating investors about the minimum investment amount to participate in a fund, as well as where and how to find them.

4. **Develop an Economic and Marketing Analysis Capability.** This would include building an ICAP Data Base to enable it, among other things, to:

   - monitor markets
   - understand investor psychology
   - analyze comparative performance and expenses of funds and competing products
   - perform long and short term economic analyses
   - study the importance of investment allocation

**Implementation.** This ICAP Comprehensive Strategic Plan sets forth an ambitious program. At this point it is more of a "Strategic Vision" than an operable plan. Whether and to what degree ICAP will be able to accomplish these goals and turn the vision into a program will depend on its ability and willingness to: attract new members; raise additional funds; and accept continued international donor assistance, if offered. Raising additional funding and receiving technical assistance would help to carry ICAP through its organizational or "start up" years.

An indication of ICAP's willingness to help itself would be for it to adopt a Business Plan which identifies short (one year) and long term (five year) objectives and the resources and staffing necessary to achieve them. Consideration should be given, over the longer term, to defining and filling two ICAP staff positions: a full-time President who could act as an advocate/lobbyist and a Director of Education and Training.

The success of the fund industry will not depend solely on ICAP. Investors and the markets need a strong investment fund industry, just as investors and the industry need fair, transparent and liquid markets that provide a broad range of investment opportunities. The concurrent development of other institutions of the capital market would also promote the development of the fund industry.

Control No. 11

CDIE

# *A Strategic Vision:*

# Strengthening Philippine Mutual Funds

# and

# Improving the Public's Perception of Them

***July 31, 1999***

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# Survey on Market Perceptions of Mutual Funds

Prof. Arturo Ilano
May 1999



92

# EXECUTIVE SUMMARY

A survey was conducted among professionals (office workers or white collar personnel), both management and staff, based in Metro Manila. The purpose of the study was to identify market perceptions that are currently harbored with respect to different forms of investments and, specifically, to mutual funds. The primary objective was to establish a comparative standing as to how the market perceives mutual funds as compared to other investment tools.

**Survey Population**

This survey is therefore limited to findings about office professionals in Metro Manila, which is still a significant market for investment tools. It does not as yet include findings about different segments of the potential market, such as homemakers, blue collar workers and personnel working outside Metro Manila. These however can be the scope of future studies on the matter.

The office professionals who are the focus of this study, however, is a significant source of data because they represent the supposedly more financially educated cluster of the population. And since the base objective of this study is to identify perceptions about mutual funds, this segment is supposed to provide leading edge indicators in terms of opinions about mutual funds since they are supposed to have more exposure to such tools of investment as compared to other sectors of society. Considering that mutual funds are still an "emerging" industry, such leading edge indicators provide a more focused source of information rather than, say, if a sampling of the general Philippine population was surveyed since such a vast population would most likely yield little information considering that most would not likely have heard about mutual funds at all.

Thus, the following results are limited to the perceptions and opinions of office professionals in Metro Manila, which represents the most likely initial target market of mutual funds at its growth phase.

Some 300 survey forms were distributed around the areas of Makati City and the Pasig/Ortigas business district, both being strong concentrations of office professionals. Of these, 156 forms were received and considered valid.

**Results**

*Awareness about Mutual Funds*

Half of the respondents claimed to have heard about mutual funds, hence establishing that there is awareness of such a form of investment. However, awareness merely implies knowledge about the phrase "mutual funds" and does not imply a more in-depth level of knowledge about the product.

A third of the respondents categorically stated that they did not know what a mutual fund is. However, at least sixty percent of the respondents believe that mutual funds are already available in the country.

A third of the respondents believed mutual funds to be high yielding investments, while about thirteen percent disagreed. Twenty percent believed it to be a risky form of investment.

Almost forty percent of the respondents did not know where to find mutual funds. A third, however, expected banks to be carrying them.

While half of the respondents did not know what the minimum investment amount for mutual funds is, fifteen percent thought that a minimum of P100,000 was required. In fact, three percent thought that the minimum amount required was a million pesos. Only six percent knew that the minimum amount required was P5,000.

*Comparison with Other Investment Options*

Mutual funds were perceived to be instruments that offered an average level of risk. It was perceived to be riskier than pre-need plans, but far less risky than stocks. It was thought to give a rate of return that was a little above average, at par with common trust funds, above bonds and pre-need plans, but below that of the stock market or of real estate.

Mutual funds were thought to be relatively less convenient to access than most forms of investment, even less than real estate. In fact, only bonds rated lower in terms of convenience.

Mutual funds were perceived to offer a below average level of liquidity, well below common trust funds and the stock market, and far below that of time deposits.

Most people, if asked to recommend an investment option, would still strongly recommend time deposits to their friends. Next would be treasury bills and real estate. The recommendability of mutual funds were just at par with stocks and pre-need plans.

*Behavioral Characteristics of Respondents*

Most of the respondents would generally prefer to invest in time deposits or real estate, while only four percent expressed a likelihood of investing in mutual funds. At present, a third of the respondents have current investments in time deposits, and another ten percent had placements in pre-need plans. Only two percent of the respondents currently had mutual fund placements.

For a third of the respondents, the primary consideration for choosing an investment vehicle was the return on investment. Another third prioritized the trustworthiness or credibility of the investment tool itself. Only fifteen percent prioritized the financial risk involved (i.e. whether its performance will meet expectations) and only twelve percent were concerned with liquidity.

Results also seem to imply that a common misconception that the troubled history of mutual funds (dating back to the 1950's) affects the current performance of the industry can be put to rest. It appears that most respondents are not even aware about the history of mutual funds in the first place.

There is a statistically significant relationship between the respondents' rank or position and where they tend to invest their money. The most likely conclusion is that as the respondents rise in rank, they rely less on savings accounts and time deposits and tend to move on to real estate or the money market.

There is also a strong observed relationship between the amount of funds available for investment and the type of investment that the respondents currently have. The data seems to show that the higher the available funds for investment, the greater the movement towards real estate.

## Conclusions and Recommendations

Generally forty percent of the target population appear to have no opinions at all about the nature of mutual funds. There is, however, an awareness of its existence. Therefore, if awareness exists, but knowledge does not, then any promotional thrust of the industry can focus on clarifying the benefits that mutual funds can offer to the target population (as opposed to promotions that focus on telling the market that mutual funds do exist in the first place).

Since much of the target population appear to prioritize an investment tool's rate of return, such an educational effort could focus on the performance history of mutual funds as compared to the stock market, emphasizing the annual rate of return that the industry has offered in the past (without exactly promising guaranteed rates of return for the future). Such a promotional campaign in itself will also take care of establishing the credibility of the industry, which is another significant criteria for the market.

The industry need not worry about the troubled history of mutual funds in the Philippines, so there is no need for "damage control" with regard to the industry's history. It is rather recommended that the industry focus on its immediate history (i.e. performance).

Since a third of the market expect banks to carry mutual funds, appropriate legislature to make this come to pass can facilitate the distribution of mutual funds and bring the immediate benefit of validating the expectations of one third of the market in terms of where to find mutual funds.

While the minimum placement for mutual funds is only P5,000, it should be noted that much of the respondents had far more than this amount to invest, so while small investors are still a valid target market, there is also a substantial market composed of people who are able to invest far more than the minimum. Apparently, the factors that are stopping them from investing in mutual funds are primarily lack of information, incongruent perceptions and simple inertia (cultural or otherwise) that direct them towards real estate and time deposits. In this case, the convenience of access to mutual funds, along with its liquidity, can become factors contributing to such market inertia.

Thus, there is resistance in moving from traditional, convenient investment options (banks) to a non-traditional form such as mutual funds. In order to propel this market into moving towards mutual funds, a powerful benefit needs to be emphasized by the industry. At present, it is still the promise of a higher level of returns that can be the best motivator for the market to do so.

## PROFILE OF RESPONDENTS

Most of the respondents were of age 35 and below, an effect of the fact that there were more barriers to access to the more senior management-level personnel. More to the point, however, much of the personnel in the companies that were approached belonged to this category as they comprise the front-lines and middle management.

About forty percent of the respondents were front-line staff (secretaries, clerks, etc.). Thirty percent were junior executives, while fifteen percent belonged to middle management and eight percent belonged to upper management. These percentages more or less approximated the stratification of jobs in office hierarchies and, therefore, is more or less proportionately distributed against the actual population. Some 60 percent of respondents were women.

A third of the respondents had monthly incomes in the range of from P15,000 to P30,000. About 28 percent had incomes from P8,000 to P15,000, and about 9 percent stated their monthly income to be from P30,000 to P50,000. Four percent of the respondents had incomes from P50,000 to P100,000, while another four percent had monthly incomes above P100,000.

About thirty percent of the respondents saved up to ten percent of their incomes. Another 26 percent saved up to 20 percent of their incomes, while another 12 percent of respondents saved up to 35 percent. Some 15 percent of the respondents stated that they were not able to generate savings at all.

Of the 156 respondents, more than half (56%) stated that they had an average knowledge of investments, while some 24% stated that they were fairly knowledgeable. Only 6 percent said that they were highly knowledgeable about investments, while 8 percent claimed that they did not know much about investments at all.

Of the 156 respondents, only 8 (5 percent) stated that they had investments in mutual funds.

The following is a summary of the general profile of the respondents:

**By Age**

| Age | Respondents | Percent |
|---|---|---|
| 24 and below | 38 | 24% |
| 25 to 35 | 88 | 56% |
| 36 to 45 | 19 | 12% |
| 46 to 55 | 7 | 4% |
| 56 and above | 4 | 3% |

**By Gender**

| Sex | Respondents | Percent |
|---|---|---|
| Male | 64 | 41% |
| Female | 92 | 59% |



9b

**By Position**

| Position | Respondents | Percent |
|---|---|---|
| Staff | 61 | 39% |
| Junior Executive | 43 | 28% |
| Middle Management | 24 | 15% |
| Upper Management | 13 | 8% |
| *Not Applicable/ No Answer* | 15 | 10% |

**Personal Income (Monthly)**

| Monthly Income | Respondents | Percent |
|---|---|---|
| to P8,000 | 18 | 12% |
| to P15,000 | 43 | 28% |
| to P30,000 | 51 | 33% |
| to P50,000 | 14 | 9% |
| to P100,000 | 6 | 4% |
| Above P100,000 | 6 | 4% |
| *Not Applicable* | 18 | 12% |

**Percent of Income Saved**

| Savings | Respondents | Percent |
|---|---|---|
| None | 24 | 15% |
| to 10% | 45 | 29% |
| to 20% | 40 | 26% |
| to 35% | 18 | 12% |
| to 50% | 11 | 7% |
| Above 50% | 8 | 5% |
| *Not applicable* | 10 | 6% |

**Amount Available for Investment**

| Available | Respondents | Percent |
|---|---|---|
| *No answer* | 8 | 5% |
| None | 39 | 25% |
| to P10,000 | 18 | 12% |
| to P25,000 | 23 | 15% |
| to P40,000 | 13 | 8% |
| to P80,000 | 19 | 12% |
| to P240,000 | 14 | 9% |
| above P240,000 | 22 | 14% |

Knowledge about Investments

| Knowledge | Respondents | Percent |
|---|---|---|
| *No answer* | 9 | 6% |
| Not much | 12 | 8% |
| Average | 87 | 56% |
| Fairly knowledgeable | 38 | 24% |
| Highly knowledgeable | 10 | 6% |

"Do you have investments in mutual funds?"

| | | |
|---|---|---|
| Yes | 8 | 5% |
| No | 147 | 94% |
| No answer | 1 | 1% |

## DESCRIPTIVE STATISTICS

### Familiarity with Mutual Funds

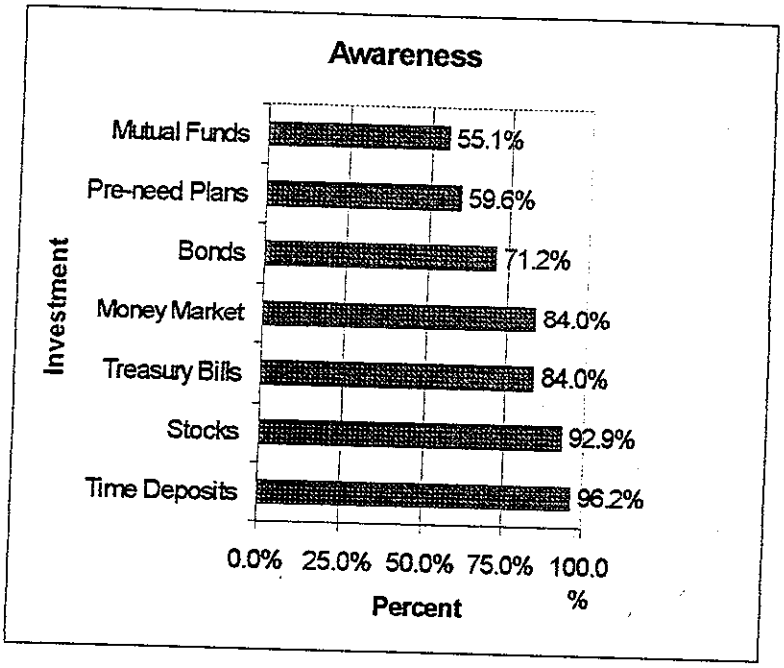
*"Which of the following investment tools have you heard about?"*

The first question in the survey seeks to make a simple determination of the target respondents' awareness of the existence of mutual funds, and to benchmark this against their general awareness of other investment options as well.

Note that awareness by itself does not imply a deeper level of knowledge. It simply means that, at the very least, the respondent has heard the term at one time or another.

While some 96% of the respondents were aware of the existence of Time Deposits as investment tools, only 55% knew about the existence of mutual funds, which meant that some 45% of the target population are not aware about what mutual funds are. This is not necessarily bad and, in fact, implies that half of the targeted population may have heard about the phrase "mutual fund" at one time or another.

By comparison, about 60% have heard about pre-need plans. Note, however, that the actual number of people who may know about pre-need plans may be much larger: a considerable bias is introduced by the fact that a number of pre-need companies do not call their services "pre-needs" but rather as "educational plans."



*"Which of the following best describes a mutual fund?"*

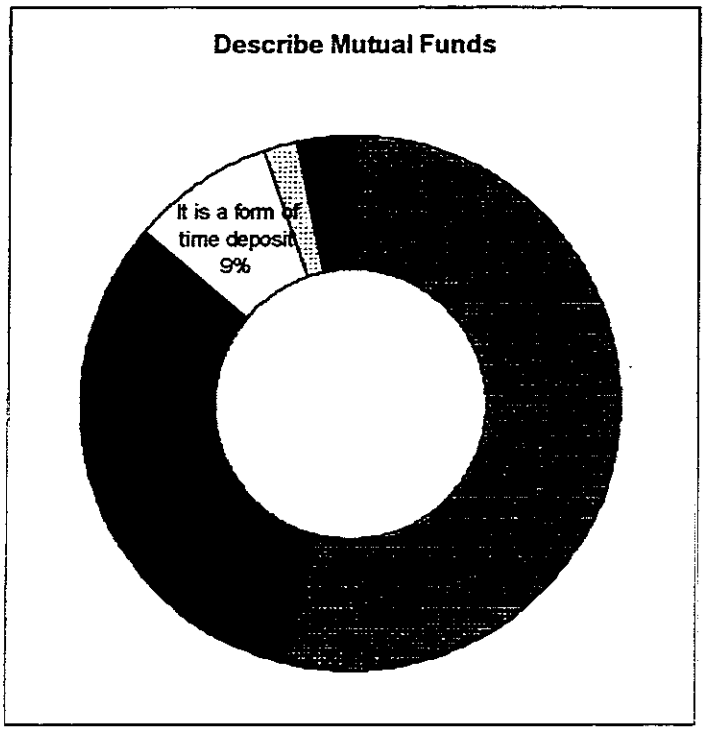
The purpose of this question is to lift minor feedback about how knowledgeable the market may be regarding the definition of a mutual fund. While the result was moderately surprising, post-survey assessment revealed that the way the question was constructed may have introduced a significant bias, i.e. the number one answer was most likely an educated guess based on the profundity of the phrase itself:

| | |
|---|---|
| It is a way of indirectly accessing a wide variety of investments | 53.9% |
| I really don't know | 32.2% |
| It is a form of time deposit | 8.6% |
| It is a form of government security | 2.0% |
| It is a high risk investment portfolio | 2.0% |
| It is a form of bond | 1.3% |

It is therefore decided that since the number one answer may be affected by this question's bias, then this percentage may not be significant for generating findings. Much of the results could be the result of "educated guesses."

However, it should be noted that despite the bias, at least 32 percent of the respondents have nevertheless stated that they do not know how to describe a mutual fund.

The actual figure of people who do not know the definition may be larger than this once bias for the number one answer is corrected.






160

**Basic Perceptions about Mutual Funds**

The next set of questions seek to gauge the respondents' basic perceptions about mutual funds. To accomplish this, the respondents were asked to agree or disagree with the following statements.

*"Mutual funds are hard to avail of"*

| | |
|---|---|
| Disagree | 41.0% |
| Don't know | 25.6% |
| Not sure | 21.8% |
| Agree | 7.7% |
| No answer | 3.8% |

This first question addresses perceptions regarding the accessibility of mutual funds. Accessibility is used in a broad sense here, encompassing issues of distribution and ease of access for individual investors.

The hypothesis was that people would perceive mutual funds to indeed be hard to avail of, in which case it was expected that the majority of respondents would tend to agree. Surprisingly, however, some 41% of respondents disagreed with this statement and only 7.7% agreed.

"Not sure" and "Don't know" however, when taken together, implies that some 47% of the target population (almost half) do not have any opinions with regard to this matter. This may be a stronger indicator about the level of knowledge that the target population has with regard to mutual funds, and ties in with the 45% who are not aware about what mutual funds are all about.

*"Mutual funds are not yet available in the country"*

| | |
|---|---|
| Disagree | 65.4% |
| Don't know | 16.7% |
| Not sure | 13.5% |
| No answer | 2.6% |
| Agree | 1.9% |

The purpose of this question is to reinforce any findings regarding the level of knowledge that the target population has with regard to mutual funds. For the respondents to agree would be to imply that these respondents know what mutual funds are but that they really are not aware of existing mutual fund providers in the country. On the other hand, for them to disagree would be indicative of some knowledge of the existence of mutual fund providers in the country.

Some 65 percent believed that mutual funds are indeed available in the country. Thus, regardless of their level of knowledge about mutual funds, this is still an indication that these respondents are aware, to some degree, about the existence of mutual funds.

*"Mutual funds are high-yielding investments"*

| | |
|---|---|
| Agree | 33.3% |
| Don't know | 25.6% |
| Not sure | 24.4% |
| Disagree | 13.5% |
| No answer | 3.2% |

This question serves to identify perceptions regarding the returns from mutual funds. At the very least, any move to agree on this statement could serve as an indication about the kind of reputation that mutual funds may have generated through history or by other means.

The phrase "high-yielding" is nevertheless a broad statement that merely presents indications about returns on investment without implying anything about risks involved.

A third of the respondents (33%) perceive mutual funds to be high-yielding investments while only 13.5 percent perceive otherwise. Half of the respondents, however, either don't know or have no opinion about this particular attribute of mutual funds.

*"Mutual funds are risky"*

| | |
|---|---|
| Disagree | 30.1% |
| Don't know | 23.1% |
| Not sure | 22.4% |
| Agree | 20.5% |
| No answer | 3.8% |

This question segregates the issue of the risk involved in investing in mutual funds.

A third of the respondents do not believe mutual funds to be risky investments. A fifth (20.5%) of the respondents, however, agree that mutual funds are risky investments.

Around forty five percent, however, either do not know or have no opinion about the riskiness of mutual funds.

*"Mutual funds have an excellent track record"*

| | |
|---|---|
| Not sure | 42.3% |
| Don't know | 29.5% |
| Disagree | 14.7% |
| Agree | 10.3% |
| No answer | 3.2% |

This question seeks to draw out any perceptions that the respondents may have regarding the history of mutual funds. The statement is purposely left in broad context in order to simply assess general perceptions rather than specific knowledge about the history of mutual funds, especially in the local context.

Seventy percent of the respondents do not know or do not have an opinion as to whether or not mutual funds have an excellent track record. About 15 percent, however, disagree with the statement and believe that mutual funds do not have an excellent track record. Only 10 percent agreed with the statement.

*"If you had extra funds to spare, where will you most likely invest it?"*

| | |
|---|---|
| Time Deposits | 26.3% |
| Real Estate | 21.8% |
| Don't know | 10.3% |
| Common Trust Fund | 9.6% |
| T-Bills | 9.0% |
| Stocks | 7.7% |
| Paintings/Jewelry | 4.5% |
| Mutual Funds | 3.8% |
| Others | 3.8% |
| Savings Account | 1.9% |
| Pre-need Plans | 0.6% |
| Bonds | 0.6% |

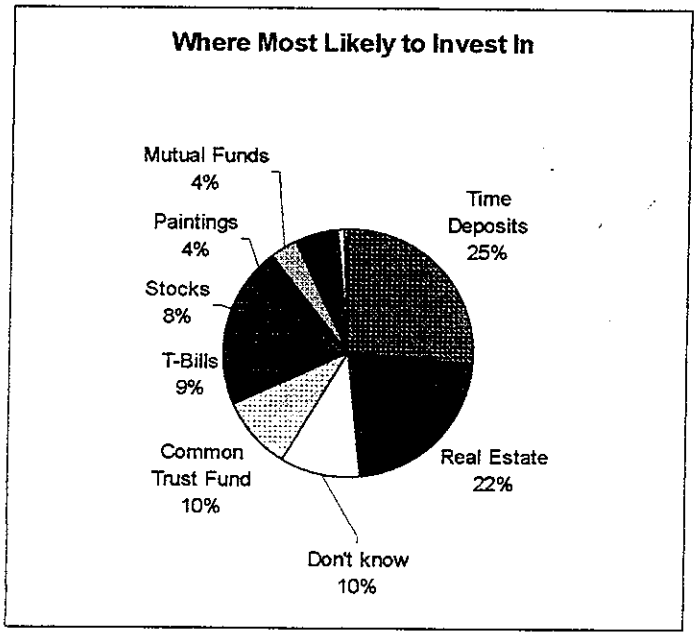
Beyond simple awareness, the market's intentions also have to be assessed. Thus, this question attempts to gauge the target population's preferences in terms of selecting their investment option.

The question is purposely left vague in terms of giving feedback as to scale of investment. In other words, "extra funds" is a flexible term that may encompass small amounts as well as substantial ones.

Note that two of the selections given for this question, namely "Paintings/Jewelry" and "Real Estate," are investment options that are not traditionally provided by financial institutions. These were nevertheless also included because of empirical observation that the target population has inclinations to invest in such non-financial instruments.

A fourth of the respondents (26.3%) expressed that any excess funds that they may have will most likely be invested in time deposits. The second most popular choice was real estate (21.8%). Every other investment option was relatively marginal. Ten percent of the respondents cited common trust funds, and only eight percent considered placements in stocks.

Only 4 percent stated that they may place their excess funds into mutual funds.



*"Where are the bulk of your investments placed, if applicable?"*

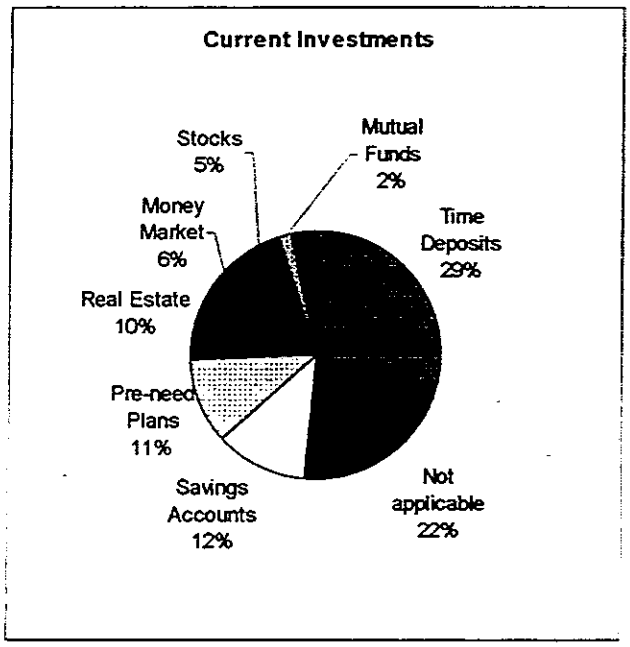
| | |
|---|---|
| Time Deposits | 28.8% |
| *Not applicable* | 22.4% |
| Savings Accounts | 12.2% |
| Pre-need Plans | 10.9% |
| Real Estate | 9.6% |
| Money Market | 5.8% |
| Stocks | 5.1% |
| Mutual Funds | 1.9% |
| Paintings/Jewelry | 1.9% |
| T-bills | 1.3% |

One of the purposes of this question is to assess the current investment practices of the respondents, especially as compared to the question about which investment tool they were most likely to invest in.

Almost a third of the respondents (28.8%) stated that the bulk of their funds are invested in time deposits. All other investment options yielded marginal responses.

Twelve percent of respondents stated that their funds are kept in savings accounts, while eleven percent stated that they have placed money into pre-need plans.

Five percent of the respondents had substantial amounts in stocks, while only two percent stated that they had money in mutual funds.






104

*"What is your primary consideration in choosing an investment vehicle?"*

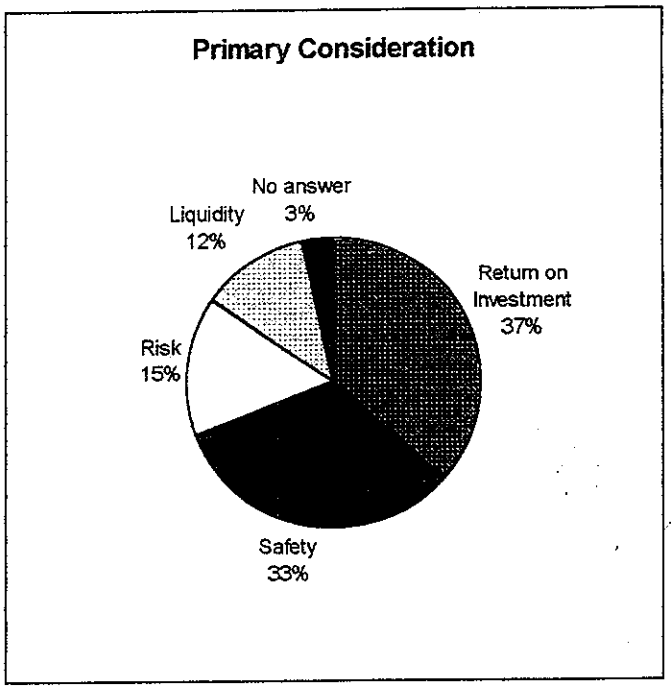
| | |
|---|---|
| Return on Investment | 36.5% |
| Safety, trustworthiness | 32.7% |
| Risk involved with Investment | 15.4% |
| Liquidity | 12.2% |
| No answer | 3.2% |

This question seeks to identify the most important criteria that the respondents have for selecting a tool for investment.

Note that "Safety, trustworthiness" is different from "Risk involved with investment." The latter is more concerned with risk in terms of the probability that the investment will indeed provide a positive return, while "safety, trustworthiness" is more about the legitimacy of the investment tool itself.

Some 36 percent of the respondents stated that their primary consideration for choosing an investment would be its rate of return on investment. Coming close at 33 percent are respondents whose primary concern involves the trustworthiness or legitimacy of the investment vehicle.

Fifteen percent of the respondents were primarily concerned with the financial risk involved with the investment, while only twelve percent were primarily concerned about keeping their investments liquid.






105

*"Where can you find mutual funds?"*

| | |
|---|---|
| Investment Houses | 40.4% |
| Don't know | 37.2% |
| Banks | 34.0% |
| Personal dealers | 5.8% |
| Insurance brokers | 5.1% |
| Central Bank | 2.6% |

This question seeks to identify existing perceptions of the target population about how mutual funds are distributed or made available to the public. The primary purpose is to extract ideas about possible misconceptions that the target population has regarding how mutual funds are made available.

Forty percent believed that if they were to look for mutual funds, these can be found in investment houses. However, it should the noted that in this context, "Investment Houses" may present an inherent bias by nature of its wording: it *sounds* like a correct answer for educated guesses and, therefore, this particular percentage may be greater than normal due to guesswork by the respondents.

Another 37 percent of the respondents categorically stated that they did not know where to find mutual funds.

A third (34%) of the respondents, however, believed that mutual funds are offered by banks. Again, since the question thrives on perceptions, it appears that a third of the target population perceive banks to be the most logical way to distribute an investment tool such as mutual funds.

*"What in your estimate is the minimum investment amount for mutual funds?"*

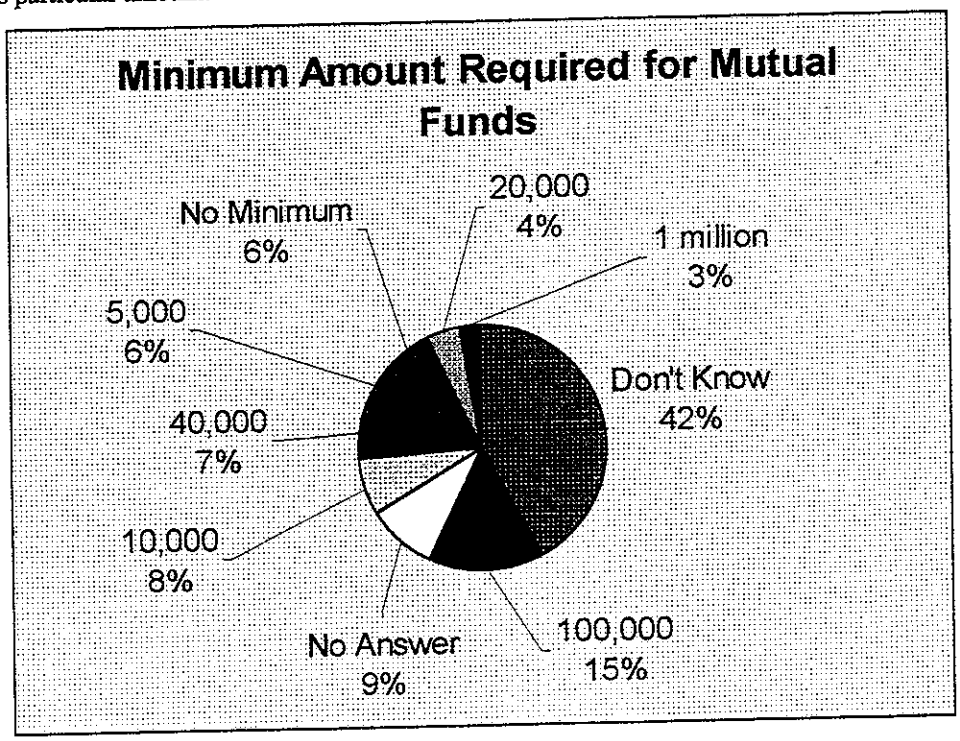
| | |
|---|---|
| Don't Know | 42.3% |
| 100,000 | 14.7% |
| No Answer | 9.0% |
| 10,000 | 7.7% |
| 40,000 | 7.1% |
| 5,000 | 6.4% |
| No Minimum | 5.8% |
| 20,000 | 4.5% |
| 1 million | 2.6% |

This is another question that aims to assess the target population's perceptions about the nature of mutual funds. In this case, it is their perception about what the minimum amount required for investment is for mutual funds.

Forty percent (42.3%) of the respondents did not know what the minimum amount for investment in mutual funds is, a figure which almost ties in with the percentage of respondents who generally do not know what a mutual fund is in the first place.

About fifteen percent (14.7%) of respondents, however, thought that the minimum amount required is P100,000. It can be concluded, therefore, that this and much of the other figures were derived from guesswork.

Only six percent (6.4%) of the respondents correctly stated that they believed the minimum investment amount to be 5,000 pesos. It is possible, however, that at least some of these respondents also simply guessed at this particular amount.






107

## RANKINGS

The following group of questions seek to assess the target population's perceptions about different kinds of investments, ranking them according to a given set of criteria. The purpose of this set of questions is to identify how the target population views mutual funds as compared to other substitute forms of investments.

The questions asked participants to rank the different investments for each criterion on a scale of 1 to 5, with 1 being low and 5 being high (with 3 generally acknowledged as "average"). While the results at this range setting were interesting enough, it was decided that to maximize the effects of each number's respondents, the scale had to be collapsed. To put it simply, the scales of 1 to 5 were compressed into scales of 1 to 3, with 1 being low, 2 being average and 3 being high. This way, each category would have more significant "loadings." Also note that for the purpose of extracting relevant means, responses of "Don't Know" were filtered out.

### Level of Risk

When the means of the respondents' rankings of the various investment tools are compared in terms of perceived risk, the following chart is compiled.

| | | Perceived Levels of Risk |
|---|---|---|
| Stocks | 2.735 | |
| Mutual Funds | 2.141 | |
| Real Estate | 2.038 | 3 = Highest Risk |
| Bonds | 1.926 | 1 = Lowest Risk |
| PreNeeds | 1.837 | |
| CTFs | 1.823 | |
| Paintings etc | 1.730 | |
| T-Bills | 1.349 | |
| Time Deposit | 1.294 | |
| Savings Accts | 1.142 | |

Note that "risk" here implies financial risks, as in the ability of the investment to assure a rate of return, as opposed to safety and trustworthiness of the instrument itself.

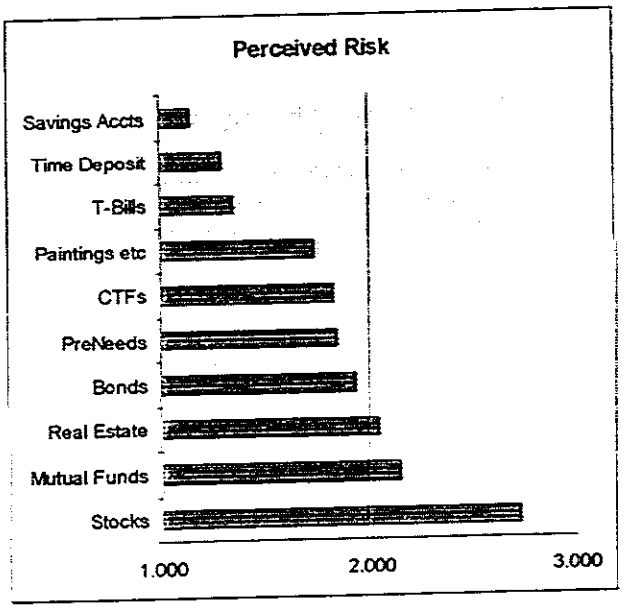
The investment tool that is perceived to hold the highest risk are stocks, which was expected to be a direct result of traditional perceptions regarding the stock market as being unpredictable.

The next highest in terms of perceived risk are mutual funds and real estate, which come close together and are perceived to be of about average risk.

Bonds, Pre-need plans, Common Trust Funds and paintings are clustered below the midpoint, while the least risky investments are the benchmark Treasury Bills, Savings Accounts and Time Deposits.

Savings accounts were perceived to be the least risk-laden investments, possibly supported by the fact that most people have experience with these already.

The fact that these are all perceptions is highlighted by the fact that the universally acknowledged "risk-free" treasury bills have higher perceived risks than both savings accounts and time deposits.



**Return on Investment**

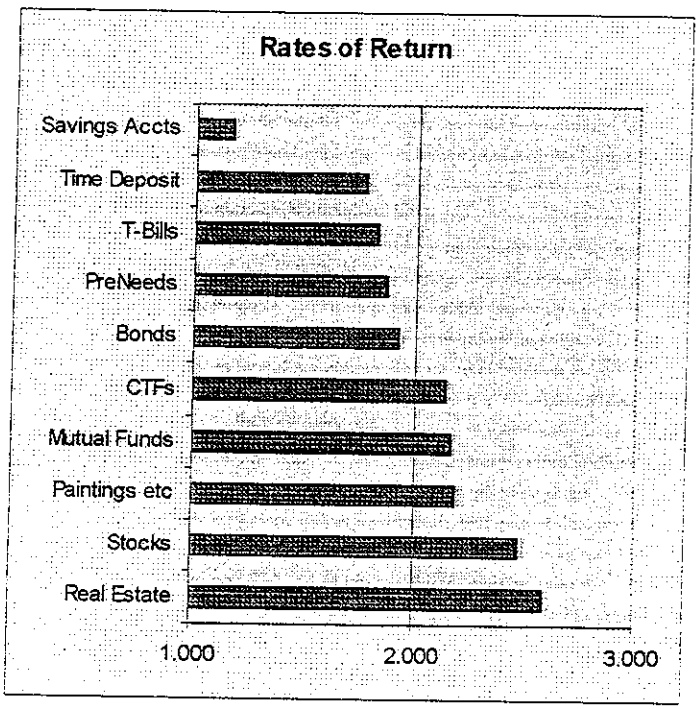
This set of ratings assess the perceptions of the target population with regard to the expected rates of returns on the different investment tools below.

| | | |
|---|---|---|
| Real Estate | 2.597 | |
| Stocks | 2.473 | **Perceived Rates of Return** |
| Paintings etc | 2.181 | |
| Mutual Funds | 2.163 | 3 = Highest |
| CTFs | 2.136 | 1 = Lowest |
| Bonds | 1.923 | |
| PreNeeds | 1.872 | |
| T-Bills | 1.827 | |
| Time Deposit | 1.768 | |
| Savings Accts | 1.167 | |

Surprisingly, the target population perceives real estate to provide the highest rates of return on their investment. Coming in second was the stock market.

Mutual funds were closely tied with paintings, jewelry and other appreciable objects, as well as with common trust funds.

Bonds, pre-need plans and treasury bills, as well as time deposits, were more or less expected to provide similar rates of return (a bit below average), while savings accounts were acknowledged to provide the least amount of returns for their funds.






109

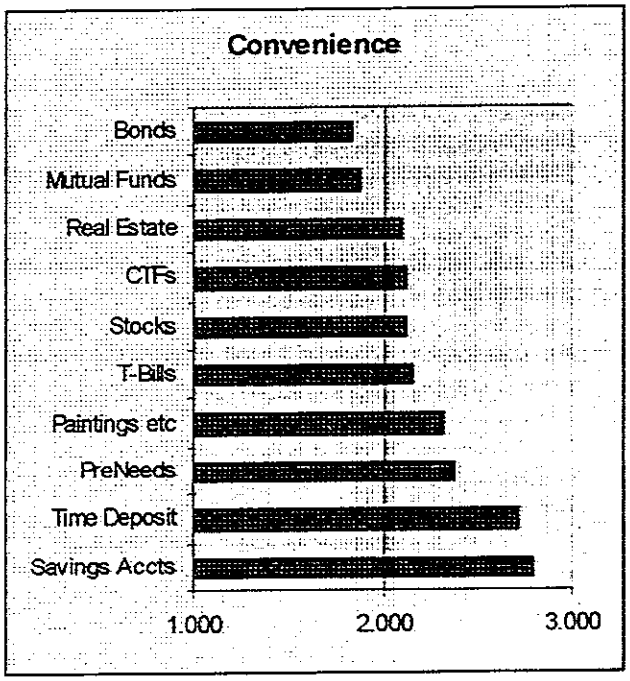
Convenience

The following scale presents the perceptions of the respondents with respect to how convenient it is to place funds into the following investment tools.

| | | |
|---|---|---|
| Savings Accts | 2.788 | **Convenience** |
| Time Deposit | 2.710 | |
| PreNeeds | 2.367 | |
| Paintings etc | 2.311 | 3 = Highest |
| T-Bills | 2.152 | 1 = Lowest |
| Stocks | 2.117 | |
| CTFs | 2.115 | |
| Real Estate | 2.091 | |
| Mutual Funds | 1.870 | |
| Bonds | 1.827 | |

Savings accounts and time deposits were perceived to provide the most convenient means of investment of funds. This may be attributed to the fact that these two are common and regularly availed of, and that banks provide the sufficient level of convenience and access for these tools.

Pre-need plans, paintings, jewelry etc. surprisingly come next in terms of convenience. The latter tangible objects can be justified by the fact that investing in these is simply a matter of acquisition. Pre-need plans, on the other hand, may also be perceived to be convenient due to their similarity to insurance policies and the like, which implies the convenience that is provided by salesmen.




Considered to be of average convenience are real estate, common trust funds, stocks and treasury bills. That real estate should be considered in this category is surprising when one notes the nature of real estate as being investments that cannot be acquired on impulse and which require much paperwork.

Mutual funds and bonds were perceived to be the least convenient forms of investments among the stated options. That mutual funds would be categorized as such is surprising, considering that entry and participation here does not entail much more than placing the funds in.

This perception of mutual funds as being relatively inconvenient compared to other investment options, however, is bound to be the result more of the lack of information about mutual fund than of anything else.

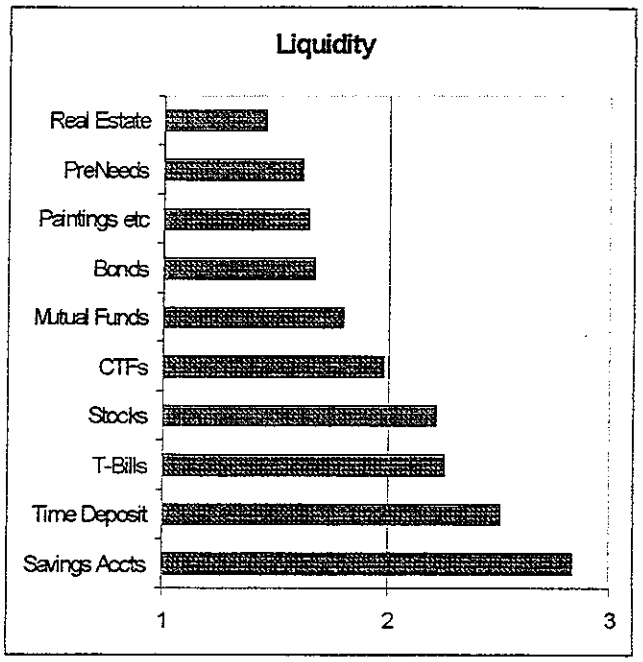


110

## Liquidity

The next group summarizes the respondents' perceptions about just how liquid (ease of conversion to cash) each of the given investment tools are.

| | | |
|---|---|---|
| Savings Accts | 2.832 | |
| Time Deposit | 2.506 | |
| T-Bills | 2.252 | **Liquidity** |
| Stocks | 2.215 | |
| CTFs | 1.976 | 3 = Highest |
| Mutual Funds | 1.798 | 1 = Lowest |
| Bonds | 1.672 | |
| Paintings etc | 1.640 | |
| PreNeeds | 1.613 | |
| Real Estate | 1.450 | |




The target population perceives savings accounts to be the most liquid form of investment (again due to the pervasiveness of savings accounts), with time deposits coming a close second.

T-bills and stocks were perceived to offer a similar level of liquidity (above average), and common trust funds come next with almost average liquidity.

While real estate rightly offered the least perceived liquidity, pre-need plans apparently ranked with paintings and bonds along the same category (odd considering the nature of pre-need plans as being long-term holdings).

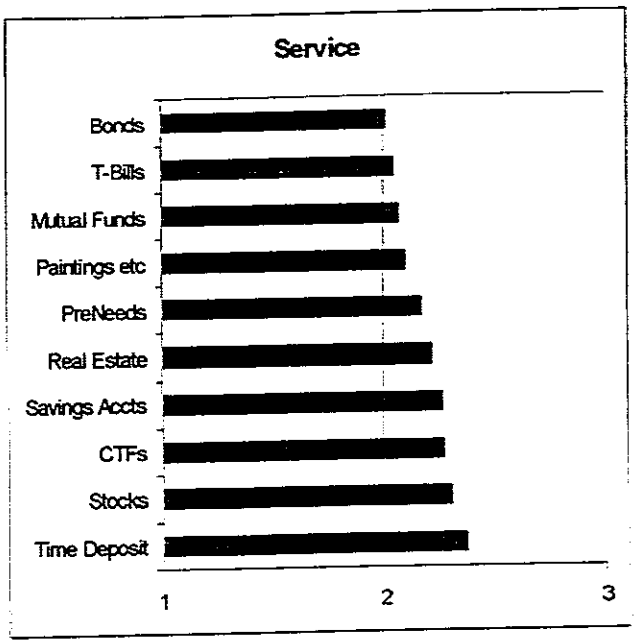
Mutual funds were perceived to be more liquid than bonds, but less liquid than common trust funds, and far less liquid than stocks, time deposits and savings accounts.

Again, since these are perceptions, a matter of market education can do well to reposition such perceptions about mutual funds.

Quality of Service

Respondents were then asked to rate the different investment tools as to their perceived quality of service.

| | | |
|---|---|---|
| Time Deposit | 2.372 | Service |
| Stocks | 2.305 | |
| CTFs | 2.266 | |
| Savings Accts | 2.260 | |
| Real Estate | 2.216 | 3 = Highest |
| PreNeeds | 2.168 | 1 = Lowest |
| Paintings etc | 2.100 | |
| Mutual Funds | 2.072 | |
| T-Bills | 2.049 | |
| Bonds | 2.009 | |




The results show that as far as the target respondents were concerned, service quality seemed to be similar among the different investment options, with all the options clustered at or slightly above average.

Time deposits had a marginal advantage over the other investment options, but not by much. Mutual funds were practically tied with T-bills, paintings and bonds at the average end.

Homogeneity of perceptions is a sign that the market is practically indifferent to distinctions in the ways by which these different investment options provide service to the customers. Level of service, however, is different from ease of access and finding these investments in convenient locations.



112

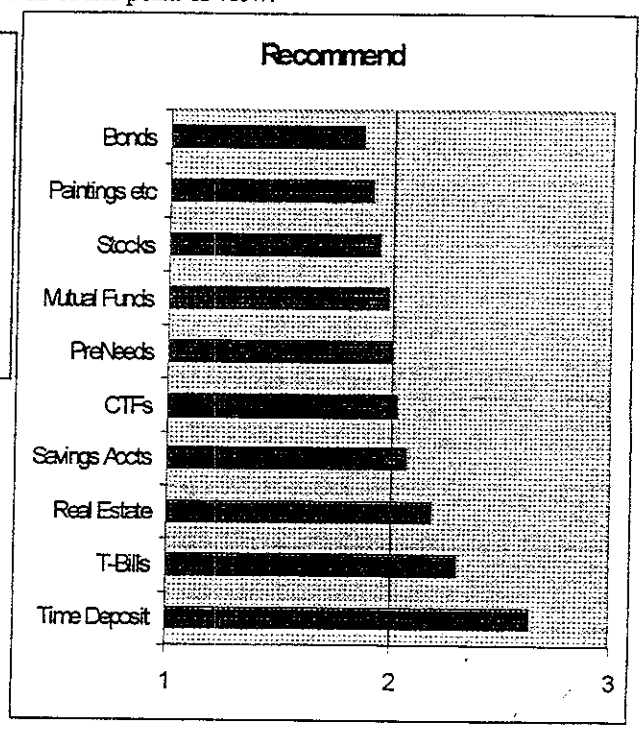
**Recommendability**

The next set seeks to gauge general satisfaction levels of the target population with respect to the different investment options available. In order to do this, the question was phrased as follows:

*"If you had a friend with extra funds, which of the following would you most likely recommend as an investment?"*

Respondents were then asked to rate each of the options as per their "recommendability," the premise being that the investment with the highest chance of being recommended may be the one that provides the respondent with the best overall set of benefits in his or her point of view.

| | | |
|---|---|---|
| Time Deposit | 2.636 | |
| T-Bills | 2.301 | |
| Real Estate | 2.188 | **Recommend** |
| Savings Accts | 2.072 | |
| CTFs | 2.025 | 3 = Highest |
| PreNeeds | 2.000 | 1 = Lowest |
| Mutual Funds | 1.980 | |
| Stocks | 1.941 | |
| Paintings etc | 1.905 | |
| Bonds | 1.858 | |




Time deposits were most likely to be recommended by the target population as a tool for investment. In other words, in terms of liquidity, risk, convenience and other relevant factors, time deposits may provide the respondents with the best mix of benefits that they could recommend to other people.

Treasury bills come next, although the barriers to obtaining T-bills have not been factored into the discussions.

It is interesting to note that the next most recommended investment medium is real estate (in spite of, or maybe because of, the fact that the real estate market was in a slump during the time of the survey).

Savings accounts were given a fairly average recommendability rating, as well as pre-need plans and mutual funds. All others were given almost average ratings in this category.

Apparently, time deposits are still the generally preferred media of investment, most likely due to their convenience, perceived safety and basic familiarity.

Note that in an earlier question, the respondents have also stated that if they had extra funds to spare, they would most likely invest in time deposits, followed by real estate.

## CROSS TABULATIONS

This section seeks to identify any possible correlation between some of the dependent variables (specific perceptions) and the independent variables of the respondents (such as age and other demographics). Whether or not such correlations do emerge, these shall nevertheless be findings about the sample's attributes.

The following are three sets of hypotheses which propose possible relationships between some demographic information about the respondents and a specific response that they have generated. Such hypotheses are then tested using cross tabulation at a 95% confidence interval.

Considering the number of respondents who answered "Don't know" or who did not have any answer for the following questions, the cases have been filtered so that only respondents who answered with "Agree" or "Disagree" are tested below.

**Hypothesis 1: The target population's age influences its perception of the availability of mutual funds.**

This hypothesis is brought about by the possibility that the more senior respondents may be more aware of the existence of mutual funds, while younger personnel would not yet have sufficient exposure to information about it.

**Result:** At a 95% confidence interval, the null hypothesis that there is no relationship between age and perception of availability of mutual funds is accepted.

**Conclusion:** The data does not show any relation between age and perception of availability. Therefore, the first hypothesis that age influences perception of availability of mutual funds is rejected.

**Hypothesis 2: The target population's age influences its perception of the yield of mutual funds.**

Again, this hypothesis is brought about by the possibility that the more senior respondents may have more knowledge about the characteristics of mutual funds, while younger personnel would not yet have sufficient exposure to information about it.

**Result:** At a 95% confidence interval, the null hypothesis that there is no relationship between age and perception of yield of mutual funds is accepted.

**Conclusion:** The data does not show any relation between age and perception of yield. Therefore, the second hypothesis that age influences perception of yield of mutual funds is rejected.

**Hypothesis 3: The target population's age influences its perception about the history of mutual funds.**

The premise for this hypothesis is based on the common presumption that the rather tumultuous history of mutual funds in the Philippines, dating back to the 50's, may be partly responsible for perceptions about the trustworthiness of mutual funds. The first step is therefore to test if the respondents are indeed aware of any questionable history on the part of mutual funds. This is then analyzed in order to assess whether the more senior age groups are indeed more aware of this history.

**Result:** At a 95% confidence interval, the null hypothesis that there is no relationship between age and perception of a questionable history for mutual funds is accepted.

**Conclusion:** The data does not show any relation between age and perception of a questionable history. Therefore, the third hypothesis that age influences perceptions about the history of mutual funds is rejected.



114

**Behavioral Findings**

The following are statistical conclusions about the behavior of the respondents, derived through further cross tabulations between imposed dependent and independent variables:

1. There is a statistically significant relationship between the respondents' positions and where they are currently investing their money. Visual observation of the data suggests that younger executives tend to place their money in savings accounts and time deposits, while more senior managers have their funds placed in real estate or the money market, although the data may not be sufficient to support such specific conclusions;

2. There is a strong statistically significant relationship between the respondents' amount of funds available for investment and the type of investments that they currently have. Visual assessment of the data seems to suggest that the greater the amount of funds available for investment, the less the reliance on savings accounts and the greater the move towards real estate;

3. There is no statistically significant relationship between age and where the respondents are currently investing their money;

4. There is no statistically significant relationship between the amount of personal income and where the respondents are currently investing their money;

5. There is no statistically significant relationship between the percentage of income that the respondents save and where the respondents are currently investing their money;

## SPECIAL NOTE REGARDING CURRENT MUTUAL FUND HOLDERS

It should be noted that the survey yielded eight respondents who currently have placements in mutual funds. While this number is too small to establish significant conclusions with, their responses to the survey questions may still be of interest to the industry. Note that a future study can be made that primarily focuses on the perceptions and opinions solely of mutual fund clients.

Since there are only eight respondents with mutual funds, their comments shall be noted down in full below.

*"On a scale of one to five, how happy are you with the overall performance of your mutual fund investment?"*

| | |
|---|---|
| VERY UNHAPPY | 2 |
| Moderately unhappy | 2 |
| INDIFFERENT | 1 |
| Moderately happy | 2 |
| Don't Know | 1 |

None of the respondents were very happy with the performance of their mutual fund. This may, however, be the result of the fact that during the time of the survey, they may have been under the mercy of a down market.

*"How did you learn about mutual funds?"*

- Through agent: Filipino Mutual Fund, and through newspaper: Philam Fund
- In a newspaper
- Bank commercial (!)
- Abroad
- Through a friend
- Part of my job

*"What are problems or complaints that you have with regard to mutual fund investments?"*

- Did not grow as expected. Down when the market is down
- Decreases with stock market
- Negative returns
- High risk, especially equity
- Poor performance due to crisis
- Hard to monitor

Apparently, complaints center on the perceived lackluster returns of their investment in mutual funds, while one respondent noted the difficulty in monitoring his investment.

## AWARENESS OF EXISTING MUTUAL FUND PROVIDERS

*"What companies are you aware of that provide mutual fund investment services?"*

Again, the following are quoted verbatim from the survey forms [except brackets which contain notes], with the primary purpose of presenting current levels of awareness or, in some cases, misconceptions by the respondents about current providers of mutual funds.

Each line represents the answer of an individual respondent, except when brackets show multiple responses (i.e. [2x]) which means that more than one person gave the same answer.

- Abacus
- First Abacus
- Deutche Bank, Citibank [NOTE: These are foreign funds]
- P&G [!]
- Filipinas Mutual Fund, Philam, Filipino Fund
- Philam Fund [3x]
- BPI
- Asia Pacific [?]
- Filipino fund
- Brokers, bankers
- Brokers, insurance
- Philam, BPI, MFCP, Clemente Capital
- Kabuhayan Fund, Standard Chartered
- Kabuhayan Mutual Fund
- Citisec, Philequity, Kabuhayan, Abacus, All Asia
- Abacus, Citisec, Wealth, Philam, Mutual Fund, JF, ING, ABN
- Filipino fund, Sino Philippines
- BPI, UCPB, Philam, Philequity, First Galleon

# ANNEX. CROSS-TABULATION TABLES

HYPOTHESIS 1: Compare age vs. perception of availability of mutual funds

AGE Age by OP1 Hard to avail of

Page 1 of 1

| AGE | Count | OP1 Agree 1.0 | OP1 Disagree 2.0 | Row Total |
|---|---|---|---|---|
| 24 below | 1.0 | 4 | 17 | 21<br>27.6 |
| 25 to 35 | 2.0 | 7 | 34 | 41<br>53.9 |
| 36 above | 3.0 | 1 | 13 | 14<br>18.4 |
| | Column Total | 12<br>15.8 | 64<br>84.2 | 76<br>100.0 |

| Chi-Square | Value | DF | Significance |
|---|---|---|---|
| Pearson | 1.00567 | 2 | .60481 |
| Likelihood Ratio | 1.16377 | 2 | .55885 |
| Mantel-Haenszel test for linear association | .77556 | 1 | .37850 |

Minimum Expected Frequency - 2.211
Cells with Expected Frequency < 5 - 2 OF 6 ( 33.3%)

| Statistic | Value | ASE1 | Val/ASE0 | Approximate Significance |
|---|---|---|---|---|
| Phi | .11503 | | | .60481 *1 |
| Cramer's V | .11503 | | | .60481 *1 |



118

HYPOTHESIS 2: Compare age vs. perception of yield of mutual funds

AGE Age by OP3 High yielding

Page 1 of 1

| AGE | Count | OP3 Agree 1.0 | Disagree 2.0 | Row Total |
|---|---|---|---|---|
| 24 below | 1.0 | 17 | 2 | 19<br>26.0 |
| 25 to 35 | 2.0 | 28 | 14 | 42<br>57.5 |
| 36 to 45 | 3.0 | 7 | 5 | 12<br>16.4 |
| | Column Total | 52<br>71.2 | 21<br>28.8 | 73<br>100.0 |

| Chi-Square | Value | DF | Significance |
|---|---|---|---|
| Pearson | 4.48685 | 2 | .10609 |
| Likelihood Ratio | 5.05312 | 2 | .07993 |
| Mantel-Haenszel test for linear association | 3.98928 | 1 | .04579 |

Minimum Expected Frequency - 3.452
Cells with Expected Frequency < 5 - 1 OF 6 ( 16.7%)

| Statistic | Value | ASE1 | Val/ASE0 | Approximate Significance |
|---|---|---|---|---|
| Phi | .24792 | | | .10609 *1 |
| Cramer's V | .24792 | | | .10609 *1 |

HYPOTHESIS 3: Compare age vs. perception of questionable history for mutual funds

AGE Age by OP6 Questionable local history



| Count | OP6 agree 1.0 | OP6 disagree 2.0 | Row Total |
|---|---|---|---|
| AGE 1.0 24 below | 3 | 4 | 7 17.1 |
| 2.0 25 to 35 | 8 | 18 | 26 63.4 |
| 3.0 36 above | 5 | 3 | 8 19.5 |
| Column Total | 16 39.0 | 25 61.0 | 41 100.0 |

| Chi-Square | Value | DF | Significance |
|---|---|---|---|
| Pearson | 2.64064 | 2 | .26705 |
| Likelihood Ratio | 2.60399 | 2 | .27199 |
| Mantel-Haenszel test for linear association | .70945 | 1 | .39963 |

Minimum Expected Frequency - 2.732
Cells with Expected Frequency < 5 - 4 OF 6 ( 66.7%)

| Statistic | Value | ASE1 | Val/ASE0 | Approximate Significance |
|---|---|---|---|---|
| Phi | .25378 | | | .26705 *1 |
| Cramer's V | .25378 | | | .26705 *1 |

**RELATIONSHIP BETWEEN POSITION AND CURRENT INVESTMENTS**

POSN Current Position by PLACE Placement



| POSN | Count | PLACE TB 1.0 | TD 2.0 | SA 3.0 | Preneed 4.0 | Mutual funds 5.0 | Row Total |
|---|---|---|---|---|---|---|---|
| Frontline | 1.0 | | 18 | 9 | 2 | 1 | 39<br>35.5 |
| Junior/New | 2.0 | 1 | 10 | 8 | 8 | 1 | 37<br>33.6 |
| Middle mgt | 3.0 | 1 | 7 | 1 | 4 | | 22<br>20.0 |
| Upper mgt | 4.0 | | 6 | | | | 12<br>10.9 |
| (Continued) | Column Total | 2<br>1.8 | 41<br>37.3 | 18<br>16.4 | 14<br>12.7 | 2<br>1.8 | 110<br>100.0 |



POSN Current Position by PLACE Placement



| POSN | Count | PLACE Stocks 7.0 | Money market 8.0 | Real estate 9.0 | Paintings 10.0 | Row Total |
|---|---|---|---|---|---|---|
| Frontline | 1.0 | 3 | 1 | 3 | 2 | 39<br>35.5 |
| Junior/New | 2.0 | 3 | 4 | 2 | | 37<br>33.6 |
| Middle mgt | 3.0 | | 4 | 5 | | 22<br>20.0 |
| Upper mgt | 4.0 | 2 | | 4 | | 12<br>10.9 |
| | Column Total | 8<br>7.3 | 9<br>8.2 | I4<br>12.7 | 2<br>1.8 | 110<br>100.0 |

| Chi-Square | Value | DF | Significance |
|---|---|---|---|
| Pearson | 37.39620 | 24 | .03993 |
| Likelihood Ratio | 44.26623 | 24 | .00710 |
| Mantel-Haenszel test for linear association | 3.35746 | 1 | .06690 |

Minimum Expected Frequency - .218
Cells with Expected Frequency < 5 - 31 OF 36 ( 86.1%)

| Statistic | Value | ASE1 | Val/ASE0 | Approximate Significance |
|---|---|---|---|---|
| Phi | .58307 | | | .03993 *1 |
| Cramer's V | .33663 | | | .03993 *1 |



121

**RELATIONSHIP BETWEEN FUNDS AVAILABLE AND CURRENT INVESTMENTS**

AVAIL Available by PLACE Placement



| AVAIL | Count | PLACE: TB 1.0 | TD 2.0 | SA 3.0 | Preneed 4.0 | Mutual funds 5.0 | Row Total |
|---|---|---|---|---|---|---|---|
| to 25,000 | 2.0 | | 12 | 7 | 9 | | 34<br>35.9 |
| to 80,000 | 3.0 | 1 | 13 | 6 | 2 | 1 | 31<br>32.6 |
| > 80,000 | 4.0 | 1 | 14 | 2 | | 1 | 31<br>32.6 |
| | Column Total | 2<br>2.1 | 39<br>41.1 | 15<br>15.8 | 11<br>11.6 | 2<br>2.1 | 95<br>100.0 |

(Continued)



09 May 99 SPSS for MS WINDOWS Release 6.0

AVAIL Available by PLACE Placement



| AVAIL | Count | PLACE: Stocks 7.0 | Money market 8.0 | Real estate 9.0 | Row Total |
|---|---|---|---|---|---|
| to 25,000 | 2.0 | 2 | 3 | 1 | 34<br>35.9 |
| to 80,000 | 3.0 | 4 | 1 | 2 | 30<br>31.6 |
| > 80,000 | 4.0 | 1 | 5 | 7 | 31<br>32.6 |
| | Column Total | 7<br>7.4 | 9<br>9.5 | 10<br>10.5 | 95<br>100.0 |

| Chi-Square | Value | DF | Significance |
|---|---|---|---|
| Pearson | 27.43559 | 14 | .11659 |
| Likelihood Ratio | 30.94592 | 14 | .10564 |
| Mantel-Haenszel test for linear association | 2.63613 | 1 | .10446 |

Minimum Expected Frequency - .632
Cells with Expected Frequency < 5 - 20 OF 24 (83.3%)

| Statistic | Value | ASE1 | Val/ASE1 | Approximate Significance |
|---|---|---|---|---|
| Phi | .53740 | | | .11659 *1 |
| Cramer's V | .38000 | | | .11659 *1 |



122

## IHAP Position Paper

## on the Mutual Fund Industry Study Submitted by AGILE

The Investment Houses Association of the Philippines (IHAP) has reviewed the paper submitted by AGILE on the mutual fund industry. IHAP concurs and supports the recommendations of AGILE as presented in their report. Specifically, IHAP agrees with and recommends the following mode of action.

1. **Legislative Agenda** : On the legislative front, IHAP endorses and supports the move to push for the enactment of several key Capital Market Reform Bills. These include the Securities Act of 1999, the Revised Investment Company Act, the Pre-Need Securities Code, and the Personal Equity Retirement Account Bill.

   A) PERA Bill: Specifically, IHAP is in favor of expanding the coverage of the Personal Equity Retirement Account Bill. In its current form, the PERA Bill has several limitations that may be open to improvements.

   IHAP is supportive of the move to widen the scope of available investment instruments to include not only mutual funds but also other instruments like Asset Backed Securities, Annuity Instruments, Pre-Need Products, Insurance Products, Investment Trusts, and others.

   B) Restrictions on Directors and Officers: IHAP would like a review and rationalization of the restriction on officers and directors of investment houses from becoming directors and officers of investment companies and mutual funds. We believe that this restriction unfairly prejudices investment houses and investment companies as well.

   C) Role of Banks and Other Financial Institutions: IHAP recommends the rationalization of the role that banks and other financial institutions will play in the development of mutual funds in the country. Specifically, we would like a review and relaxation on the prohibition that banks and other financial institutions cannot sell or be involved in the sale of mutual funds.



123

2. Fiscal Policy IHAP is supportive of the move to recommend amendments to the tax laws in order to correct prejudicial affects these may have to mutual funds IHAP endorses the move to lobby and encourage actions seeking liberalization and amendments to prevailing tax laws, especially those consistent with its vision of strengthening domestic trading and underwriting activities.

3. **Regulatory Reforms** : IHAP is supportive of the move to recommend and initiate internal structural reforms in the Securities and Exchange Commission and in the Bangko Sentral ng Pilipinas in order to improve its regulatory and oversight functions over the industry.



124

| | | |
|---|---|---|
| Memo to | | Mr. Ping Francisco<br>Mr. Bobby Arendido<br>Mr. Bing Matoto<br>Mr. Noel Borlongan |
| From | | Mr. Terry Coronel |
| Date | : | April 26, 1999 |
| Re | : | Proposed IHAP Position Paper on the Mutual Fund Industry |

We are pleased to attach the proposed position paper of the Investment House Association of the Philippines for your comments.

Trusting that it meets your requirement.

Terry Coronel



125

## Position Paper of the Investment Houses Association of the Philippines on the Mutual Fund Industry

### A. The State of the Philippine Mutual Fund Industry

As the Philippines improves its infrastructure support to meet the demands of a robust domestic economy, there is a need for its investment requirements to be matched by long term sources of domestic financing. The shortage of such domestic financing must be addressed immediately to avoid the occurrence of an unsustainable level of foreign debt and to lessen the vulnerability of the economy against volatile foreign capital. While the national government has been successful in generating fiscal surpluses in the past through the proceeds it generates from its privatization efforts as well as through borrowings from abroad, there is an immediate need to replace such sources of funds by increasing the savings rate of households and other government entities.

A key element in the rapid development of other countries is a dynamic capital market that will provide the impetus and sustained financing for present and future economic requirements. This is traditionally coursed through the Stock Markets, Fixed Income Markets and the Mutual Fund Industry. While the Philippines is on its way towards developing and improving the state of its Stock Markets and Fixed Income Markets, the Mutual Fund Industry is one sector which should merit considerable attention.

The Philippine Mutual Fund industry is still too small, too unknown, lacking in resources, young and unprofitable. While the industry does exist, it is far from the viable and vibrant mutual fund markets which have played key roles in other countries. A successful mutual fund industry can be an engine for the development of Philippine capital market through the provision of liquidity in the secondary market. This added liquidity will help encourage new public offerings, provide viable alternative products and services, improve intermediation, capital allocation and formation, and ultimately,

can spur the development of the economy. No doubt, the development of the Philippine Mutual Fund industry is consistent and complementary to the vision of the Investment Houses Association of the Philippines in terms of improving the state of capital markets in the Philippines.

## B. The Mutual Fund Industry's Underperformance

One of the reasons for the disappointing performance of the industry has been attributed to the negative perception it has gained through the years. The scandals and high front end loads during the initial years have contributed to investor disappointment, as well as to overly strict government reactions. When the government decided to allow the mutual fund industry to operate again in the 1990's, the industry has now been hampered by stringent regulations, the lack of long term track record, the lack of well funded sponsors, and the lack of expertise both on the investor, sponsor and government sectors.

Mutual fund industries in many countries started in the 1970s. But as early as the 1950s, the Philippines already had its first mutual fund. The minimal participation of Philippine mutual funds in equity investments reflected the government's cautious policy towards the development of the industry.

Economic stability in the 1970s led to a growing middle class that sought diversified investment vehicles with higher rates of returns. This has led to agency and trust agreements between investors and the larger commercial banks, and to the birth of the common trust funds (CTF). While the CTFs overtook the performance of the popular deposit accounts, they did not perform all the functions of a mutual fund, which include public disclosure of investment policies, transparency of investment holdings and net asset values, investment in publicly listed stocks, etc. The CTFs became very popular because of the absence of a reserve requirement from the Central Bank. The imposition of the reserve requirement on CTFs effectively halted their rapid growth.



127

and the asset levels dropped to P70 billion by 1995. The immense asset base of the CTF at its height definitely point to the market potential for mutual funds in the country

With substantial improvements in economic fundamentals and the recent success of the Philippine Stock Exchange, the regular Filipino investor is now more confident in exploring various investment alternatives, one of which may be the mutual fund industry. With the appropriate government support, funds in the CTF business can otherwise be channelled into developing a proper mutual fund industry that will be more open and transparent. This next step will definitely be a milestone in the further development of the Philippine capital markets.

## C. The Investment Banking Industry and the Mutual Fund Industry

There is no doubt that the eventual success of the mutual fund industry in the Philippines will mean a tremendous improvement in the state of the capital markets, and to Investment Banking in general. The Investment Houses Association of the Philippines, through its members, will be one of the prime beneficiaries of such an improvement through the following:

1. **Increased liquidity in the financial system will serve as an incentive for the creation of new financial instruments.** At present, the Philippine capital markets has a limited number of investment vehicles to cater to the small size of the market. Even though the Philippines has one of the oldest stock exchange in Asia, we only have 120-140 issues actively traded, and out of which only 50 issues can account for almost 90% of the entire stock market capitalization. This pales in comparison to Thailand's 413 issues or Malaysia's 736 issues listed and traded. The increased liquidity generated from the mobilization of funds through mutual funds will incentivize users to tap the capital markets through new issuances and instruments, therefore providing additional activities and business for investment houses.



128

2. **Opportunities for Investment Houses to become sponsors of funds.** Another opportunity whereby investment houses can actively participate and benefit from the mutual fund industry is through the organization and formation of Investment Companies. At present there are several investment houses who have already taken the initiative to organize their own funds and asset management companies.

3. **Increased professionalism of the industry will have a carryover effect into the capital markets.** The regeneration of the mutual fund industry will definitely attract global expertise, talent and resources into the Philippines. The entry of such professionals, either as employees or through joint ventures with domestic corporations will indirectly result in technology transfer and in the upgrading of the skills and benchmarks for our own domestic industry. This will eventually result in the adoption of best practices at competitive pricing. All this will redound to the benefit of industry participants and investors, including the investment houses in general.

4. **Increased investor sophistication will open up opportunities for more creative and innovative products and services.** With the increased participation of the general public through mutual funds, it is expected that a larger percentage will become more familiar with the available investment instruments. This will make the public more educated and willing to evaluate potential new instruments to be structured by investment houses. Increased sophistication will eventually increase the public's propensity to try and adopt new methods, practices and instruments for the market.

5. **Wider participation into the capital markets will decrease volatility, thereby reducing long term risks from underwriting activities.** One main criticism of the Philippine market is that we are highly dependent on the whims of foreign portfolio investments. With the occurrence of every boom or bust, the market can possibly swing wildly in one direction or the other, often having adverse effects on the holdings of the individual Filipino. With the greater participation of Filipinos in the investment arena through mutual funds, we can hopefully mitigate and balance the overpowering influence of foreign funds through a healthy domestic market. This will reduce volatility in the markets, and will eventually lower the risks being faced by investment houses in their underwriting activities leading to lower intermediation costs in the future.

## D. Investment Houses Association of the Philippines (IHAP) Position

Based on the above mentioned arguments, the Investment Houses Association of the Philippines concurrs and supports the recommendations of AGILE as presented in their report for the Mutual Fund Industry. Specifically, IHAP would like to take the following mode of action.

1. **Legislative Agenda** : On the legislative front, IHAP endorses and supports the move to push for the enactment of several key Capital Market Reform Bills. These bills which could have significant direct and indirect beneficial effects on the fund industry will also indirectly benefit and rationalize the capital markets. These include the Securities Act of 1999, the Revised Investment Company Act, the Pre-Need Securities Code, and the Personal Equity Retirement Account Bill.

A) PERA Bill: Specifically, the Investment Houses Association is in favor of expanding the coverage of the Personal Equity Retirement Account Bill. In its current form, the PERA Bill has several limitations that may be open to improvements. One of these is the limitation on investment vehicles to fixed income securities and to shares of stocks of listed domestic companies only. Apart from these two instruments, IHAP is supportive of the move to widen the scope of available investment instruments to include not only mutual funds but also other instruments like Asset Backed Securities, Annuity Instruments, Pre-Need Products, Insurance Products, Investment Trusts, and others. These limitations, along with the limitation that allows only banks to play a key role in the savings generation campaign may prove detrimental and imprudent, especially in light of the principle of diversification and liberalization.

B) **Restrictions on Directors and Officers**: Another key item which the Investment Houses Association would like to address is a review and rationalization of the restriction on officers and directors of investment houses from becoming directors and officers of investment companies and mutual funds. We believe that this restriction unfairly prejudices investment houses and investment companies as well, by depriving investment companies of the needed expertise in terms of evaluating market conditions and new instruments. Investment houses have been one of the most active sectors which have promoted capital market instruments, and are most familiar with the capital market situation. This knowledge and information is a valuable resource which fund management companies can utilize. While there is the argument that a potential conflict of interest may arise, it is our belief that the proper safeguards can be put in place without the need for a sweeping generalization that works to the prejudice of both industries.



131

C) **Role of Banks and Other Financial Institutions**: One of the most important issue that has to be addressed in the legislative front is the rationalization of the role that banks and other financial institutions will play in the development of mutual funds in the country. While we recognize the fact that the mutual fund industry has suffered because of the bad experiences in the 1970's, it is the opinion of the IHAP that the mutual fund industry can only flourish if credibility is brought back. This can only be done if mutual funds can benefit from the credibility and financial backing of the larger commercial banks and financial institutions. During this fledgling stage, it is important that a critical mass be achieved soon, and this can be done by allowing banks and other financial institutions to become involved -- either through ownership, sponsorship, synergy in terms of personnel and experience, or through the use of common facilities. We believe that this move, if allowed by the regulatory bodies, will enable the industry to experience a quantum leap in terms of growth. While we recognize the potential for conflicts of interests, it is our position that the benefits will far outweigh any potential issues, and that the proper safeguards can be put into place to mitigate these issues.

2. **Fiscal Policy** : The Investment Houses Association is supportive of the move to recommend amendments to the tax laws in order to correct prejudicial effects these may have, not only to mutual funds but to other securities in general. While the Tax Reform Act of 1997 provided fundamental relief to the mutual fund industry by reducing the burden of double taxation, there are still a number of other tax provisions and regulations which continue to hamper and discriminate against mutual funds and other securities. These include the Documentary Stamp Tax, the Dividends Tax, Stock Transaction Taxes, Capital Gains Tax, Withholding Tax, and the Initial Public Offering Tax, and the "No Tax Preference for Pre-Need Companies". The taxation the Philippine government imposes acts more as a disincentive for investment and secondary trading, which eventually hampers and limits the growth of the domestic capital markets. IHAP endorses the move to



132

lobby and encourage actions seeking liberalization and amendments to prevailing tax laws, especially those consistent with its vision of strengthening domestic trading and underwriting activities.

3. **Regulatory Reforms** : IHAP is supportive of the move to recommend and initiate internal structural reforms in the Securities and Exchange Commission and in the Bangko Sentral ng Pilipinas in order to improve its regulatory and oversight functions over the industry. Being under the purview of the SEC and the Bangko Sentral ng Pilipinas, IHAP recognizes the need to work hand in hand with its regulators in upgrading the skills and the capabilities of the SEC and BSP in order to police the industry from unscrupulous activities. It is only through the creation of an environment of confidence and trust will the investing public come back and put its faith and funds in the capital markets.

**Comments of Lewis J. Mendelson**
**Capital Market Consultant**
**on**

**The Revised Securities Act("RSA")**
**House Bill ___**
**Consolidating HB 297 and 3349, with SEC proposals**
**Eleventh Congress, First Regular Session**

# THE SECURITIES ACT OF 1999

## I. INTRODUCTION

Thank you for this opportunity to congratulate the Committee on Banks and Financial Intermediaries and express my strong support for enactment of the historic **Securities Act Of 1999**. This is an excellent Bill. Its passage, *with a few essential clarifications which are needed to maintain the internal consistency of the legislation and the integrity of the market*, should improve the protection of investors; strengthen the regulatory framework; and allow the market to play a more decisive role in the more efficient allocation of capital and the development of the Philippines capital market and, through it, of the economy.

On one level, this law is highly specialized. It bristles with unfamiliar technical legal terms and can be difficult to understand. On another level, its objectives are clear. They are to protect investors and to develop a fair, efficient, and transparent market in which informed investment decisions and fair competition allow the market to better allocate capital. My comments are designed to achieve those objectives by helping to assure the broad application of the protections that this law provides.

## II. THE "STATUTORY UNDERWRITER" AND THE NEED TO REGISTER CERTAIN PUBLIC OFFERS

My concern relates to preventing unauthorized persons from contaminating the distribution process in order that high standards of professionalism will prevail in the market. I would substitute a broad catch-all definition of a statutory **"underwriter"**. similar to that in S. 297, Section 2. (q), for the narrow definition, based on the Investment Houses Law, now found in Section 2.(r) of the Draft Bill. The lack of a "catch-all" definition of a person who has purchased securities from an issuer with a view to their distribution etc. will encourage back-door unregulated distributions of securities. The inclusion of such a provision will promote full disclosure, informed investment decisions,

Mr. Mendelson, an Attorney, spent 32 years at the US Securities and Exchange Commission, in both its Division of Enforcement, as a Senior Counsel, and its Division of Investment Management where he served as an Assistant Director. While at the SEC, he also undertook several international consulting assignments. In 1993, he joined PricewaterhouseCoopers as an international capital market specialist.

investor protection and the better allocation of capital.

That is because the concept of the *statutory underwriter* is a trigger for registration of securities. It protects against the sale of unregistered securities when there is a distribution in which such an unauthorized underwriter is involved. It goes further, because the Bill would hold the statutory underwriter accountable for damages in a civil action for false and misleading registration statements of issuers and their control persons that he participates in. Unless such a provision is included in the Bill, unauthorized persons who participate in the distribution of securities could not be sued. Fewer investors would receive the accurate information and protection that the registration of securities provides and possibilities for fraud and manipulative and deceptive practices would be increased.

The broad definition that I am suggesting is borrowed verbatim from the US law and is recognized around the world as a vital cog in securities regulation. Creating a *statutory* "underwriter" under this widely accepted definition would not bestow any privileges, licenses or even apparent authority on the person or entity to which it attaches. It would not alter the Investment Houses' exclusive status as the only entities licensed to "guarantee the distribution and sale of securities." To the contrary, defining such unlicensed persons as "statutory underwriters" protects investors and the integrity of the securities laws by requiring such "statutory underwriters" to provide the safeguards and to be held accountable and liable for any role they play in facilitating distributions of securities. It does not "license" them to do "underwriting."

Let me illustrate with a scenario. Assume that an intermediary could purchase a large block of unregistered securities from an issuer, as an "investor" in a "private placement" as permitted by Section 7.(a) (12) of the Draft Bill. Imagine that the XYZ Corporation would like to sell some shares to raise money for reasons it does not wish to disclose to the public or that it wants to avoid registration of those shares with the SEC. XYZ knows that if it makes a "public offering," in accordance with Section 5 of the Bill, it must register its shares and provide audited financial statements and complete accurate disclosures. It also knows that if it makes a "public offering" of its shares it will probably need to go through an "underwriting" with a licensed investment house and that would involve payment of an underwriting commission which it would rather avoid. Even worse, it knows that if it uses such a legitimate underwriter, the underwriter will perform "due diligence" as described in Section 16 (b) (2) of the Bill in order to avoid possible civil liabilities on account of a false registration statement.

**Conspirators.** To avoid registration and at the same time get the shares distributed and raise the money it needs, XYZ looks for a short cut. It finds someone who will pretend to "take for investment," but who they both know will market the shares in his own way as soon as possible thereafter. The deal is struck. XYZ sells its shares to less than 20 persons over 12 months, so it looks like a "private placement." The dummy investor resells the shares he bought in the "private placement" to a lot of unsuspecting investors.

Let's suppose that XYZ is in the computer business and it knew when it sold its shares that none of its computers were Y2K compliant and after December 31, no one could use them, and they couldn't be sold. Before this is discovered, the officers and directors of XYZ have gone off to Hong Kong or Brazil, disappeared with all the cash from the private placement. Now XYZ's customers are suing it, its stock price has plummeted and you are a shareholder who bought from the dummy investor.

You go to a lawyer. He says "we'll sue the dummy investor. He and XYZ should have registered those shares." Your lawyer files the case, but the dummy investor says "I'm exempt from the registration provisions either under Section 7 (a) (3) or 7 (a) (11) of the Bill . The sale to you was an isolated transaction not one made in the course of a repeated and successive transactions. And ***I'm not an "underwriter," I'm not licensed to guarantee the distribution and sale of securities of any kind by another corporation.*** Under the Securities Act of 1999, Section 7(a) (11), the dummy investor explains, ***"all transactions not involving an issuer or underwriter are exempt from the registration requirements, so forget about suing me or requiring me to file a registration statement."***

The point of my comment is that the Bill will not work if you restrict the definition of "underwriter" to one who is licensed to guarantee the distribution and sale. It needs to cover persons who act as conduits for placing securities in the hands of the investing public. That was the legislative intent of the US Congress when it adopted Section 2 (11) of the Securities Act of 1933, the model for this section and a lynchpin of the US Securities Act and the Bill you are considering.

A dummy investor or statutory "underwriter" could be liable to anyone who suffered damages on account of a false registration statement. He would be liable if the XYZ Corp. had registered the securities, even if it used a *bona fide* underwriter, if the dummy investor also had participated in the distribution by selling securities for the issuer in connection with the distribution (or in any of the other enumerated ways). Such a purchaser would be able to sue and recover damages from a "statutory underwriter" under Section 16 (a) (6) of the Bill, but would not be able to do so under the narrow definition in Section 2 (r ).

There are many variations of the basic scenario. Under each the dummy investor or statutory underwriter should be required to register any such securities purchased from an issuer with a view to distribution when he sells them. So long as the ultimate purchasers are members of the general public, that kind of transaction calls for the protection of the Act's registration provisions. The dummy investor does not have to conspire with the issuer to become a statutory underwriter. He may become one,

In SEC v. Chinese Consolidated Benevolent Association, 120 F.2d 738 (2d.Cir.,1941). A not for profit association helped solicit investment in foreign government bonds. The association maintained that it was not acting as securities promoters in the traditional sense, and that in promoting a worthy cause they should be exempt from the Act's coverage. The court held that the association's sales efforts were sufficient participation in the distribution and underwriting process so as to render the defendant's "underwriters" within the meaning of Section 2(11) of the Securities Act of 1933.

inadvertently, by aiding in a distribution. The securities could initially be registered and when resold could be required again to be registered by the "investor-underwriter" as a secondary distribution. Underwriter status also could attach to sales made by intermediaries on behalf of "controlling persons" and thus require the filing of a registration statement. Each variation leads to the same results.

I understand the concerns that you share with the Investment Houses. As securities lawyer and capital market specialist, I too am very concerned that high standards of professionalism prevail in the market. The best way to maintain the high standards of Presidential Decree No. 129, "The Investment Houses Law," to limit unauthorized persons from contaminating the distribution process and to protect investors by requiring the registration of securities where an intermediary acts as a conduit of securities to the public would be to substitute a provision similar to that in RSA 2.(q) for Section 2. (r) of the Bill.

## II. TRADITIONAL DISCLOSURE BASED SECURITIES REGULATION

### A. The Definition of "Securities" and the Choice of Regulator of Pre-Need Plans Affects the Allocation of Capital

Among the goals set forth in the Declaration of Policy is to "promote the development of a capital market and encourage the widest participation of ownership and the democratization of wealth." These are not just high sounding phrases. If this Bill can help to achieve these goals, it will have made an important start in providing capital for many enterprises, creating jobs and providing new products and technology to develop the economy.

My concern is that a narrow interpretation of the terms "securities" and "investment contract" will deny the protections that this law provides to an broad class of investors, many of them young first time investors who have no other savings. The definition of "securities" and the selection of the appropriate regulator will determine whether or not

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According to Professor Louis Loss' Treatise on Securities Law, Ch. 4, p. 246,

> "It is very common (in the US) for institutional investors, as well as wealthy individuals, to purchase large blocks of both registered and unregistered offerings. When these investors subsequently sell their securities there frequently may be a question as to the necessity for registration under the Act. [See, e.g. US v. Wolfson, 405 F.2d779 (2d.Cir.1968, cert.denied 394 US 946, 39. S. Ct. 1275, 22 L.Ed. 479 1969)] The problem is most likely to arise where the initial offering was not registered under the Act....The Commission has recognized the dangers of such large block purchases filtering down to the investing public (even when in connection with a public offering) may call for additional protection under the Act. Accordingly, the SEC formulated the "presumptive underwriter doctrine" under which anyone who purchased at least ten percent of a registered offering could be considered an underwriter unless the purchaser was able to prove that he orn she had sufficient investment intent." Pp.246-247.

The US SEC defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise. 17 CFR Sec. 230.405(f). Accordingly, the question of who is a control person is highly factual and does not depend on ownership of any specific percentage.



37

they understand before they invest, that there is a high risk of losing as much as 95 percent of their investments.

**My suggestion** is a change in emphasis. I would clarify that even though the Bill does not specifically define a "pre-need plan" as "securities," as in the existing Revised Securities Act ("RSA"), it is still a "security" because it is an "investment contract" and not insurance. The definition of "securities" does not need to be changed. I would like to make clear how broad and inclusive it is, so that the full scope of this Bill will be understood by those who must obey it, as well as those who must implement it. I would simply amend the " Declaration of Policy" and Section 13 (b) relating to regulation of Pre-Need Plans by the SEC, to assure that the SEC applies traditional disclosure based regulation to such securities in order that prospective plan holders receive the protections that their predecessors have lacked.

**Better allocation of capital.** The Philippines has a very low savings rate relative to many of its neighbors in South East Asia. To be competitive it needs to marshal as much of its assets as possible into productive investment. The Philippines needs to find a way to encourage savers to invest in productive enterprises. The need to attract domestic savings and investment to the capital market is linked to the definition of "securities" and to how securities are regulated. In more efficient capital markets, where there is abundant information about the securities offered, investors are able to make more intelligent choices and through their collective choices the market allocates capital.

**Pre-Need Plans.** Many Filipinos invest in Pre-Need Plans. Pre-Need Companies had sold **3.5 million plans** for a gross contract price of **P170 billion**, with gross collections of **P40 billion** and total benefits paid of only **P4** billion at year-end 1997 the latest available figures. The Pre-Need Industry had assets of **P 78.8 billion** at that date, compared with **P 90 billion** invested in Common Trust Funds ("CTFs") and only **P 3.3 billion** in investment companies at year-end 1998.

**Follow the money.** I was surprised to learn that a relatively small portion of plan holder's payments or trust fund assets reaches the securities markets. I estimate that out of gross collections of P40 billion only P5 billion or P 6 billion is invested in stocks. Start with the fact that only **40 percent** of what a pre-need plan holder invests must be placed in trust and invested in his behalf. Indeed, only **5 percent** during the first two years after investment. Total pre-need trust funds at year-end 1997 were **P 20 billion**. According to information compiled by the SEC, stocks (including net increment) accounted for 26.9 % of trust fund assets. That's roughly **P5 to P6 billion.** Real estate accounted for 26.2 % of the total (including a 10% appraisal increment) at year-end 1997. Moreover, because of the lack of prudential investment standards and rigorous controls on related transactions, some portion of those funds could be invested pet projects of the plan company managers.

For the market to improve the allocation of resources, investors will need to be given

Based upon the 1997 distribution of the portfolio investments of the 24 largest Pre-Need Corporations with trust fund equity of over P 16.9 billion, representing 94 % of total trust fund equity.

more information. In a sense, they will need to be re-educated. One way to start would be through traditional offer document risk disclosure. Although they will vary from plan to plan, risk factors that could apply to many plans and which might influence an individual investment decision and the allocation of capital, if disclosed, would probably look something like the following:

- Only 40% of your money will be invested on your behalf over the pay-in period of your installment contract, and only 5% during the first two years;
- Your sales agent will receive 50% of the payments you make during the first two years of your plan;
- The success of this plan depends upon a large percentage of individual plans lapsing;
- The lapse experience on this plan is that more than (some percentage) (50%) (60%) of plans sold have lapsed before reaching their availment date:
- If your plan lapses, you are likely to lose more than half of your investment;
- A typical plan pays a rate of between 3% to 7% per year depending how long it is held, or an average annual return of approximately 5%, which is less than the 8% average rate of inflation over the past five years, thus the real rate of return on this investment over that period has been negative; and
- Of the money invested in the plan trust fund, a large portion has been invested in real estate which may currently be over-valued and illiquid; if this condition continues it may affect the plan company's ability to meet the "guaranteed" amount of your plan.

***Who will educate investors?*** The Pre-Need Industry has over 200,000 sales agents located throughout the Philippines. Few are full-time. Most have other jobs and sell almost exclusively to their friends and relatives. They receive a high commission in the form of a front-end load on each installment plan that they sell. There is high turnover among them. Once they have sold their friends and relatives they may remain sales agents in name only. SEC rules allow pre-need salesmen's licenses to be issued simply upon certification under oath *by the issuer (plan company)*, that the salesman has been duly trained under a training program approved by the SEC. The rules do not specify the training standards.

These sales agents, armed with Pre-Need sales literature, are the people who have direct contact with a large segment of young or first time investors who are potential long-term investors. Under the **SEC's** present non-disclosure policy, or under regulation by the **Office of the Insurance Commission**, these sales agents (even if subject to more stringent licensing requirements) would continue to be the persons who educate investors. Only they would provide those investors with whatever information they are going to get in order to make intelligent investment decisions. Those sales agents are the persons that are influencing a significant portion of capital allocation in the Philippines.

***"Full Disclosure, a better way."*** Full disclosure is a better way to educate and protect investors and to allocate investments to the capital market. As securities, pre-need plans have been and should continue to be subject to SEC regulation. The SEC has not

yet required the kinds of disclosures outlined above. SEC Chairman Yasay testified on February 16, 1999, to the effect that if the SEC were to treat Pre-Need Plans like other securities, it would have to require full disclosure of the risks involved in investing in them.

The US SEC when confronted with a similar question involving Scholarship Plans in 1968, opted for full disclosure. *In the Matter of The Trust Fund Sponsored by the Scholarship Club, Inc.*, ICA Rel. No. 5524, (1968 SEC LEXIS 563) (October 25, 1968). The Commission ruled that the plan was an investment company, but relied on traditional principles of disclosure to grant exemptions that resolved difficult regulatory problems under the Investment Company Act. It stated:

> "We are not prepared to assume, in advance, that it will not be possible to arrive at a proper presentation, in the prospectus and sales literature as well as in the terminology of the plan agreements, which will give adequate, accurate and explicit information, fairly presented, as to the nature of the plans." (p.5)

> "* * *(W)e believe that the critical requirement here ... is that of a full disclosure of the features of the plans with respect to the forfeiture provisions and their consequences." (p.7)

The SEC could require that pre-need plans, just like any other offering of securities, provide investors an offering document or prospectus which complies with SEC rules and provides the information and education that traditional SEC risk disclosure would provide.

Section 13 of the Bill should be more than a transitional provision that provides stop-gap regulation pending approval of a Pre-Need Code. To provide for better allocation of capital and to protect investors, I recommend that regulation of pre-need plans be kept with the SEC, an agency that is devoted to full disclosure as well as maintaining the soundness of the product. The education of these kinds of investors would then, at least in part, be subject to review by an objective third party experienced in requiring the disclosure of accurate material information.

Section 13 (b) authorizes the Commission to promulgate rules, regulations and orders necessary and appropriate to regulate the sale of pre-need plans by, "requiring disclosures to prospective planholders." To assure that the SEC devotes itself to *full* disclosure, I recommend that the quoted words be amended to read: "requiring ***full*** disclosures ***of material risks*** to prospective plan holders ***to enable them to make***

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In a companion case, decided by a Hearing Examiner, *In the Matter of the Trust Fund Sponsored by the Episcopal School Foundation College Award Program, Inc.*, Initial Decision of Hearing Examiner Sidney Gross, AP File No. 3-1374, 812-2229 (1968 SEC LEXIS 2734) (October 24, 1968), another Plan also was found to be an investment company. To reach that conclusion, it first had to be decided that the plan company was issuing securities. Neither Scholarship Club challenged that fact. (Copies of each case will be supplied to the Committee.)

***informed investment decisions....***" I also suggest that the Declaration of Policy be amended as follows to provide similar guidance.

> "It is hereby declared to be the policy of the state ***to protect investors,*** to encourage private corporations to broaden the base of their ownership, to enhance a socially-conscious free market that regulates itself, to promote the development of a ***fair, efficient and transparent*** capital market...etc.."

I don't have a crystal ball, but I suspect that with full disclosure the Pre-Need Companies would improve their products and have their sales agents trained and licensed so that they would become investment counselors who would offer a broad range of investments to meet their clients' needs. Full SEC risk disclosure regulation will provide the best protection to investors, will allow the market to better allocate capital to the most efficient enterprises, and will provide the kind of recognizable legislative and regulatory environment that inspires trust and confidence among global investors.

**B. Legal Analysis**

The RSA in Section 2(a) specifically includes both "investment contracts" and "pre-need plans" under its definition of securities. The removal of the specific words "pre-need plans" from the definition of "securities" in the pending Bill does not mean that pre-need plans are not securities. Pre-need plans are securities because they are "investment contracts" and investment contracts are securities.

Section 3 (a) (2) of the Bill, as here relevant, defines securities as "shares, participation, or interests in a corporation or a commercial enterprise or profit making venture and evidenced by a certificate, contract or instrument. It includes:

....

(2) Investment contracts, certificates of interest or participation in a profit sharing agreement,..."

The leading US case that defined an "investment contract" as a "security" under the Securities Act of 1933 is SEC v. Howey Co., 328 US 293 (1945). It held that:

> "an investment contract for purposes of the Securities Act (n25) means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." At p. 299.

The pre-need plan fits this definition. It involves a "contract, transaction or scheme," ( *i.e.,* the pre-need plan, contract or certificate) whereby the plan holder investor gives his money to a common enterprise. It is a "common enterprise" because the plan company must invest at least 40 percent in a trust fund for the benefit of the planholder and applies 60 percent for its expenses and profits. The plan holder is led to expect profits

(the plan proceeds after passage of a number of years) solely from the efforts of the promoter or a third party (the trustee) and not from the plan holders' own efforts.

The definition of "pre-need plans" at Section 3 (ee) of the Bill describes them as "*contracts* which provide *for ...the payment of future monetary considerations*...with or without insurance coverage..." It recognizes that they are not insurance, but that they are investment contracts. The inclusion in the Bill of Section 13 which provides for continuing SEC regulation of Pre-Need Plans can be rationalized on the ground that the plan is an investment contract and therefore falls within the Bill's definition of "securities."

**Statement of Lewis J. Mendelson**
**on**
# THE SECURITIES ACT OF 1999

Thank you for this opportunity to congratulate the Committee on Banks and Financial Intermediaries and to express my strong support for enactment of the historic **Securities Act Of 1999**. A more complete version of my views, supported by the legal authority, has been submitted to the Committee. This is an excellent Bill. Its passage, *with a few essential clarifications which are needed to maintain the internal consistency of the legislation and the integrity of the market*, should improve the protection of investors; strengthen the regulatory framework; and allow the market to play a more decisive role in the more efficient allocation of capital and the development of the Philippines capital market and, through it, of the economy.

On one level, this law is highly specialized. It bristles with unfamiliar technical legal terms and is difficult to understand. On another level, its objectives are clear. They are to protect investors and to develop a fair, efficient, and transparent market in which informed investment decisions and fair competition allow the market to better allocate capital. My comments are designed to achieve those objectives by helping to assure the broad application of the protections that this law provides.

My concern relates to preventing unauthorized persons from contaminating the distribution process in order that high standards of professionalism will prevail in the market. I would substitute a broad catch-all definition of a statutory **"underwriter"** similar to that in S. 297, Section 2. (q), for the narrow definition, based on the Investment Houses Law, now found in Section 2.(r) of the Draft Bill. The lack of a "catch-all" definition of a person who has purchased securities from an issuer with a view to their distribution etc. will encourage back-door unregulated distributions of securities. The inclusion of such a provision will promote full disclosure, informed investment decisions, investor protection and the better allocation of capital.

That is because the concept of the *statutory underwriter* is a trigger for registration of securities. It protects against the sale of unregistered securities when there is a distribution in which such an unauthorized underwriter is involved. It goes further, because the way the Bill is designed it would hold the *statutory underwriter* accountable for damages in a civil action for false and misleading registration statements of issuers and their control persons that he participates in. ***Unless such a provision is included in the Bill, unauthorized persons who participate in the distribution of securities could not be sued. Fewer investors would receive the accurate information and protection that the registration of securities provides and possibilities for fraud and manipulative and deceptive practices would be increased.***

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Mr. Mendelson, an Attorney, spent 32 years at the US Securities and Exchange Commission, in both its Division of Enforcement, as a Senior Counsel, and its Division of Investment Management where he served as an Assistant Director. While at the SEC, he also undertook several international consulting assignments. In 1993, he joined PricewaterhouseCoopers as an international capital market specialist.

The broad definition that I am suggesting is borrowed verbatim from the US law and is recognized around the world as a vital cog in securities regulation. Creating a *statutory* "underwriter" under this widely accepted definition would not bestow any privileges, licenses or even apparent authority on the person or entity to which it attaches. It would not alter the Investment Houses' exclusive status as the only entities licensed to "guarantee the distribution and sale of securities." To the contrary, defining such unlicensed persons as "statutory underwriters" protects investors and the integrity of the securities laws by requiring such "statutory underwriters" to provide the safeguards and to be held accountable and liable for any role they play in facilitating distributions of securities. It does not "license" them to do "underwriting."

Let me illustrate that with a scenario. Assume that an intermediary could purchase a large block of unregistered securities from an issuer, as an "investor" in a "private placement" as permitted by Section 7 (a)(12) of the Bill. Imagine that the XYZ Corporation would like to sell some shares to raise money for reasons it does not wish to disclose to the public or that it wants to avoid registration of those shares with the SEC. XYZ knows that if it makes a "public offering," in accordance with Section 5 of the Bill, it must register its shares and provide audited financial statements and complete accurate disclosures. It also knows that it will probably need to go through an "underwriting" with a licensed investment house and that would involve payment of an underwriting commission which it would rather avoid. Even worse, it knows that if it uses such a legitimate underwriter, the underwriter will perform "due diligence" as described in Section 16 (b) (2) of the Bill in order to avoid possible civil liabilities on account of a false registration statement.

**Conspirators.** To avoid registration and at the same time get the shares distributed and raise the money it needs, XYZ looks for a short cut. It finds someone, let's call him a dummy investor, who will pretend to "take for investment," but who they both know will market the shares in his own way as soon as possible thereafter. The deal is struck. XYZ sells its shares to less than 20 persons over 12 months, so it looks like a "private placement." The dummy investor resells the shares he bought in the "private placement" to a lot of unsuspecting investors.

Let's suppose that XYZ is in the computer business and it knew when it sold its shares that none of its computers were Y2K compliant and after December 31, no one could use them, and they couldn't be sold. Before this is discovered, the officers and directors of XYZ have gone off to Hong Kong or Brazil, disappeared with all the cash from the private placement. Now XYZ's customers are suing it, its stock price has plummeted and you are a shareholder who bought from the dummy investor.

Your lawyer says "we'll sue." The dummy investor and XYZ should have registered those shares and disclosed all this information. But the dummy investor says "I'm exempt from the registration provisions either under Section 7 (a) (3) or 7 (a) (11) of the Bill . The sale to you was an isolated transaction, not one made in the course of repeated and successive transactions. And ***I'm not an "underwriter," I'm not licensed***

***to guarantee the distribution and sale of securities of any kind by another corporation.*** Under the Securities Act of 1999, Section 7(a) (11)," the dummy investor explains, ***"all transactions not involving an issuer or underwriter are exempt from the registration requirements, so forget about suing me or requiring me to file a registration statement."***

On the other hand, a dummy investor or statutory "underwriter" could be liable for damages on account of a false registration statement, even if the XYZ Corp. had registered the securities and used a *bona fide* underwriter. If the dummy investor also had participated in the distribution by selling securities for the issuer in connection with the distribution (or in any of the other enumerated ways), he would be liable to anyone who suffered damages. Under Section 16 (a) (6) of the Bill, that person would be able to sue and recover damages from a statutory underwriter, but would not be able to do so under the narrow definition in Section 2 (r ).

The dummy investor does not have to conspire with the issuer to become a statutory underwriter. He may become one, inadvertently, by aiding in a distribution. The securities could initially be registered and when resold could be required again to be registered by the "investor-underwriter" as a secondary distribution. Underwriter status also could attach to sales made by intermediaries on behalf of "controlling persons" and thus require the filing of a registration statement. Each variation leads to the same results. So long as the ultimate purchasers are members of the general public, that kind of transaction calls for the protection of the Act's registration provisions.

The Bill will not work if you restrict the definition of "underwriter" to one who is licensed to guarantee the distribution and sale. It needs to cover all persons who act as conduits for placing securities in the hands of the investing public. That was the legislative intent of the US Congress when it adopted Section 2 (11) of the Securities Act of 1933, the model for this section and a lynchpin of the US Securities Act, and of the Bill you are considering. If the concept of statutory underwriter is dropped, you will have to take a long hard look at this bill to find another way to prevent the mischief I have described and protect investors.

I understand the concerns that you share with the Investment Houses. I too want high standards of professionalism to prevail in the market. The best way to prevent unauthorized persons from contaminating the distribution process and to protect investors is to substitute a provision similar to that in RSA 2.(q) for Section 2. (r) of the Bill.

I would also like briefly to mention another concern. Too narrow an interpretation of the terms "security" and "investment contract" would deny the protections that this law should provide to pre-need investors. Although the Bill does not specifically define a "pre-need plan" as a "security," as in the existing Revised Securities Act ("RSA"), the pre-need plan still fits that definition because it is an "investment contract" and not insurance. I would retain the SEC as the long-term regulator of Pre-Need Plans and would simply amend the "Declaration of Policy" and Section 13 (b) relating to regulation of Pre-Need Plans by the SEC, to assure that the SEC applies traditional



145

disclosure based regulation to such securities in order that prospective plan holders receive the protections that their predecessors have lacked.

**Preliminary Comments of Lewis J. Mendelson,**
**Capital Market Consultant**
**on**

**The Revised Investment Company Act ("RICA")**

**House Bill No. 85, Eleventh Cong. First Reg. Sess.**
**S.B. 152, Eleventh Cong. First Reg. Sess.**

## Introduction: Principles of Investment Company Regulation

Investment companies (mutual funds) can play a dynamic role as a catalyst to market development. To the extent that the Philippines fund industry can more fully realize its potential, it should bring more people and assets into the securities markets. It should not only provide sounder investments for shareholders and help to better educate investors, but should also play a more significant role in capital formation, helping to build and maintain the liquidity of the capital markets. As sophisticated, discriminating investors, funds can help to raise standards in the securities markets. As investment companies earn the public's trust and confidence they can make an enormous contribution to the growth, health and vitality of the Philippines capital markets and through them to its economy.

To encourage the development of the fund industry:

- ***the legislative and regulatory framework*** must include the essentials of mutual fund regulation;
- the ***regulator's*** approach, organization and capacity should be sufficient and flexible enough to fully implement the regulatory scheme; and
- ***the mutual fund industry*** should "buy in" to the regulatory program as a full partner , whether through self regulatory organizations or trade associations, in order that the entire industry and its individual mutual funds and investment managers observe high professional standards and foster a climate of compliance.

Although I have included some policy and technical comments which I hope can be of some benefit, I am pleased to be able to say that that the proposed RICA legislation meets or exceeds the essentials of mutual fund regulation and I urge that it be enacted as soon as possible with only a few changes.

### *The Regulatory Framework*

Investment companies present a unique regulatory challenge. They involve large amounts of liquid assets often managed by persons not personally known to the shareholders and who may also be associated with larger enterprises involved in other businesses. In view of the possible conflicts of interest, which their structure can engender, funds require

special protection. Every phase of investment company regulation should be guided by the broad general principle that investment companies are like trusts. Their officers and directors, investment advisors and managers and the persons involved with them, like trustees, must observe the highest duty of loyalty to the shareholders who are essentially the beneficiaries of the trust. Investment companies must be administered solely in the interests of their shareholders, and any business practice that deviates from this basic fiduciary principle should not be tolerated.

**Essentials of Investment Company Regulation.** We can measure the proposed RICA legislation against the *"Objectives and Principles of Securities Regulation"* published by the International Organization of Securities Commissions ("IOSCO"). Its *"Principles for Collective Investment Schemes"* raise the following questions:

Does the regulatory system set standards for the licensing and regulation of those who would market and operate a collective investment scheme? Does the regulatory system provide rules setting the legal form and structure of such schemes and the segregation and protection of client assets? Does the regulatory system require disclosure, as for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme? Do regulations ensure that there is a proper and disclosed basis for asset valuation and the pricing and redemption of units in a collective investment scheme?

I am quite comfortable that the answer to these questions with RICA is "Yes, for sure." I considered the IOSCO Principles and other standards of investment company regulation used around the world. Experts have distilled them into what one might call the essentials of investment company regulation. The proposed RICA legislation includes the seven major areas of protection for investors which I believe are the hallmarks of successful mutual fund regulation the world over:

1. **Prohibit various forms of self dealing,** (See, for example, Section 7 which limits the functions and activities of investment companies and Section 21which prohibits transactions with certain affiliated persons and underwriters);

2. **Provide economic regulation of the remuneration of affiliates,** [See, for example, Section 17 (c ) which limits operational expenses of a registered investment company to 10 percent of average daily net asset value or such other amount the Commission by rule may prescribe. While the principle is correct, the 10% cap is far too high and would undermine the reason to invest in a fund. It should be lowered, perhaps in two steps, immediately to 5 % and within two or three years to a maximum of 3%. Sales loads are defined broadly and adequately in Section 3 (dd) and are required to be disclosed];

3. **Restrict unsound capital structures,** (See, for example, Section 14 that governs the structure and capitalization of investment companies. Para. 14 (2) requires that an investment company issue shares consisting solely of common stock.);



148

4. **Require clear disclosure of investment objectives and policies;** (See, for example, Section 8(2) which prevents deviation from any fundamental policy and Section 24(b) (3) {not (d) (3)} which requires filing of a registration statement containing fundamental investment policies, including investment objectives, concentration by issuer or industry group, liquidity standards, portfolio mix and other investment policies);

5. **Protect the physical integrity of assets,** (See, for example, Section 21 (f) which requires every registered investment company to place and maintain its securities and similar investments in the custody of a bank or such other category of person as the Commission may designate by rule to act as custodian and Section 21 (g) which gives the Commission Rulemaking power to require bonding of officers and employees with access to funds);

6. **Assure fair valuation of investor purchases and redemptions,** (See, for example, Section 3 (hh) which defines "value" and requires value to be market value for securities for which market quotations are readily available and fair value as determined in good faith by the board of directors for other securities and assets); and

7. **Assure that investors receive accurate periodic reports about the funds and their investments,** (See, for example, Sections 25 (a) and (b). These Sections set forth the reportorial requirements for Investment Companies and Affiliated Persons and include the requirement of filing with the Commission and transmitting to investment company stockholders an annual report containing financial statements and much other material and useful information and filing such other information and documents with the Commission as it may require to keep reasonably current the registration statement of the investment company).

**Provision for Self -Regulation of Investment Companies and Affiliates.** In addition to these essential provisions, I would like to compliment the draftsmen of RICA for including in it Section 42. That far-sighted Section provides the mechanism by which any association of registered investment companies and affiliated persons, such as the Investment Company Association of the Philippines may become a Self-Regulatory Organization for its members, including the power to train, administer proficiency examinations, and discipline its members. This could be one of the most important initiatives contained in this legislation.

My one concern is that RICA's excellent statutory and regulatory protections should be applied equally to all funds and investors in like financial products regardless of how they are packaged and who their sponsors may be. Investment funds may take various forms. They may be trusts, as in the United Kingdom, India and many other parts of the world. They may include insurance-like products such as variable annuities or face-amount contracts to pay a specified sum at a future date. Such certificates were popular in the United States during the 1930's as a hedge against deflation are recognized in the US "Investment Company Act of 1940" which includes a very broad definition of investment

company. There are perhaps two overriding reasons for a broader definition of investment company:

1) To provide equal protection to all investors in similar intangible collective investments the structure of which involves possible conflicts of interest.

2) To level the playing field, in other words, to not allow the regulatory framework to provide one or the other product a competitive advantage and thus favor it or even pre-ordain the investor's choice.

**Interpretation of RICA**

RICA's Section 2. The **Declaration of Policy** already has been modified significantly to reflect the importance of investment companies to today's conditions in the Philippines securities markets. It recognizes the funds role in improving the allocation of capital and in the creation of capital. Although the Declaration of Policy does not contain substantive provisions, it will guide the SEC, Courts and those subject to it in their subsequent interpretations of it. I suggest that you consider several language changes to emphasize the need to protect investors and to expand their choices by encouraging wider access to the industry and the creation of new investment company products. Specifically, consider:

Line 4. Insert after "in order to" "protect investors and "

Line 6. Insert after "is to" "promote the public interest by providing" (strike "provide") "a favorable" etc.;

Line 9. Refer to the need to encourage and promote sponsorship of the mutual fund industry by the best qualified professional investment managers regardless of origin; and to broaden the range and types of investment companies in order to expand the range of investment opportunities available to Filipinos;

Line 15. Refer to the need to interpret the Act liberally to provide equal protection to investors in all similar pooled investment vehicles and to provide the same competitive environment for all similar vehicles, their investment managers and sponsors;

Page 2
Line . 1. Insert after "at the same time" "promote the application of fiduciary principles in the management and supervision of mutual funds and high standards of professionalism by their distributors and others that provide services to them and" "seek etc."

**Sec. 3. *Definitions*.** Definitions are important to the interpretation and scope of the Act. The following comments are perhaps somewhat technical, however I believe they could improve the Act both substantively and stylistically.

(e) "Common stock"

Lines 22-24. Restore original definition. The prohibition against issuing senior securities is clearly stated in Section in Section 8 (a) (1). If necessary, amend Section 14 (1) to clarify further that investment companies may issue only one class of securities. See also Sections 9(a) and 11(b) (i) and (ii) referring to classes or series of securities. Should these also be modified to conform to the fact that no company may have classes or series of securities?

(g) "Control"

Line 29. Substitute "twenty-five percent (25 %)" for "thirty percent (30%)" in order to accord more closely with the realities of the market. The rebuttable presumption of control should take effect at 25%.

Page 7

(hh) "Value"

Lines 9 and 10

Page 8

Lines 9 and 10. There appears to be a discrepancy between the (hh) definition of "value" which excludes, and the Section 4 (a) (3) definition of Investment Company which includes, "The value of securities acquired after the end of the last fiscal quarter shall be the cost thereof." It may be advisable to harmonize these definitions.

Line 25. Add "except that a variable annuity issued by an insurance company shall be considered to be an investment company for purposes of the Act." See also p. 16, Lines 18-20. Section 13, which makes it unlawful for any investment company to guarantee any obligation of whatever kind or nature. Add to that, "however, issuance of a variable annuity shall not be deemed to be such a "guarantee."

**Substantive Provisions**

Page 12

Line 18. Refer to "Section 24 (b) (3)" not (d).

Lines 22 –29. No change is recommended in this section. However, in addition to changing investment policy, a similar result could be achieved if investment managers were permitted to manage more than one fund and to offer their shareholders the opportunity to switch from one to the other fund to achieve a more suitable investment



15

policy. This change would be accomplished in the recommendation below contained in the comment at Page 19, Line 22.

Page 13

Lines 7 and 12. References to particular "classes and series' of securities may be inapposite, in light of the Section 14 (2) limitation requiring investment companies to issue shares consisting solely of common stock. Is it intended that different series or classes of common stock be issued? Would they have different voting, dividend or liquidation rights? Perhaps this should be clarified.

Page 14

Lines 15-18. Section 9 (f) gives the Commission rulemaking power to limit excessive sales loads. In exercising this power it may wish to consider whether the payment of an exit fee of up to 2 % for redeeming fund shares less than two years after they are purchased should be made to the manager or distributor which is the current industry practice or more appropriately should be made to the investment company which may incur expenses if it must readjust its portfolio to accommodate such premature redemptions.

Page 19

Line 16. Substitute " shall not exceed five percent (5 %) during the first two years following enactment of this law and thereafter shall not exceed three percent (3%)" for shall not exceed ten percent (10 %)." An investment company with expenses approaching 10% has very little to offer investors. Even 5% will limit viability. Although I would not recommend a cap as high as 5%, I can understand it. There are currently few economies of scale because of the relatively small size of the funds.

Far better would be to remove inhibitions (duplicate regulation) on managers who manage more than one fund. (See Line 22, below.) That would encourage economies of scale that benefit all shareholders and help the fund industry become more viable.

Line 22. Add after "manager." "Upon such registration the Commission shall be the sole regulator of such investment manager, provided however that such manager shall restrict its activities to investment company management." This addition would eliminate dual regulation by the SEC and the BSP of investment managers that are solely engaged in mutual fund related operations.

Line 23. At some time in the near future it may be appropriate to enact a relatively simple Investment Advisors Act, requiring the registration and regulation of investment advisors. It would compliment RICA, provide increased transparency and professionalism and better protect investors. Drafting of such an Advisers Act can be deferred lest it any way impede the enactment of RICA.

## COMMENTS ON THE REVISED INVESTMENT COMPANY ACT AND ON THE SUGGESTED REVISIONS OF THE INVESTMENT COMPANY ASSOCIATION OF THE PHILIPPINES

We strongly support the call of the Investment Company Association of the Philippines (ICAP) for the urgent passage of the Revised Investment Company Act (RICA).

We believe that investment companies (mutual funds) can play a dynamic role as a catalyst to capital market development. To encourage the development of the mutual fund industry, a sound legislative and regulatory framework must be in place.

The proposed RICA legislation [Senate Bill (S.B.) No. 1118 authored by Senator Roco] includes the seven (7) major areas of protection for investors which we believe are the hallmarks of successful mutual fund regulation the world over:

1. ***Prohibit various forms of self dealing*** – See for example Section 7 which limits the functions and activities of investment companies and Section 21 which prohibits transactions of certain affiliated persons and underwriters;
2. ***Provide economic regulation of the remuneration of the investment companies and affiliates*** – See for example Section 17 (c) which limits operational expenses of a registered investment company to 10% of average daily net asset value or such other amount the Commission by rule may prescribe. While the principle is correct, the 10% cap is far too high and would undermine the reason to invest in a fund. We suggest that the cap be lowered to 5% and that within two or three years as the Commission shall determine, be lowered further to a maximum of 3%. Sales loads are defined broadly and adequately in Section 3 (ee) and are required to be disclosed;
3. ***Restrict unsound capital structures*** – See for example, Section 14 that governs the structure and capitalization of investment companies. Section 14 (2) requires that an investment company issue shares consisting solely of common stock;
4. ***Require clear disclosure of investment objectives and policies*** – See for example Section 8 (2) which prevents deviation from any fundamental policy and Section 24(b) (3) which requires filing of a registration statement containing fundamental investment policies, including investment objectives, concentration by issues or industry group, liquidity standards, portfolio mix and other investment policies;
5. ***Protect the physical integrity of assets*** – See for example Section 21 (f) which requires every registered investment company to place and maintain its securities and similar investments in the custody of a bank or such other category of person as the Commission may designate by rule to act as custodian and Section 21 (g) which gives the Commission rulemaking powers to require bonding of officers and employees with access to funds;

6. ***Assure fair valuation of investor purchases and redemptions*** – See for example Section 3 (ii) which defines "value" and requires value to be market value for securities for which market quotations are readily available and fair value as determined in good faith by the board of directors for other securities and assets; and
7. ***Assure that investors receive accurate periodic reports about the funds and their investments*** – See for example Sections 25 (a) and (b). These Sections set forth the reportorial requirements for investment companies and affiliated persons and include the requirement of filing with the Commission and transmitting to investment company stockholders an annual report containing financial statements and such other material and useful information and the filing of such other information and documents with the Commission as it may require to keep reasonably current the registration statement of the investment company.

Aside from the investor protection provisions, another important initiative contained in the RICA is the provision for self-regulation of the investment companies and its affiliates which includes the power to train, administer proficiency examinations and discipline its members.

The RICA, however, is not without flaws. The provision on the Declaration of the Policy can be revised to emphasize the need to protect investors and to expand their choices by encouraging wider access to the industry and the creation of new investment products. We wholly agree with ICAP that the definition of "underwriter" should be the expanded definition and not the narrow one which is in the proposed bill.

As regards the suggested revisions of the ICAP based on the RICA version dated September 19, 1997, we agree with its suggested revisions on the following:

1. On Section 9 - the insertion of the open-end companies in the title and on Section 9 (a) - the change of the term "investment company" to "open-end company".
2. On Section 14 (b)
3. On Section 17 (c) - the basis on the computation of the cap, but as we have earlier stated the cap of 10% should be lowered to 5% and within two or three years as the Commission shall determine, to 3%.
4. On Section 18 (d) (4)
5. On Section 20 (d) (Section 20 (c) of the RICA)
6. On Section 21 (a)
7. On Section 21 (d)
8. On Section 40 (a) (1)
9. On Section 3 (ff), (Section 20 (hh) of the RICA) except that there should be an additional phrase to be inserted between the words "undertaking" and "but" and should read "or participates or has a participation in the direct or indirect underwriting of any such undertaking;" and between the words "issuer" and

"any" and should read "any person directly or indirectly controlling or controlled by the issuer, or".

10. On Section 3 (x).

We are happy to note that the suggested revisions of the ICAP that we agree on, with the exception of No. 9 which deals with the definition of underwriter, have been incorporated in S.B. No. 1118.

On ICAP's suggested revision on Section 20 (a), ICAP is suggesting that there is an internal conflict between Section 17 (a) and Section 20 (a). We would resolve it by keeping Section 17 (a) as is. This would mean that the fund's principal underwriter could be a member of the fund's board.

We, however, do not agree with the following suggested revisions of ICAP:

1. On Section 9 (a) as we believe that the promoter should be second to the investor.
2. On Section 14 (a) (4) as we believe that a paid-up capital which shall remain unimpaired at all times thereafter be maintained.
3. On Section 3 (gg) (Section 3 (ii) of the RICA) and on Section 4 (a) (3) as we believe that when there is no current quote or closing price, the value should be the fair value as determined in good faith by the board of directors similar to that of the Investment Company Act of 1940 and its implementing rules and regulations. This is a suggestion to assure that there is a fair valuation of investor purchases and redemptions. It does not preclude the use of either the average bid/ask rate or closing price. It just says that it must be the "fair" price.

We hope that you find the foregoing useful.

**Comments of Lewis J. Mendelson**
**Capital Market Consultant**
**on**

**The Pre-Need Securities Code ("Code")**
**H.B. Nos. 83, 5483, and 1611**
**Eleventh Congress, First Regular Session**

## I. Introduction and Summary of Recommendations

Thank you for this opportunity to express my strong support for the Committee's efforts to create a Pre-Need Securities Code ("Code") in order to provide a sounder structure for the comprehensive regulation of Pre-Need Plans and those who sell them.

Before I consider the Pre-Need Securities Code, let me request that we focus first and foremost on investors who need the protections your legislation can provide and the sales agents who sell Pre-Need Plans. We are not talking about wealthy or sophisticated clients whose brokers in Manila are calling to tell them to invest in Ayala Land or San Miguel Corp. More likely, we are looking at newly-weds, young professionals, teachers, small entrepreneurs and shop owners and many other first time investors across the Philippines who are placing their hard-earned savings and their hopes for the future in this product. The plan holder is likely to have very little savings. When hard times come, plans lapse and Plan holders suffer stiff penalties.

The Pre-Need Industry has over 200,000 sales people located throughout the Philippines. Few are full-time. Most have other jobs and sell almost exclusively to their friends and relatives. There is high turnover among them. Once they have sold their friends and relatives they remain sales agents in name only.

The comments that follow are about what the law you are enacting can do to give investors a fairer deal. They are about how you can protect a significant proportion of them from losing most of the money that they put into pre-need plans. My subtext is about what the law can do to help to turn pre-need sales agents into financial advisers so that they can become true professionals, improve their status and offer their clients meaningful choices that meet their needs. In addition, it is about how the law can help to channel savings into more productive enterprises that will benefit Philippine industry and the economy, and ultimately help to create capital.

The three draft House Bills that you are considering go a long way toward establishing a sounder regulatory structure. However, to achieve the ambitious goals just outlined; to provide meaningful protections to investors; there is a need to dig deeper, to ask, and demand answers to, difficult questions which have not yet come to the surface in order to consider some bedrock issues. Were I in your place, I would find it very difficult, almost impossible, to make sound legislative decisions without solid information about:

- industry lapse rates;
- the percentage of plan holders who have suffered losses on their plans and the amount and percent of their investment represented by any such losses;
- sales agent training, licensing registration and turnover;
- industry sales practices and the extent and operation of the secondary market in pre-need plan contracts;
- rates of return on pre-need plans and alternative investments;
- the kinds of investments and the proportions in which the pre-need industry is invested in each;
- valuation methods, particularly the amount and percentage of Pre-Need Plan assets invested in possibly over-valued and illiquid real estate; and
- the economic impact on the industry that would result if front-end loads were abolished or significantly reduced.

To make your job as legislators easier, my first suggestion is that you:

- require an independent, objective and comprehensive study of the Pre-Need Industry which would provide you with answers to these fundamental questions.

Based upon the information provided in such a study you would be much better able to understand the need to take meaningful steps to:

- inject greater transparency requirements into the regulatory structure, including prominent disclosure of actuarial assumptions and lapse experience in an offering document;

- insist on improved procedures for training, testing, licensing and monitoring salesmen to assure industry-wide professional sales practices;

- encourage the Federation of Pre-Need Plan Companies (the "Federation") and the Investment Company Association of the Philippines ("ICAP") and others to form jointly a Self-Regulatory Organization ("SRO")with powers similar to those which would be granted to ICAP under Section 42 of RICA;

- reduce the severity of plan holder losses from lapses, perhaps by leveling front end loads. For example, you could require that, henceforth, not less than 80% of all payments would be available immediately to plan holders upon lapse or withdrawal, instead of the 5% which would be perpetuated under pending bills; and

- consider providing pre-need plan holders protections comparable to those that would be provided to mutual fund shareholders under the proposed RICA, including possibly by defining Pre-Need Plan Companies as investment companies such as those in the U.S. that issue installment face-amount certificates.

*SEC/SRO Regulation.* After balancing logic and experience as well as considering alternatives, I favor leaving jurisdiction over Pre-Need Plans with the SEC, on condition that it create a separate department for pre-need plan regulation. Such a department should be adequately staffed with capable well-trained people, including a full-time senior actuary. In addition, I would suggest that legislation authorize the creation of a Self-Regulatory Organization, under SEC supervision, not just for Pre-Need Plans but, to test, certify, register and monitor those brokers, dealers and sales agents that offer or sell any security not listed on an exchange. The SRO should create and enforce a Code of Fair Practices and review sales literature to assure that it is not misleading. Additional suggestions of a more technical nature may be found below, following an analysis of the pending bills.

## II. Objectives

Before explaining the thinking behind these suggestions, let me state my biases. After 32 years at the US Securities and Exchange Commission and five as an international capital markets consultant with PricewaterhouseCoopers, LLP, I believe that good regulation means good business. I strive to promote capital markets that are transparent and fair and have as their primary objective the protection of investors. I try to encourage high standards of professionalism in selling; reliable valuation, accounting and auditing practices and actuarial assumptions that are sound. I advocate regulatory structures based on "functional regulation" and under which opportunities for affiliated transactions, self-dealing and misleading advertising are tightly controlled. I like to see "level playing fields" in which the regulatory structure treats all similar products and investors in them equally. Ultimately, like the Congress, I am concerned that savings be channeled into investments that improve the allocation of capital and capital formation. Those are the objectives that my comments aim to achieve.

## III. Background

*The Pre-Need Industry.* As of 1997, there were 88 Pre-Need Plan Companies with total assets of P 78.8 billion. They had sold 3.5 billion plans for a gross contract price of P170 billion, with gross collections of P40 billion and total benefits paid of only P4 billion. Plan company paid-up capital was P1.8 billion and total trust funds were P 20 billion. [Source: Philippine Federation of Pre-Need Plan Companies, Inc.("Federation" ) Survey, Philippine Daily Inquirer, p.D.1, December 10, 1998.]

According to information compiled by the SEC from 1997 Trust Fund Statements, the 1997 distribution of the portfolio investments of the 24 largest Pre-Need Corporations with trust fund equity of over P 16.9 billion, representing 94 % of total trust fund equity, showed that stocks, including net increment, accounted for 26.9 % and real estate and appraisal increment in real estate accounted for 26.2 percent of the total. The components were as follows:



152

| Component | Percent |
|---|---|
| Real Estate | 16.2 |
| Appraisal Increment in Real Estate | 10.0 |
| Stocks | 25.8 |
| Revaluation Increment/Decrement | 1.1 |
| Government Securities | 17.0 |
| Loans | 10.4 |
| Cash/Time Deposits | 10.0 |
| Receivables and Other Assets | 1.9 |
| Commercial Paper/Promissory Notes | 1.5 |
| Other investments (without breakdown) | 6.0 |
| | 100.0 |

Appendix I, Distribution of Pre-Need Trust Fund Portfolio Assets: 1997, is the SEC Table that is the source of this data.

The industry counted over 200,000 sales persons nationwide. [Inquirer, op. Cit.] Its growth continues to be dynamic. According to the Inquirer,

> "SEC Documents show that during the past five years, the industry grew by an average 20 percent per year. Total assets rose at an annual average of 30.2 percent, with net [*plan company.*] profit after tax posting an average increase of 28.2 percent per year." [Inquirier. Id.]

***Twins.*** A Pre-Need Plan is, in essence, the same product as an investment company. Stripped to their essentials, both offer a security that entitles the holder to participation in a collective investment vehicle managed by a professional manager. Pre-Need Plans are marketed to the same investors as mutual funds are marketed. Their investment goals are similar, providing for education or retirement. Both have been regulated by the SEC, but under different regulatory frameworks. Their marketing processes and investor protections are very different.

It was somewhat surprising to learn that the Philippines' investment company industry is much smaller than the Pre-Need Industry. The fund industry consists of 15 companies with total assets of P 3.3 billion as of December 31, 1998, managed by 11 management companies. [Source: Investment Company Association of the Philippines ("ICAP")] ICAP estimates that on that date there were approximately 14,000 investment company investors, 6,000 in the 14 Philippine mutual funds and 8,000 in the single closed-end company. The contrast that the Pre-Need and Investment Company figures present, suggests a need to strengthen the regulation of the Pre-Need Industry.

## IV. Balancing Logic and Experience in the Choice of the Appropriate Regulator

***Regulatory Choices.*** The first question that the House of Representatives and, ultimately, Congress must resolve is which agency: the Securities and Exchange Commission ("SEC"); the Insurance Commission ("IC"); or a newly constituted agency; should regulate the Pre-Need Industry. Logic dictates that it should be the SEC. Experience suggests further consideration.

***Logic.*** Pre-Need Plans are securities and not insurance contracts. They are securities because they are "investment contracts." The plan beneficiary receives a beneficial interest in the profits or earnings, or title to the property, of the issuer. This conclusion is buttressed by a series rulings by the U.S. Securities and Exchange Commission ("USSEC") relating specifically to "Scholarship Plans." [1]

On the other hand, pre-need plans are not "insurance contracts" because they do not involve a contingent or unknown event, past or future, for which a person having an insurable interest may be indemnified. The Pre-need industry have dubbed the plans "quasi-insurance" because they may be garnished with optional insurance features such as decreasing or level term life insurance, disability insurance or group credit life. These merely insure payment and recovery of premiums should the plan holder be unable to do so because of death or disability. The insurance feature is an "add-on" which is not essential to the basic pre-need plan. Stated differently, "these are the icing on the cake." To rely on the insurance aspect as the hook by which to require Insurance Commission regulation would be to have the tail wag the dog, a grafted-on tail at that. For these reasons, logic would have pre-need plans continue to be regulated by or under the SEC.

***Underwriter, Broker/Dealer Regulation.*** By virtue of the fact that they are securities, the principal distributor of a pre-need plan is an "underwriter" and those that sell them are currently subject to SEC regulations [Revised Rules on Registration and Sale of Pre-Need Plans, etc.("SEC PNRules"), Feb. 20, 1984, Secs.10 and 11]. The SEC PNRules require issuers to be licensed as dealers and securities salesmen to be licensed by the SEC. As distributors of "securities," brokers and sales agents would be subject to the "suitability" rules of the securities laws. These rules are sometimes referred to as the "Shingle Theory" because as a professional you are required to "know your customers" and treat them fairly. Under the rules brokers and agents must not recommend any security that would be unsuitable for a customer. For example, it would be a violation for an agent to recommend a pre-need plan if the agent knows that the customer does not have the ability to continue to make payments and is likely to forfeit his investment.

[1] The reasoning on which these rulings are based and the decisions of the United States Supreme Court on what constitutes a "security" may be helpful to you. These cases are collected in Appendix II.

***Investment Company Regulation.*** Classification of the pre-need plan as a security, leads to another legislative option. In the U.S. pre-need plans would qualify generally as investment companies under the U.S. "Investment Company Act of 1940" ("ICA") if they promise to pay for a need of an indeterminate amount and 40 percent or more of their total assets is invested in investment securities (*i. e.,* securities other than government securities, shares of employee securities companies or majority-owned subsidiaries of an issuer that are not investment companies). They would qualify as "face amount certificate" investment companies if they promise to pay a fixed amount. [2] You will note that the cases held the U.S. Scholarship Plans were not only issuing securities, but were investment companies. The U.S. SEC, relied heavily on full disclosure to protect investors while acting flexibly to grant exemptions under the Investment Company Act ("ICA") to allow the Scholarship Plan to continue in business without altering its basic form. Its Findings and Opinion *In the Matter of The Trust Fund Sponsored by the Scholarship Club, Inc.*, ICA Rel. No. 5524, (1968 SEC LEXIS 563) (October 25, 1968) states:

> "We are not prepared to assume, in advance, that it will not be possible to arrive at a proper presentation, in the prospectus and sales literature as well as in the terminology of the plan agreements, which will give adequate, accurate and explicit information, fairly presented, as to the nature of the plans." (p.5)

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[2] Section 3(a) of the ICA defines an investment company as any issuer which - "(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of each such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.)

"Investment securities" includes "all securities except (A) government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries which are not investment companies. Section 3 (a) (2) defines it as any issuer which is engaged or proposes to engage in the business of issuing face –amount certificates of the installment type, or has been engaged in such business or has any such certificate outstanding."

Section (2) (a) (15) defines "face-amount" certificate to mean "any certificate, *investment contract,* or other security which represents an obligation on the part of its issuer to pay a stated or determinable sum or sums at a fixed or determinable date or dates more than twenty-four months after the date of issuance, in consideration of the payment of periodic installments of a stated or determinable amount (which security shall be known as a face amount certificate of the installment type); or any security which represents a similar obligation on the part of a face-amount certificate company, the consideration for which is the payment of a single lump sum (which security shall be known as a "fully paid" face amount certificate)."

"* * *(W)e believe that the critical requirement here ... is that of a full disclosure of the features of the plans with respect to the forfeiture provisions and their consequences." (p.7)

You may wish to consider whether, for the protection of investors and to level the playing field, pre-need plans should properly be classified and regulated in the same manner as "investment companies." If you do not decide that pre-need plans should be registered as investment companies, you may wish to apply concepts of investment company regulation to them.

***Functional Regulation.*** Logic does not stop there. It would seem anomalous to have an agency other than the SEC interpret provisions and administer a regulatory program involving a security. H.B. Nos. 83 and 5483 recognizes in Section 24 that Pre-Need Contract is a "security." Nevertheless, the Bills would require registration with the Insurance Commission under the *Revised Securities Act* and would require that registration may be revoked on any ground specified in the *Revised Securities Act* and that the Insurance Commission would conduct hearings to determine whether the sale of "any such security should be revoked on any ground under the *Revised Security Act*.." The SEC should be the agency that defines the standards of the laws relating to securities. This is "functional regulation." Its theory is that like products should be administered by the same agency and be subject to the same standards. Therefore, to promote uniform and consistent interpretation of the securities laws it would be best to leave the application and interpretation of those laws as they relate to Pre-Need Plans to the SEC, not the Insurance Commission.

***The Secondary Market In Paid-up Pre-Need Plan Contracts.*** There is a secondary market in paid-up plans. The combination of transferability, face value well in excess of cost and the lack of other short-term debt instruments gives impetus to this market. If you own a plan and your needs change you can sell it at a discount or perhaps at a premium over face value, but in any event for more than it cost you. I have been told that some shrewd investors have bought paid-up plans as a means of speculation. The price received will depend upon the creditworthiness of the guarantor plan company, nearness to the maturity or availment date of the plan and the commission paid to, or mark-up received by, the sales agent who brokers the deal or buys the plan contract from you and resells it. This secondary market is unregulated, decentralized and lacks in transparency. These are the conditions that spawn misrepresentations, fraud and sharp practices. As a policy matter , Pre-Need Plans should be classified as securities because the SEC needs to retain jurisdiction over these instruments in order to police this secondary market.

***Experience.*** While the SEC has improved its capacity over the last few years, it still has too many responsibilities that go beyond the regulation of the capital markets. It has become the regulator of last resort. It has responsibility for administering the Corporation Code and quasi-judicial functions involving inter-corporate disputes as well as bankruptcy administration. This range of regulatory responsibilities may have distracted it from focusing on more traditional subjects of investor protection such as Pre-

Need Plans and the sales practices under which they are sold. The Financial Executives of the Philippines ("FINEX") Research and Development Foundation "FINEX Report" of August 1996 recommended the SEC drop many of those responsibilities in order to focus on development and regulation of the capital market.

While the SEC has been over-utilized, it has also been under-funded and understaffed. Since 1978, although under SEC supervision, the Pre-Need Industry has lacked transparency. The SEC has focused primarily on trust fund and capital requirements. Pursuant to the SEC Pre-Need Rules ("PN Rules") all pre-need advertisements must be pre-approved by the SEC. The SEC may inspect Pre-Need Companies' books and records and require information to keep them current. It also may suspend or revoke issuer's licenses or permits and fine them for violations. Last year the SEC filed a case against OCE Plans alleging fraud and rule violations including refusal to render service on fully paid plans and diversion of funds. The SEC recently organized an *ad hoc* group to inspect the books and records of pre-need companies for compliance and capital requirements.

The SEC has not treated pre-need plans as requiring special attention. It has not required Pre-Need Plan sales agents to meet the more rigorous licensing, testing and monitoring standards that mutual fund and securities salesmen must meet. The PN Rules allow pre-need salesmen's licenses to be issued upon certification under oath *by the issuer*, that the salesman has been duly trained under a training program approved by the SEC. The Rules do not specify the training standards.

Nor has the SEC required critical information about plan lapse rates and actuarial assumptions to be clearly and prominently disclosed in any pre-need plan offering document or prospectus. The industry has taken advantage of differentials in regulation to register remarkable growth. Meanwhile, complaints over the operation of the Pre-Need Companies have mounted.

- Recently, Zinnia dela Pena of the Manila Times reported that seventeen Pre-need Plan Companies, other than OCE Plans, stopped operating or have been ordered dissolved.

- Spokesmen for the insurance industry complain of unfair competition from Pre-need salesmen. They tell us that a pre-need plan salesperson can be created in just two hours. They beg for regulation of Pre-Need Companies by the Insurance Commission to "level the playing field." This raises concern over why the SEC has not controlled access to the Pre-Need Industry by better controlling the training, licensing and monitoring of Pre-need salespersons.

- It is also curious that in view of the huge losses suffered by mutual fund contractual plan investors in the late '50s and early 60s, as a result of early redemptions of heavily front-end loaded plans, that the SEC has not raised questions about the similarly front-end loaded fee structure of the Pre-Need Plans and its consequences to investors whose payments lapse.

- The Pre-Need Industry has recognized the need for improved regulation to help to raise standards, up-grade its image, increase public trust and confidence and provide it greater respectability.

Chairman Yasay of the SEC earlier said that the SEC was most qualified to supervise the pre-need sector and pledged to create a separate department, presumably fully staffed, to do it. However, the SEC has not taken an institutional decision on which agency should regulate the Pre-need industry. It would defer to the judgment of the Congress in that decision. The SEC has several full time staff mathematicians who function as "semi-actuaries," but who are not supervised by an actuary. The SEC hires consulting actuaries from industry from time to time as needed. While beneficial, this does not provide the continuity, supervision or independence that a Senior SEC Staff Actuary would provide.

*An SRO Alternative.* Several of the proposed bills would require any pre-need company to be a member of the Federation. At present 63 of the 88 registered Pre-Need Companies are members. Among other things, the Federation is dedicated to "promot(ing), protect(ing) and safeguard(ing), the welfare and interest of pre-need plan companies and plan holders, and of the pre-need plan industry in general."

The Federation has already taken steps along the path of self-regulation. It has adopted a Code of Ethics that includes advertising standards, general financial capacity provisions and sales practice provisions to protect against unfair competition and sharp selling practices. A Committee or Regulatory Body may be formed to hear and decide alleged violations. Violations are punishable by fines or suspension or revocation of membership. Federation President, Atty. Eliseo Dizon, is looking to strengthen this Code. The Federation has also taken an active interest in promoting higher professional standards. It has proposed its own version of a Code. It also proposes to create a training institute. The Federation has proposed to the SEC that membership to the Federation be compulsory. "We want to police ourselves and help the SEC through self-regulation," said Dizon. In his vision, the sales agent of the future

> "will look to the job of selling as a dignified job, because they won't be just agents. They will be financial counselors who are not after the plan holder's money but are concerned with their client's future needs." (Inquirer, op. cit.)

This is a platform worthy of an SRO. Before building, one must test the ground, on which the building will stand, match words to deeds. The Federation has been in existence since October 1990. Since that time has enjoyed a continuous and active dialogue with the SEC and a smooth exchange of ideas between the two bodies. Why, one might wonder, have the excellent sentiments it has expressed not yet been converted into meaningful actions? Also, when testing the ground, we must remember that the most successful SROs are those with a strong SEC/regulator watching over them.

## V. Proposed Legislation

### A. Features

***The Pending Bills.*** The pending Bills offer a number of improvements in regulation which will strengthen the protections offered to plan holders, primarily through stronger reserve requirements, greater reliance on independent trustees, verified information about assets and establishment of a "Planholder's Protection Fund". One major difference between them is choice of the regulator. H.B. 83 as well as the Federation proposal and S.B. No. 1217 say it should be the Insurance Commission; H.B.No.1611 and S.B. No. 1424 say the SEC.

Other than the difference in the regulator, and authority to establish a Planholders' Protection Fund, they appear to be virtually similar. They would establish a "Pre-Need Plan Securities Code." ("Code"). H.B. 83 would require registration with the Insurance Commission. All of the House Bills set minimum capital requirements and require registrants to be members of the Federation.

***Planholder Recovery.*** One noteworthy difference is from a Senate Bill, S.B. No. 1187, the main focus of which is on what may be recovered by defaulting plan holders. It would increase the percentage of payments recoverable by a plan older who terminates early from 5 to 20% during the first two years and accordingly thereafter. This is a positive step in the right direction, but still a small one.

***Trust Fund and Reserve Requirements.*** All the pending House Bills would establish a bank administered trust fund, a schedule of deposits into the trust fund and subject the fund to periodic valuation by an actuary. The policies, portfolio mix and manner of government of the trust fund would be spelled out in the trust agreement which would also limit investment in "related" interests of the plan company and its officers and directors. They would also require each plan to establish a liquidity reserve fund of at least 10% of the trust fund, but not less than P500,000.

***Contractual Rights.*** The Code would require a plan company to comply with its contract upon full payment of the contract price, limit amendments to those with approval of the plan holders and the Commission and provide for reinstatement periods and minimum termination values.

***Financial and Actuarial Soundness.*** Each company would be required to hire a qualified actuary who would be directly responsible for all actuarial work of a plan company. Companies would be required annually to determine their financial stability and solvency in accordance with actuarial standards of the Actuarial Society of the Philippines and submit to the Commission an audited financial statements and an annual report in accordance with uniform accounting standards prescribed by the Commission. The financial statements would need to be published in two newspapers of general circulation.

***Remedies.*** All the House Bills also provide for suspension or revocation of a license or permit of a Pre-Need Plan and of the permit to sell such security, or for withdrawal of registration by the issuer. It also gives the regulator jurisdiction to adjudicate all plan holder complaints against pre-need sales associates, solicitors and /or issuers, as well as among issuers. It would also provide penalties for issuance or sale of overpriced plans.

***Planholders' Protection Fund.*** A key feature of H.B. No. 83 and 5483, not found in H.B. No. 1611, is the authority it would give the Commission to establish a Planholder's Protection Fund to compensate planholders for the extraordinary losses or damage they may suffer due to failure or insolvency of a pre-need company.

***Administrative Sanctions.*** The Commission would also have the authority, after proper notice and hearing to impose administrative sanctions ranging from suspension and revocation of licenses and permits, fines disqualification of individuals from certain officers in issuers, among others penalties.

## B. Comments

***Specific Comments.*** I would like to mention a few specific comments on the proposals now under consideration. Please consider

- increasing the paid-up capital requirements from P10 to P 50 million and the liquidity reserve to 10% but not less than P500,000 in order to assure more adequate capitalization of the industry;

- establishing a Plan Holders Protection Fund to cover plan holders of failed companies;

- eliminating any requirement that any portion of trust assets be invested in Countryside and Business Enterprises established under RA 6810 and low-cost housing programs of the government in order that trustees be free to exercise their best judgment on the merits of an investment in accordance with the highest prudential and fiduciary standards;

- omitting any power to limit the registration of pre-need companies to prevent "overcrowding and undue competition" because it would tend toward creating monopolies and overriding the market's judgments;

- providing valuation standards that require real estate which is worth less than it cost to be valued at current market value because it provides sounder more realistic valuations;

- assuring that there will be no affiliations between the plan company and its trustee, no direct or common control, no cross ownership, no relationships

with officers, directors or other insiders so as to strictly protect against the conflicts of interest which are built into the management structure and historically have plagued the management of investment funds; and

- making explicit the fiduciary standard "utmost faith, care and prudence required by a fiduciary relationship" as the standard to be observed by a Trustee.

***General Comments.*** While almost every Bill offers improvements over the present situation, none deals with what is most needed: a disclosure-based approach that would give prospective purchasers a clear understanding of their chances of realizing the "guaranteed" benefits.

**Sales Agent Qualification.** None of the Bills prescribes stringent training, testing, licensing and monitoring of pre-need plan sales agents. No Bill goes very far to change significantly the front-end load sales load structure that inflicts heavy losses on the many plan holders who fail to complete their payments. Although one Bill, S.B.No. 1187 moves in this direction, the minimum deposit refund provisions of the Bill would not change sufficiently or improve the plight of the plan holder whose plan lapses.

**Lapse Rate Disclosure.** As noted above, Pre-Need Plans are sold on the basis of guarantees to purchasers. They are risk averse and are looking for certainty. Yet, experience may show that the Pre-Need Contract is a high-risk product. Potential pre-need plan purchasers need to understand the actuarial assumptions on which their plans are based. They need to see what the actual lapse rates of each plan have been before they buy. Congress needs to know this before it legislates.

I have asked the SEC to provide a sampling of actuarial assumptions on which the educational plans of the largest pre-need companies are sold. They are a critical prerequisite to inform this legislative effort. Other critical in-puts are the amounts of investor losses, agent turnover rates, agent sales tactics, what kinds of assets and what percentage of each do individual pre-need plans invest in, how are Pre-Need trust assets valued, especially real estate and what are the rates of after tax returns on pre-need plans and other comparable investment alternatives.

**US SEC Face-Amount Certificate Study.** In 1969, the U.S. Congress considered some of the same issues now facing the Philippine Congress with respect to Pre-Need Plans. The United States Senate, while considering amendments to the Investment Company Act of 1940, asked the SEC for a study of face amount certificate companies to determine, among other things:

- current redemption rates on face amount certificates;
- the percentage of investors who suffered losses on their purchases of these certificates;
- the sales techniques used by face-amount certificate companies and the economic classifications of those persons purchasing such certificates;

- the after tax yields obtainable on similar alternative investments; and
- the economic impact on the securities industry which would result if the front-end load on face-amount certificates were abolished.

A copy of the SEC Summary of that Study is attached as Appendix III to this Comment. It bears on the present legislative effort because of the similarities of pre-need plans and face-amount certificates, the high turnover, high incentive pay sales forces used to sell them, the high incidences of lapses and the relevance of the inquiries which the U.S. Senate made to the legislative process. With the addition of information about the investments made by Pre-Need Plans and their valuation, the U.S.SEC Study could serve as a model for the Philippines Study of the Pre-Need Industry.

As a result of its Study, the US SEC required front-page prospectus disclosure of lapse rates of face-amount certificate companies. Congress limited front end sales loads to 20 % instead of 50%, so that in no event would less than 80 % of the gross payments made on the certificate be recoverable. This provision was equal to the sales load permitted on front-end loaded periodic payment contractual plans sold by other types of investment companies. The U.S. investment company industry prospered. Face Amount Certificate companies were then a small part of that industry and are a smaller part of a booming U.S. fund industry today. Their sponsors and sales agents sell a wide variety of other securities.

## VI. Recommendations and Conclusions

***Analysis.*** The choice of which agency should regulate the Pre-Need Industry should not depend solely on whether the Pre-Need Contract is defined as a "security," "insurance" or "quasi-insurance". Definitions are important, but the consequences of the choice of regulator are more important. Key questions to ask are:

- *Which classification and regulatory structure provides the best protection for investors?*
- *Which regulatory scheme would provide the best fit to the product and thus result in the most level playing field?*
- *Would one or the other choice distort the over-all regulatory structure?*
- *What are the differences in the regulatory approach of the competing agencies?*
- *What role, if any, would the "Federation" be willing and able to assume in the regulatory process?*
- *Which agency will provide the greatest transparency to investors?*

- *Which agency and regulatory structure will promote better capital allocation and capital formation?*

***Consider Regulatory Philosophy.*** In choosing the appropriate regulator, the House of Representatives may wish to consider the differences in the philosophy of regulation of the SEC and the Insurance Commission. Normally, the SEC thinks in terms of disclosure so that an investor can make an informed investment decision. The Insurance Commission thinks in terms of assuring that the premises on which payment is based are sound and that the insured will receive the benefit of his bargain. The SEC also has regulatory functions with respect to investment companies and is responsible for policing fraud and misrepresentation in secondary markets.

***Level the Playing Field.*** Congress, the SEC and the public may wish to consider mutual fund type regulation as a model for Pre-Need regulation. A pre-need plan holder receives far fewer protections than an investor in a mutual fund. Pre-need plans are sold by high turnover sales forces compensated through a heavy front end load commission structure which punishes investors who fail to make payments and whose plans lapse. Mutual funds may be sold only with level loads. Pre-Need Plan sales agents may receive very little training. They are not subject to the more rigorous testing and monitoring that are required of mutual fund, insurance and securities salesmen.

***Require Transparency.*** Pre-Need Plans are not transparent. Mutual funds disclose their risks and expenses and their investment portfolios. Plan holders generally are risk averse. Plans are sold on the basis of the guarantees they offer. Plan holders do not receive information in advance about the company's lapse assumptions and lapse experience. They need this to alert them to how risky the product is. There is a high risk that lapses will erode most of their investment.

Mutual funds also disclose their performance. A fund investor can compare rates of return of investment companies everyday in a local newspaper. A Pre-Need plan holder sees only the ultimate amount that is guaranteed by the plan, but cannot compare it with the compounded rate of return on a bank deposit or the total return or average annual return on a mutual fund or investment company.

***Consider Investment Company Style Regulation.*** Pre-need companies, like investment companies or mutual funds, present a unique regulatory challenge. They involve large amounts of liquid assets often managed by persons not personally known to the plan holders and who may also be associated with larger enterprises involved in other businesses. In view of the possible conflicts of interest that their structures can engender, as evidenced by the suspension of operations by several pre-need companies, Pre-Need Plans require special protections, beyond the trust provisions of the proposed bills. Every phase of investment company regulation is guided by the broad general principle that as trusts, their trustees, asset management companies and the persons involved with them must observe the highest duty of loyalty to the beneficiaries of the trust. Investors in such intangible products require the kinds of special protections offered by investment company regulation.

Among other things, in addition to providing the utmost transparency to assure that investors have complete information on which to base an investment decision, those protections would:

1. Prohibit various forms of self dealing;
2. Provide economic regulation of the remuneration of affiliates;
3. Restrict unsound capital structures;
4. Require clear disclosure of investment objectives and policies;
5. Protect the physical integrity of assets;
6. Assure fair valuation of investor purchases and redemptions; and
7. Assure that investors receive accurate periodic reports about the funds and what the funds invest in.

If the House of Representatives agrees that pre-need plans should be regulated like investment companies a host of needed protections could fall into place. The playing field would immediately be leveled. In addition to the legal basis for applying the definition of "investment company" to Pre-Need Plans, there are perhaps two overriding policy reasons:

1) To provide equal protection to all investors in similar intangible collective investments the structure of which involves possible conflicts of interest.

2) To not allow the regulatory framework to provide one or the other product a competitive advantage and thus favor it or even pre-ordain the investor's choice.

*Conclusions.* 1.) **Pre-Need Plans are Securities: Strengthen the SEC's Ability to Regulate Them.** Classifying the pre-need plan as a "security" provides the best protection for investors because it accords with reality. It would not distort the regulatory structure. The pre-need plan is not insurance or even 'quasi-insurance.' Insurance is merely an optional add-on. After balancing logic and experience as well as considering alternatives, I favor leaving jurisdiction over Pre-Need Plans with the SEC, on condition that it create a separate department for pre-need plan regulation. Such a department should be adequately staffed with capable well-trained people, including a full-time senior actuary. Competition combined with full disclosure, including portfolio disclosure, and elimination of distortions in the pricing structure caused by the front-end load would promote better capital allocation and capital formation.

2.) **Organize an Objective Comprehensive Study of the Pre-Need Industry Modeled on the US Face-Amount Certificate Study.** A sound legislative program for the regulation of Pre-Need Plan Companies would start with a study similar to the Face Amount Certificate Study. It would help to better understand:

- the need for disclosure of:
  - lapse rates, amounts, incidence and degree of losses



170

- performance
- investment portfolios; and
- policies;
- the operation of the secondary market in paid-up plan contracts; and
- the value and liquidity of the assets, including real estate, that back plan guarantees.

What will be learned about the incidence and degree of losses, sales agent turnover rates, rates of return and pre-need company investments will be of overriding importance to legislative decisions and the protection of Philippine investors and savers.

3.) **Authorize Creation of An SRO to Regulate Brokers, Dealers and Sales Agents of Non-Exchange Traded Securities.** To assist it in providing informed knowledgeable regulation, you may wish to authorize the creation of a single SRO for the regulation of all brokers, dealers and agents who offer and sell securities that are not listed on an exchange. As a starting point, inclusion of both Federation and ICAP representatives, in addition to representatives of other securities firms, among its directors would provide for greater expertise and impartiality and add a further dimension of checks and balances. The best model for this is the U.S broker/dealer regulatory body, the National Association of Securities Dealers, Inc. (the "NASD").

4.) **Set Forth an SRO Agenda: Develop a Corps of Professional Investment Advisors.** It will be most important for the SEC or an SRO to undertake a vigorous testing, licensing and monitoring program to develop a corps of professional brokers, who are familiar with a wide variety of products and would be prepared to act as bona fide financial advisers, able to put their clients' needs above their need to sell a specific product. The SRO should also review all fund and pre-need advertising in accordance with its advertising code. Of course, any SRO would have to be supported by its members, both through their commitment to self-regulation and financially, and would have to be subject to strict oversight by a vigilant and forceful SEC.

# Appendix I

## Distribution of Pre-Need Trust Fund Portfolio Assets: 1997



172

Table 1 - Amount and Percentage Distribution of the Investments Portfolio of the Trust Fund Assets of Twenty-four Large Pre-Need Corporations: 1997

( Amount in thousand pesos )

| Type of Component | 1997 | |
|---|---|---|
| | Amount | Percent to Total |
| Total Trust Fund Assets | P16,909,682.1 | 100.0 |
| Cash/Time Deposits | 1,692,827.7 | 10.0 |
| Commercial Papers/Promissory Notes | 260,064.3 | 1.5 |
| Government Securities | 2,870,843.5 | 17.0 |
| Loans | 1,761,103.8 | 10.4 |
| Stocks | 4,364,014.7 | 25.8 |
| Revaluation Increment/Decrement | 178,416.0 | 1.1 |
| Real Estate | 2,732,214.0 | 16.2 |
| Appraisal Increment in Real Estate | 1,691,407.1 | 10.0 |
| Bonds/Bill Discounts/Premium Amortization | 12,486.8 | 0.1 |
| Other Investments 1/ | 1,022,897.7 | 6.0 |
| Receivables and other Assets | 323,406.5 | 1.9 |

* Too small to show distribution.

n.a. Not available.

1/ Included investments without breakdown.

Source of Data: 1997 Trust Fund Statements of twenty-four large pre-need corporations with trust fund equity representing 94% of the total.

Prepared by:
Pre-Need Division
Brokers and Exchanges Department
Philippines, Securities & Exchange Commission

11-25-98 mag

Statement of Lewis J. Mendelson
Capital Market Consultant
on

The Pre-Need Securities Code ("Code")
H.B. Nos. 83, 5483, and 1611
Eleventh Congress, First Regular Session

Thank you for this opportunity to express my strong support for the Committee's efforts to create a Pre-Need Securities Code ("Code") in order to provide a sounder structure for the comprehensive regulation of Pre-Need Plans and those who sell them. I have prepared more complete Comments that I have submitted to the Committee. The statement I am making now summarizes my conclusions. For a fuller explanation of my views, please refer to that comment.

Before considering the Pre-Need Securities Code, let me request that we focus first and foremost on investors who need the protections your legislation can provide and the sales agents who sell Pre-Need Plans. We are not talking about wealthy or sophisticated clients whose brokers in Manila are calling to tell them to invest in Ayala Land or San Miguel Corp. More likely, we are looking at newly-weds, young professionals, teachers, small entrepreneurs and shop owners and many other first time investors across the Philippines who are placing their hard-earned savings and their hopes for the future in this product. The plan holder is likely to have very little savings. When hard times come, plans lapse and Plan holders suffer stiff penalties.

The Pre-Need Industry has over 200,000 sales people located throughout the Philippines. Few are full-time. Most have other jobs and sell almost exclusively to their friends and relatives. There is high turnover among them. Once they have sold their friends and relatives they remain sales agents in name only.

My comments are about what the law you are enacting can do to give investors a fairer deal. They are about how you can protect a significant proportion of them from losing most of the money that they put into pre-need plans. My subtext is about what the law can do to help to turn pre-need sales agents into financial advisers so that they can become true professionals, improve their status and offer their clients meaningful choices that meet their needs. An additional theme, is how can the Code help to channel savings into more productive enterprises that will benefit Philippine industry and the economy, and ultimately help to create capital.

The Bills that you are considering go a long way toward establishing a sounder regulatory structure. However, to achieve the ambitious goals just outlined: to provide meaningful protections to investors: there is a need to ask difficult questions which have not yet come to the surface. The answers to these questions should help you to make sound legislative decisions.

**First suggestion.** To make your job as legislators easier, my first suggestion is that you **require an independent, objective and comprehensive study of the Pre-Need Industry** which would provide you with answers to fundamental questions. There is a precedent and a model for such a Study in the experience of the United States.

**US SEC Face-Amount Certificate Study.** In 1969, the U.S. Congress considered some of the same issues now facing the Philippine Congress with respect to Pre-Need Plans. It focused on an instrument called a "face-amount certificate" which was a security issued by a special kind of investment company. The United States Senate, while considering amendments to the Investment Company Act of 1940, asked the SEC for a study of face amount certificate companies to determine, among other things:

- current redemption rates on face amount certificates;
- the percentage of investors who suffered losses on their purchases of these certificates;
- the sales techniques used by face-amount certificate companies and the economic classifications of those persons purchasing such certificates;
- the after tax yields obtainable on similar alternative investments; and
- the economic impact on the securities industry which would result if the front-end load on face-amount certificates were abolished.

A copy of the SEC Summary of that Study is attached as Appendix III. to my full Comments. It bears on the present legislative effort because of the similarities of pre-need plans and face-amount certificates, the high turnover, high incentive pay sales forces used to sell them, the high incidences of lapses and the relevance of the inquiries which the U.S. Senate made to the legislative process. With the addition of information about the investments made by Pre-Need Plans and their valuation, the U.S.SEC Study could serve as a model for a Philippines Study of the Pre-Need Industry.

Based upon the information provided in such a study you would be much better able to evaluate the need to:

- inject greater transparency requirements into the regulatory structure, including prominent disclosure of actuarial assumptions and lapse experience in an offering document;

- insist on improved procedures for training, testing, licensing and monitoring salesmen to assure industry-wide professional sales practices;

- encourage the Federation of Pre-Need Plan Companies (the "Federation") and the Investment Company Association of the Philippines ("ICAP") and others to form jointly a Self-Regulatory Organization ("SRO")with powers similar to those which would be granted to ICAP under Section 42 of RICA;

- reduce the severity of plan holder losses from lapses, perhaps by leveling front end loads; and

- consider providing pre-need plan holders protections comparable to those that would be provided to mutual fund shareholders under the proposed RICA, including possibly by defining Pre-Need Plan Companies investment companies such as those in the U.S. that issue installment face-amount certificates.

**Second Suggestion.** After balancing logic and experience as well as considering alternatives, I recommend leaving jurisdiction over Pre-Need Plans with the SEC. I believe the best form of regulation would be to apply traditional disclosure based principles of securities regulation to such plans. This would give investors the opportunity into make better informed investment decisions.

**SEC Regulation is Good Law and Good Policy.** My suggestion is based on the conclusion that pre-need plans are securities, not insurance contracts. They are securities because they are "investment contracts." The plan beneficiary receives a beneficial interest in the profits or earnings, or title to the property, of the issuer. This conclusion is buttressed by a series of rulings by the U.S. Securities and Exchange Commission ("USSEC") relating specifically to "Scholarship Plans." The reasoning on which these rulings are based and the decisions of the United States Supreme Court on what constitutes a "security" may be helpful to you. These cases are collected in Appendix II.

As a policy matter, classifying the pre-need plan as a "security" provides the best protection for investors because it accords with reality. It would not distort the regulatory structure. The pre-need plan is not insurance or even 'quasi-insurance.' Insurance is merely an optional add-on. I would hope that the SEC would create a separate department for pre-need plan regulation. Such a department should be adequately staffed with capable well-trained people, including a full-time senior actuary. Ultimately, competition combined with full disclosure, including portfolio disclosure, would promote better capital allocation and capital formation.

**Third Suggestion.** To assist the SEC in providing informed knowledgeable regulation, you may wish to authorize the creation of a single SRO for the regulation of all brokers, dealers and agents who offer and sell securities that are not listed on an exchange. As a starting point, inclusion of both Federation and ICAP representatives, in addition to representatives of other securities firms, among its directors would provide for greater expertise and impartiality and add a further dimension of checks and balances. The best model for this is the U.S broker/dealer regulatory body, the National Association of Securities Dealers, Inc. (the "NASD").

It will be most important for the SEC or an SRO to undertake a vigorous testing, licensing and monitoring program to develop a corps of professional brokers, who are familiar with a wide variety of products and would be prepared to act as *bona fide* financial advisers, able to put their clients' needs above their need to sell a specific product. The SRO should also review all fund and pre-need advertising in accordance

with its advertising code. Of course, any SRO would have to be supported by its members, both through their commitment to self -regulation and financially, and would have to be subject to strict oversight by a vigilant and forceful SEC.

**Fourth Suggestion.** Please consider some Specific Comments on the pending Bills. Consider:

1. increasing the paid-up capital requirements from P10 to P 50 million and the liquidity reserve to 10% but not less than P500,000 in order to assure more adequate capitalization of the indiustry;

2. establishing a Plan Holders Protection Fund to cover plan holders of failed companies;

3. eliminating any requirement that any portion of trust assets be invested in Countryside and Business Enterprises established under RA 6810 and low-cost housing programs of the government in order that trustees be free to exercise their best judgment on the merits of an investment in accordance with the highest prudential and fiduciary standards;

4. omitting any power to limit the registration of pre-need companies to prevent. "overcrowding and undue competition" because it would tend toward creating monopolies and overriding the market's judgments;

5. providing valuation standards that require real estate which is worth less than it cost to be valued at current market value because it provides sounder more realistic valuations;

6. assuring that there will be no affiliations between the plan company and its trustee, no direct or common control, no cross ownership, no relationships with officers, directors or other insiders so as to strictly protect against the conflicts of interest which are built into the management structure and historically have plagued the management of investment funds; and

7. making explicit the fiduciary standard "utmost faith, care and prudence required by a fiduciary relationship" as the standard to be observed by a Trustee.

February 24, 1999

**HON. JOSE MACARIO L. LAUREL**
Chairman
House of Representative
Batasan Hills, Diliman, Quezon City

Dear **Cong. Laurel:**

I was pleased to have the opportunity to comment on February 16, 1999 on the Committee's efforts to create a Pre-Need Securities Code ("Code"). As I explained then, the investors who need the protections of the Code are most likely to be first time investors: newly-weds, young professionals, teachers, small entrepreneurs and shop owners who are likely to have very little savings. When hard times come, and their plans lapse they will suffer stiff penalties.

My goal was to suggest ways to:

- give those investors a fairer deal, to protect a significant proportion of them from losing most of the money that they put into pre-need plans;
- improve the status of pre-need sales agents by turning them into financial advisers who can offer their clients meaningful choices that meet their needs; and
- channel savings into Philippine industry and the economy, and ultimately help to create capital.

I made four suggestions:

1. Require an independent, objective and comprehensive study of the Pre-Need Industry, using as a model the 1969 US SEC Face-Amount Certificate Study, the summary of which was included as Appendix III. Such a study would enable the Congress to evaluate better the need to:

    - inject greater transparency requirements into the regulatory structure;



178

- improve procedures for training, testing, licensing and monitoring salesmen to assure industry-wide professional sales practices;

- encourage the formation of a Self-Regulatory Organization ("SRO") for broker dealers and sales agents;

- reduce the severity of plan holder losses from lapses, perhaps by leveling front end loads; and

- consider protections comparable to those that would be provided to mutual fund shareholders under the proposed RICA.

2. Leave jurisdiction over Pre-Need Plans with the SEC because pre-need plans are securities, not insurance contracts, and instruct the SEC to apply traditional disclosure based principles of securities regulation to such plans so that investors have the opportunity to make better informed investment decisions.

3. Authorize the creation of a single SRO for the regulation of all brokers, dealers and agents who offer and sell securities that are not listed on an exchange modeled on the National Association of Securities Dealers, Inc. (the "NASD"). Emphasize the need for SEC or an SRO to undertake a vigorous testing, licensing and monitoring program. Require it to establish a Code of Fair Practices; review all mutual fund and pre-need advertising in accordance with its advertising code; design it to be self-financing; and have it subject to strict oversight by a vigilant and forceful SEC.

4. Consider seven specific comments on the pending Bills.

   1. Increase the paid-up capital and reserve requirements;
   2. Establishing a Plan Holders Protection Fund;
   3. Eliminate any requirement that any portion of trust assets be invested in government programs;
   4. Omit any power to limit the registration of pre-need companies;
   5. Provide valuation standards that require real estate which is worth less than it cost to be valued at current market value;
   6. Assure that there will be no affiliations between the plan company and its trustee, no direct or common control, no cross ownership, no relationships with officers, directors or other insiders; and
   7. Make explicit the fiduciary standard "utmost faith, care and prudence required by a fiduciary relationship" as the standard to be observed by a Trustee.

As I indicated during the hearing, I would be pleased to discuss with you or your staff, the concepts presented in my comments or to answer any other questions related to this matter.

Sincerely yours,

Lewis J. Mendelson
Capital Market Consultant

## LEVEL THE REGULATORY PLAYING FIELD

### A. Help the Philippines Capital Market to Become Stronger and More Competitive

#### 1. Better allocation of capital.

- The Philippines has a very low savings rate relative to many of its neighbors in South East Asia.
- To be competitive the Philippines needs to marshal as much of its assets as possible into productive investment.
- Find a way to encourage savers to invest in more productive enterprises.
- Where there is abundant information about the securities offered, investors are able to make more intelligent choices and through their collective choices the market allocates capital.

#### 2. Pre-Need Plans Take in a lot of money, but contribute very little to the Development of the Capital Market.

Many Filipinos invest in Pre-Need Plans.

By year – end 1997,

Pre-Need Companies had:

- sold **3.5 million plans** for a gross contract price of **P170 billion.**
- gross collections of **P40 billion** and total benefits paid of only **P4** billion.
- Total assets of **P 78.8 billion.**

At year-end 1998

- Common Trust Funds ("CTFs")---**P 90 billion**
- Investment companies **P 3.3 billion**.

3. **Follow the Pre Need money collected.**

- A relatively small portion of plan holder's payments or trust fund assets reaches the securities markets:

- Out of **gross collections of P40 billion, only P5 billion or P 6 billion is invested in stocks.** Because:

  - Only **40 percent** of what a pre-need plan holder invests must be placed in trust and invested in his behalf.

  - Only **5 percent** during the first year after investment in a five year plan.

- Total pre-need **trust funds** at year-end 1997 were **P 20 billion.**

  - **Stocks** (including net increment) accounted for **26.9 %** of trust fund assets = roughly **P5 to P6 billion.**

    - Because of the **lack of prudential investment standards** and **rigorous controls on related transactions**, some portion of those funds could be invested pet projects of the plan company managers.

  - **Real estate** accounted for **26.2 %** of the total **(including a 10% appraisal increment)** .

B. **What the Pre-Need Plan Purchaser Needs to Know**

- For the market to improve the allocation of resources, investors will need to be given more information --- re-educated.

- Traditional offer document risk disclosure.

*(Although they will vary from plan to plan, risk factors that could apply to many plans and which might influence an individual investment decision and the allocation of capital, if disclosed)*

- **How much of what I pay goes to work for me?**

  **Only 40%** of your money will be invested on your behalf over the pay-in period of your installment contract, and only 5% during the first two years;

- **How much does the sales agent get?**

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Based upon the 1997 distribution of the portfolio investments of the 24 largest Pre-Need Corporations with trust fund equity of over P 16.9 billion, representing 94 % of total trust fund equity.

**Your sales agent will receive 50% of the payments you make during the first year** of a five year plan, or first two years of a ten year plan;

- **What are the chances of a plan lapsing?**
  **The success of this plan depends upon a large percentage** of individual plans **lapsing;**

- **What is the lapse experience on this plan?**
  The lapse experience on this plan is that **more than (some percentage) (50%) (60%) of plans sold have lapsed** before reaching their availment date:

- **What happens to my investment if my plan lapses?**
  If your plan lapses, **you are likely to lose more than half of your investment;**

- **What's the rate of return that the plan pays?**
  **A typical plan pays a rate of between 3% to 7% per year** depending how long it is held, or **an average annual return of approximately 5%**

- **How does that compare with inflation?**
  **It's less than the 8% average rate** of inflation over the past five years, thus **the real rate of return** on this investment over that period **has been negative**; and

- **Does the trust fund invest in anything risky or that may not be properly valued?**
  Of the money invested in the plan trust fund, **a large portion has been invested in real estate** which may currently be over-valued and illiquid; if this condition continues **it may affect the plan company's ability to meet the "guaranteed" amount of your plan.**

C. **Who will educate investors?**

- **The Pre-Need Industry has over 200,000 sales agents** located throughout the Philippines.
- **Few are full-time**. Most have other jobs and sell almost exclusively to their friends and relatives.
- They receive a **high commission in the form of a front-end load** on each installment plan that they sell.
- There is **high turnover** among them. Once they have sold their friends and relatives they may remain sales agents in name only.
- SEC rules allow pre-need salesmen's **licenses** to be **issued** simply **upon certification under oath** ***by the issuer (plan company)***, that the salesman has been duly trained under a training program approved by the SEC. **The rules do not specify the training standards.**

- These sales agents, armed with Pre-Need sales literature, are the people who have direct contact with a large segment of young or first time investors who are potential long-term investors.

- Under the **SEC's** present non-disclosure policy, or under regulation by the **Office of the Insurance Commission, these sales agents** (even if subject to more stringent licensing requirements) **would provide those investors with whatever information they are going to get.**

- **Those sales agents are the persons that are influencing a significant portion of capital allocation in the Philippines.**

D. **"Full Disclosure, a better way."**

- **Full disclosure is a better way to educate and protect investors and to allocate investments to the capital market.**

  - As securities, pre-need plans have been and should continue to be subject to SEC regulation.

  - **The SEC has not yet required the kinds of disclosures outlined above.** SEC Chairman Yasay testified on February 16, 1999, to the effect that **if the SEC were to treat Pre-Need Plans like other securities, it would have to require full disclosure of the risks involved in investing in them.**

**The US SEC** when confronted with a similar question involving Scholarship Plans **in 1968, opted for full disclosure. It stated:**

> **"* * *(W)e believe that the critical requirement here ... is that of a full disclosure of the features of the plans with respect to the forfeiture provisions and their consequences."** (p.7)

- **The Philippines SEC could require that pre-need plans**, just like any other offering of securities,

  - **provide investors** an offering document or prospectus which complies with SEC rules and provides the information and education that **traditional SEC risk disclosure** would provide.

D. **Proposed Amendments to the Securities Act of 1999 and the PreNeed Code**



184

- **Section 13 of the Bill should be more than a transitional provision** that provides stop-gap regulation pending approval of a Pre-Need Code.

- Section 13 (b) authorizes the Commission to promulgate rules, regulations and orders necessary and appropriate to regulate the sale of pre-need plans by, **"requiring disclosures to prospective planholders."**

  **To assure that the SEC devotes itself to *full* disclosure, I recommend that the quoted words be amended to read:** "requiring ***full*** disclosures ***of material risks*** to prospective plan holders ***to enable them to make informed investment decisions....***"

  - **To provide for better allocation of capital, amend the Declaration of Policy to read:**

"It is hereby declared to be the policy of the state ***to protect investors,*** to encourage private corporations to broaden the base of their ownership, to enhance a socially-conscious free market that regulates itself, to promote the development of a ***fair, efficient and transparent*** capital market...etc.."

F. **My crystal ball.**

**With full disclosure the Pre-Need Companies** would:

- **improve their products** and

- have their **sales agents trained and licensed** so that they would **become investment counselors** who would **offer a broad range of investments to meet their clients' needs.**

- **provide the best protection to investors,**
  **allow the market to better allocate capital to the most efficient enterprises,** and

- **provide the kind of recognizable legislative and regulatory environment that inspires trust and confidence among global investors.**

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*1970 SEC LEXIS 156, **

In the Matter of THE TRUST FUND SPONSORED BY THE SCHOLARSHIP CLUB, INC., 15 E. Broward Boulevard, Fort, Lauderdale, Florida 33301

Admin. Proc. File Nos. 3-2720, 812-2794

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940, Release No. 6250

1970 SEC LEXIS 156

November 17, 1970

**CORE TERMS:** load, investor, exemption, notice, supervisor, salesman, savings, monthly payment, public interest, installment, regulation, presently, deducting, allocated, remainder, aggregate, federally, deducted, maximum, insured, exempt

**TEXT:** [*1]

NOTICE OF APPLICATION PURSUANT SECTION 6(c) FOR EXEMPTION FROM SECTION 27(a)(3) OF THE ACT AND FOR AMENDMENT OF PREVIOUS ORDER

NOTICE IS HEREBY GIVEN that The Scholarship Club, Inc. ("Club"), sponsor of the Trust Fund Sponsored by the Scholarship Club, Inc. ("Fund"), and Scholarship Services, Inc. ("Services") which is Fund's distributor, and Fund (referred to collectively as "Applicants") have filed an application pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") for an order to exempt Applicants from the provisions of Section 27(a)(3) of the Act and to allow a sales load to be charged upon the sale of Fund's investment plans ("**Scholarship Plans**") which is greater than the load presently permitted by a current Commission order. All interested persons are referred to the application on file with the Commission for a statement of the representations contained therein, which are summarized below.

Fund was organized on July 22, 1965, by Club, a non-profit Florida corporation, for the purpose of administering **scholarship plans** which would provide funds to be used towards the college education of children designated by investors. The **scholarship plans**, which investors [*2] establish by depositing money on a lump sum or monthly basis in either a federally insured savings bank or a federally insured savings and loan association located in Florida are offered solely to bona fide residents of the State of Florida through Services a separate organization engaged in the selling of the **scholarship plans.**

On October 25, 1968, the Commission, by order Investment Company Act Release No.



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and the proposed methods of deducting such loads from the payments to be made by investors and has signified his approval. A copy of his letter has been filed as an exhibit to the application.

Applicants consent that should the Commission grant the requested exemption Applicants will file [*6] with the Commission annually a statement of the number of **scholarship plans** which lapsed during each calendar year broken down by years of participation in the plans.

NOTICE IS FURTHER GIVEN that any interested person may, not later than December 11, 1970, at 5:30 P.M., submit to the Commission in writing a request for a hearing on the matter accompanied by a statement as to the nature of his interest, the reasons for such request, and the issues of fact or law proposed to be controverted, or he may request that he be notified if the Commission should order a hearing thereon. Any such communication should be addressed, Secretary, Securities and Exchange Commission, Washington, D.C., 20549. A copy of such request shall be served personally or by mail (air mail if the person being served is located more than 500 miles from the point of mailing) upon Applicant at the address stated above. Proof of such service (by affidavit or in case of an attorney-at-law by certificate) shall be filed contemporaneously with the request. At any time after said date, as provided by Rule 0-5 of the Rules and Regulations promulgated under the Act, an order disposing of the application herein may be [*7] issued by the Commission upon the basis of the information stated in said application, unless an order for hearing thereon shall be issued upon request or upon the Commission's own motion. Persons who request a hearing or advice as to whether a hearing is ordered will receive notice of further developments in this matter, including the date of the hearing (if ordered) and any postponements thereof.

By the Commission.

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n1 Section 6(c) authorizes the Commission to exempt any person, security or transaction from all provisions of the Act if it finds such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. [*2]

The Commission's order of April 17, 1968 presents the following matters and questions for consideration:

"(1) Whether Applicant is an investment company within the meaning of Section 3(a) of the

(2) Whether Applicant, pursuant to Section 3(c)(3), 3(c)(6) or 3(c)(12) of the Act, is excepted from the definition of an investment company;

(3) Whether the granting of the requested exemptions and orders under the Act is (a) necessary or appropriate in the public interest, (b) consistent with the protection of investors, and (c) consistent with the purposes fairly intended by the policy and provisions of the Act; and

(4) If the requested exemptions and orders are to be granted, what conditions, if any, should be imposed in the public interest and for the protection of investors."

After hearings were held at which applicant appeared by counsel, proposed findings of fact, conclusions of law and briefs were filed by counsel on applicant's behalf and by the Division of Corporate Regulation ("Division"). Applicant also filed a "Memorandum of Rebuttal".

The Episcopal School Foundation College Award Program, Inc. ("CAP") is a Florida non-profit membership corporation organized in April [*3] of 1966. Its sole business is the operation of a **scholarship plan,** offered to residents of Florida, which is authorized and regulated under the Florida Statutes. n2 The Reverend Hunter Wyatt-Brown, Jr. is President and Executive Director of CAP and has operated it since its inception. Aaron I. Sanson ("Sanson") has been its Secretary since inception. Both are members of the Board of Directors.

n2 Florida Statutes, Section 617.50 et seq.

The same **scholarship plan** was originally presented in 1965 by the Episcopal School Foundation (ESF) a non-profit corporation formed for the purpose of aiding the Episcopal Church in general and education in particular. In addition to the **scholarship plan,** ESF ran three religious schools. Rev. Wyatt-Brown is ESF's Executive Director and Sanson is its Secretary. Its Board of Trustees include a Bishop of a diocese of the Episcopal church and the majority of its members are communicants of the church. Having been advised that under Florida law a corporation offering a **scholarship plan** must have that objective as its sole purpose, ESF's Board of Trustees authorized the creation of CAP to succeed it as operator of the **scholarship plan.** [*4] All original subscribers of CAP's Articles of Incorporation were members of the ESF Board of Trustees.

The Plan

The plan offers a program under which a person interested in a child's future education may become a member of CAP by paying a membership fee and by opening a savings account in a federally insured savings bank or savings and loan institution. n3 Upon enrollment the member designates the child or candidate who is to be the beneficiary of the scholarship award. The child must be eight years of age or younger. The current membership fee is $ 175.00 n4

n3 In addition to Florida, **scholarship plans** have been offered in Pennsylvania by The

College Award Foundation, a Delaware corporation ("CAF-Del") formed in November 1966, and in Iowa by The College Award Foundation, an Iowa corporation ("CAF-Iowa") formed in 1967. All agreements by CAF-Del and CAF-Iowa with their members have been assigned to CAP. Since all three plans are identical, all future references to the plan will be applicable to all three.

n4 This fee has been increased at least twice from $ 100 to $ 120 and, thereafter, to the present figure.

The member creates his savings account by either a lump [*5] sum deposit or by making monthly, quarterly or annual deposits. CAP has issued deposit schedules indicating the required amount of each such payment into the member's savings account dependent upon the age of the candidate at the time of enrollment. Each of these savings accounts is calculated, computed at 4% interest, to produce the sum of $ 664.79 when the candidate reaches college age regardless of how the deposits are made.

Upon subscribing to membership in the plan, the member assigns the interest from his savings account to a trustee, irrevocably. n5 Currently, the trustee is the Atlantic National Bank of Jacksonville ("Atlantic"). n6 The interest earned by the member's saving account constitutes the fund from which scholarship payments are intended to be paid. "The monies in this trust fund are kept in cash interest-bearing savings accounts and are designated to the class of the scholarship candidate of the donor [member]." n7

n5 CAP's Regulations provide "Sponsor [member] shall donate by irrevocably assigning, until maturity date of Candidate's CAP Savings Plan, all right, title and interest in and to all earnings from his CAP Savings Account and direct the savings institution to transfer these earnings immediately on their accrual to the College Award Program Trust Fund (CAP Trust Fund)".

n6 The State of Florida has approved the trust agreement entered into between CAP and Atlantic covering the funds created by CAP's Florida plan. CAP has also submitted to the State of Florida for its approval agreements pursuant to which Atlantic would act as trustee in respect of the funds created by the CAP-Del and CAF-Iowa plans. The State has not yet responded. The parties have stipulated that the trusts created by CAF-Del and CAF-Iowa may also be considered applicants in this proceeding. Accordingly, future references to the Trust Fund will include the CAF-Del and CAF-Iowa plans.

n7 Applicant's brief, p. 5. [*6]

Pursuant to a cost analysis prepared by CAP, all administrative expenses connected with the plan are to be paid out of the $ 175 enrollment fee charged each member. It is contemplated that $ 115 will be allocated towards the cost of the sales program and $ 60 to the cost of administration. n8 No deductions of any kind may be made from the monies deposited by each member into the trust fund. The trustee's fees, which CAP computes at $ 1.00 per investor per year, n9 are payable out of the $ 60 allocated to administration expenses.

n8 CAP's cost analysis is predicated upon an estimated future enrollment of 5,000 members per year.

n9 The $ 1.00 figure appears in CAP's cost analysis. Presumably, it is a simplification of the provision of the trust agreement pursuant to which CAP is to pay to the trustee for its services an annual fee of 1/2 of 1% on the first $ 100,000 of principal, 1/3 of 1% on the next $ 400,000 of principal and 1/4 of 1% on all above $ 500,000, less 25% of the fees so computed.

The member always maintains sole control of and all right, title and interest in his savings account. If he completes the payments to that account pursuant to the plan and if his [*7]

candidate survives, is graduated from high school and successfully completes his freshman collegiate year, the trust funds are to be used to pay the cost of the remaining three years of his college education. n10

n10 The plan contemplates that the member's savings account will be used to pay the cost of the candidate's freshman year.

Upon enrollment each candidate is assigned a "maturity date", i.e., the year he is expected to enter college. n11 Candidates having the same maturity dates are deemed to be in the same class. When a class enters its sophomore year the amount available in the trust for that class is divided into three parts -- one part for each of the remaining college years. One such part is divided by the number of eligible candidates in that class. The resulting sum is then paid directly to each candidate's college to cover the candidate's college expenses for the sophomore year. n12

n11 This is also the date on which the assignment to the trustee of interest earned by the member's savings account will terminate.

n12 For the junior year the remaining fund is divided into two parts and one such part is divided by the number of candidates remaining in the class. For the senior year the fund is merely divided by the number of candidates in the class. Determination as to what constitutes "college expenses" is left to the discretion of each candidate's college. If a candidate's expenses exceed the amount of the scholarship award he is expected to make up the difference. If the entire amount of the award is not used by the candidate during any college year, the unused moneys are to be returned to the trustee who will add it to the funds of that candidate's class. [*8]

However, in order that a candidate may participate in the benefits of the scholarship award the member must complete the savings account deposits prescribed by the plan and the candidate must successfully meet the academic requirements for advancement to the sophomore year. A candidate's ineligibility to participate may result in a number of ways including his permanent physical inability to continue his education, n13 failure of the member to make the necessary installment payments into his savings account whether because of financial inability or voluntary termination of the plan, scholastic failure or dropout from high school or college by the candidate at any time for any reason. If scholastic failure or dropout occurs after the sophomore year, the candidate also becomes ineligible. The result of ineligibility is complete forfeiture of all monies paid into the trust by the member. The amount forfeited would, of course, vary with the age of the candidate on enrollment and the length of time the member continued his membership in good standing prior to either his termination of the plan or ineligibility of the candidate.

n13 Arrangements for delayed entrance into college are made for temporary illness or service in the armed forces. Further, in the event of the death of a candidate prior to his "maturity date", the enrollment may be transferred to a younger child. [*9]

The record leaves no doubt that the success of the plan depends entirely upon forfeitures in substantial numbers in every class. Obviously, $ 664.79 is hardly adequate to cover the cost of three years of college education. Both ESF and CAP recognized this in their sales literature which is replete with representations of anticipations and expectations, albeit no guarantees, of scholarship awards of $ 1,500 per year for three years for each candidate. Some of the literature expands that figure to "$ 4,500 to $ 6,000". The forfeiture aspects of the plan are emphasized by the literature which explains that the success of the plan is made possible through interest obtained from the member's savings account "PLUS the added revenue accruing from student dropouts, PLUS the interest accumulated from certain sponsors who fail to follow through with their savings program * * *." CAP's literature also includes charts designating their source as "U.S. Dept. of Health Education and Welfare", which demonstrate that out of 1,000 enrollees only 603 will enter college; of those 603, 312 will

not qualify to enter the sophomore year, 90 will not qualify for their junior year and 36 will not qualify [*10] for their senior year. n14

n14 Data furnished by CAP to the State of Florida was interpreted by the State's actuary to have even more drastic forfeiture results as follows:

| | |
|---|---|
| "Starters | 1,000 |
| Finish High School | 635 |
| College Sophomores | 140 |
| College Juniors | 119 |
| College Seniors | 86" |

It is also evident from the testimony of George Ling, whose firm of consulting actuaries has been retained by CAP for actuarial research, that the meaningfulness of the program depends on dropouts or forfeitures. n15 This report to CAP points out the need for forfeitures and the various means which might be employed to reduce "anti-selection", n16 i.e., "Enrolling members at only the very early ages"; "High proportion of sales to * * * the low income group; and "Flexible conditions for payment of enrollment fee". Moreover, the experience of the plan during the short time of its existence n17 should not be disregarded in considering the degree of forfeitures. In about one and one-half years 3,777 memberships were sold in Florida, of which about 3,300 were still in effect at the time of the hearing. 173 memberships were sold in Pennsylvania in less than one year, of which 141 are still [*11] in effect and 33 were sold in Iowa in less than one year of which 25 are still in effect.

n15 "If you enroll only those who you know will go to college and they are from wealthy families, the program is going to have no meaning."

n16 Ling's report defines anti-selection:

"'Anti-Selection' applicable to any financial situation may be defined as the obligation to individuals or groups, for a consideration, which include a high proportion of those who actually expect to benefit either to a greater degree or else sooner than is the average case.

For example, if an insurance company sells policies only to heart patients at standard (average) premium rates, sales records will be broken but so will the company before very long."

n17 Sales of the plan were suspended in September 1967 apparently awaiting the determination of this proceeding.

Applicant's Status under Section 3 of Act

Section 2(a)(8) of the Act defines a "company" to include "a trust, a fund." Obviously, the interest from members' savings accounts assigned to the trustee and funnelled into the CAP Trust Fund ("Trust Fund") constitutes a "fund". Indeed, the name of the applicant in this proceeding, The Trust [*12] Fund Sponsored By the Episcopal School Foundation College Award Program, Inc. is itself indicative of recognition by applicant that the fund is a company within the purview of the Act and within the holding of Prudential Insurance Co. v. S.E.C. 326 [ILLEGILE TEXT] F. 2d 383, 387 (C.A. 3, 1964) that a fund, otherwise having no recognized identity as a legal entity, may nevertheless constitute a "company" as that term is defined in the Act.

Section 3(a)

The relevant provisions of Section 3(a) of the Act define an investment company as any issuer n18 which

"(1) is or holds itself out as being primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities;"

"(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis." n19

n18 Section 2(a)(21) of the Act defines "issuer" as "every person who issues or proposes to issue any security, or has outstanding any security which it has issued."

n19 Section 3(a)(2) which relates to issuers engaged "in the business of issuing face-amount certificates of the installment type" is not applicable. Section 2(a)(15) defines a face-amount certificate as an obligation to pay a stated or determinable sum. "Face-amount certificates are contracts under which the company is bound to pay a fixed sum at maturity * * *." Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, December 2, 1966, p. 37. CAP's representation of a $ 4500 non-guaranteed scholarship award hardly falls within the category of a "fixed sum." [*13]

Applicant urges that the Trust Fund is not an investment company under Section 3(a), but offers no rationale other than the statements that "CAP and its Fund do not reinvest or trade in securities" and "they are not engaged in the business of investing, reinvesting, owning, holding, or trading in securities."

However, CAP's sales literature refers to the trust and its earnings. CAP's Regulations created Trust Fund and all contracts by CAP with its members refer to the Regulations. Its trust agreements with Atlantic have been furnished to the State of Florida. These agreements provide that the trustee shall manage, invest and reinvest the assets of Trust Fund. n20 Atlantic, qua trustee, has no business other than the management of Trust Fund.

n20 The Regulations provide that "[CAP] shall contract with the Trustee that all such interest so assigned and deposited shall remain in said CAP Trust Fund and be managed, invested and reinvested until such time as the Trustee is authorized by [CAP] to make payments of scholarship awards." The trust agreements state that the trustee shall "* * * manage, invest and reinvest the funds and all income and interest earned therefrom * * * [and] payout for such scholarship purposes such amounts to such recipients and at such times as [CAP] shall designate * * * " [*14]

Moreover, the trust funds are presently invested in savings accounts. n21 Thus, Trust Fund is and holds itself out to the public, its members and the State of Florida as being engaged primarily in the business of investing and reinvesting.

n21 At one time the trust funds were invested in U. S. Government bonds. It is CAP's present intention that the trust funds be invested only in savings accounts. However, should it be determined that Trust Fund is excepted from the provisions of the Act, "we would like to be able to purchase savings certificates and, if possible, government bonds, or whatever we can that would be qualified to increase the interest earnings." (Testimony of Rev. Wyatt-Brown).

The only question remaining under Section 3(a)(1) n22 is whether the assets of Trust Fund constitute securities. Even assuming that the trust funds are not to be utilized for any purpose other than their deposit in interest bearing savings accounts, they, nevertheless, are securities under Section 2(a)(35) for the reasons (1) that the arrangement resulting in the creation of Trust Fund is an "investment contract" and (2) that the savings accounts into which the funds are deposited [*15] by the trustee are "evidence[s] of indebtedness." n23

n22 Under Section 3(a), "'Investment company' means any issuer I I I.F Trust Fund is the issuer. Although CAP wrote the contracts which gave rise to the obligation to set up the fund and to the promises of scholarship awards," * * * the investment fund, the 'company' to which the investment interests relate, is the 'issuer' of those interests." The Prudential Insurance Company of America, 41 S.E.C. 335, 345 (1963); See also Prudential Ins. Co. v. S.E.C. supra, p. 388.

n23 Section 2(a)(35) of the Act defines "security" to include "any * * * evidence of indebtedness, * * * investment contract, * * *"

In determining whether Trust Fund is an investment company under the Act "we start with the premise that securities legislation must be broadly construed in order to insure the investing public a full measure of protection". n24 As set forth above, the **scholarship plan** provides for management by the trustee of the interest proceeds of each member's savings account. CAP represents that such proceeds, calculated at $ 664.79, will result in a scholarship fund for each candidate of at least $ 4,500 representing a substantial [*16] profit to the member. It becomes readily apparent therefore, that the plan conforms to the Supreme Court's definition of an "investment contract" which is a security as defined in Section 2(a)(35).

n24 Prudential Insurance Company v. S.E.C., supra, p. 386.

"In other words, an investment contract for purposes of the Securities Act n25 means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promotor or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." S.E.C. v. Howey Co. n26

n25 The definitions of "security" in the Securities Act of 1933 ("Securities Act") and in the Investment Company Act of 1940 are identical.

n26 328 U.S. 293, 299 (1945). See also S.E.C. v. Joiner Corp. 320 U.S. 344 (1943).

Moreover, as stated in Justice Brennan's concurring opinion in S.E.C. v. Variable Annuity Co., the controls of the Act "are of particular relevance to situations where the investor is committing [ILLEGIBLE TEXT] funds [*17] to the hands of others on an equity basis, with the view that the funds will be invested in securities and his fortunes will depend on the success of the investment." n27 In Prudential v. S.E.C. supra, the court adopted the same position n28 in respect of the variable annuity contracts under which Prudential established a fund for investment in securities for the benefit and at the risk of purchasers of the contracts. And in S.E.C. v. Variable Annuity Co., supra, the court declared that the term "security" as defined in the Securities Act "is broad enough to include any 'annuity' contract." n29 As relevant here, the relationship between CAP, its members and Trust Func offers little meaningful difference from that of the insurance company, the variable annuity and its investors.

n27 359 U.S. 65, 79 (1959).

n28 At pp. 386, 387.

n29 At pp. 67, 68.

We now turn to the question whether the savings accounts maintained by Trust Fund constitute "evidence[s] of indebtedness." The crux of this problem is the nature of the obligation created by the savings accounts. Ordinarily, the relationship between a savings bank and its depositor is regarded simply as that of debtor [*18] and creditor absent an

agreement to the contrary. n30 Here, not only has no agreement to the contrary been shown, but under the law of Florida where the savings accounts are maintained, "depositors of [savings banks] in this state are creditors of the bank and have the same rights as depositors in other banks." n31 The law is clear, therefore, that the savings accounts maintained by the trustee represent evidences of indebtedness n32 and securities under Section 2(a)(35).

n30 9 C.J.S. Banks and Banking, P 992.

n31 Robinson v. Aird, 43 Fla. 30, 29 So. 633 (1901). See also Tcherepnin v. Knight, 389 U.S. 332, 334 (1967) where the implication is plain that even the more complex withdrawable capital share of a savings and loan institution would have constituted an evidence of indebtedness absent a state statute providing specifically that the holder thereof does not become a creditor.

n32 "A savings bank pass book, like a bill of exchange or note, is for many purposes a chattel, and is not merely an evidence of debt but is representative of it. It imparts a liability of the bank to the depositor for the amount of money entered therein as deposited, an agreement to repay at such time and in such manner as he shall direct. . . ." 9 C.J.S. Banks and Banking P 986. [*19]

Appellant's reply brief contends that the member makes a gift of the interest from his savings account to the trust fund which he may cut off at any time; that the member has no right in these interest payments after they reach the trust and concludes, therefore, that "there are no investments made but merely gifts." On the other hand, applicant's brief admits that the candidate will receive the benefits of the member's "gift" if he qualifies. Obviously, applicant cannot have it both ways. It is the very essence of a gift that the donor retains no rights in a donation either for himself or for others. That here, the CAP member retains a right which he may forfeit at some future time negates the fundamental concept of a gift. Applicant's further argument that the member's contract with CAP "has nothing to do with any agreement with Trust itself" is untenable since CAP's sales literature refers to the trust and the contract or application through reference to CAP's Regulations and By-Laws n33 provides for the maintenance of the trust from which the ultimate benefits of the contract are to be distributed.

n33 One form of contract executed by an applicant on November 8, 1966 provides that the application is "subject to the By-Laws of [CAP] which I have examined." The By-Laws include reference to the Regulations. In a different form, the application is "subject to the regulations pertaining to its College Award Program (which I have examined)." The preamble to the Regulations refers to an agreement between CAP and the member whereby the member "binds himself and his candidate to abide by these CAP Regulations. * * *" [*20]

Undoubtedly, under certain circumstances, a savings account may be deemed "cash" rather than investment securities in reaching a determination under Section 3(a)(3) whether the value of an issuer's investment securities exceeds 40% of its total assets. However, that treatment should properly be accorded only where the nature of the issuer's business and assets raise a legitimate question, but not where, as here, the maintenance of savings accounts is the issuer's principal business and sole means of fulfilling its obligations to its investors. In addition, since the savings accounts may not be utilized until the maturity dates of the various classes, their total lack of liquidity negates consideration of these accounts as "cash" within the meaning of Section 3(a)(3).

Under all the circumstances set forth above, it is concluded that Trust Fund is an investment company under Section 3(a) of the Act. n34

n34 On September 25, 1967 applicant filed "Form N-8A, Notification of Registration Filed Pursuant to Section 8(a) of the Investment Company Act of 1940."



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Section 3(c)(3)

This section excepts "any bank or insurance company" from investment company status. It also excepts [*21] "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee * * *." n35

n35 The "common trust fund" excepted by Section 3(c)(3) is defined in H. Doc. 476, 76th Cong. (1939) (Report of the Commission on Common Trust Funds) as a number of small personal trusts or estates combined by a trustee bank or trust company into one larger fund for common administration and management. Regulation F of the Federal Reserve Board refers to the common trust fund as "investment funds held for true fiduciary purposes, * * *." See, also, Prudential Insurance Co. of America, supra, p. 346, footnotes 24 and 25.

Appellant asserts that it falls within the exception since the trust funds are held in trust by and administered by a national bank. Prudential v. S.E.C., supra, held that Prudential is separable from the variable annuity fund it operated and its exception from the Act as an insurance company did not extend or carry over to the fund. Atlantic is performing the functions of a trustee under a specific contract setting forth its duties and obligations. [*22] It, also, is separable from Trust Fund and its status as a bank is no more relevant in the instant matter than was Prudential's status as an insurance company in that case.

Nor is the common trust fund exception applicable to Trust Fund. In considering the same problem in Prudential v. S.E.C., supra, the court held that the Congress did not intend to include is the exception funds used for general public investment. It said:

"* * * Obviously, if as Prudential argues, the exemption of banks and insurance companies had been intended to include an exemption of funds set up by such companies, there would have been no need to provide for the additional specific exemption of funds set up by banks. Congress thus viewed such funds even though usually maintained as departments of the bank, as separate from the banking business. It rested this exemption on the special considerations that the funds were used for bona fide fiduciary purposes rather than as a medium for general public investment and had only a limited impact in the investment fund picture." n36

n36 [Illegible Text] at p. 388.

CAP and its sister scholastic plans certainly were not set up or used for "bona [*23] fide fiduciary purposes." To the contrary they had been offered to the general public of Florida, Pennsylvania and Iowa and cannot, therefore, qualify for exception as common trust funds. It follows that the provisions of Section 3(c)(3) are not available to Trust Fund.

Section 3(c)(8)

Section 3(c)(8) excepts from the provisions of the Act:

"Any company 90 per centum or more of the value of whose investment securities are represented by securities of a single issuer included within a class of persons enumerated in paragraph (5), (6) or (7)."

Paragraphs (5) and (6) are obviously inapplicable. Paragraph (7), however, excepts any company primarily engaged in one of the businesses described in paragraph (3). Paragraph (3) includes "any [Illegible Text]." In view of applicant's intention to maintain all its funds in savings accounts which have been found above to constitute securities under Section 2(a) (35), question is raised whether the value of applicant's securities are "represented by securities of a single issuer." n37

n37 It is assumed Atlantic maintains the savings account in its own bank. If they are on deposit in another bank the issue remains unaffected. [*24]

To translate the language of Section 3(c)(8) to the specifics of the matter before us, the "company" is Trust Fund. The "single issuer" is Atlantic, as a bank and not as trustee. The "Securities of a single issuer" as contemplated by Section 3(c)(8), would represent investment on an equity basis in the enterprise which is Atlantic, in all its underlying assets and in the results of Atlantic's operations as a bank. Trust Fund's savings accounts maintained in Atlantic and the interest earned by these savings accounts constitute nothing more than a debt owing by Atlantic to Trust Fund. This debt is a security of Trust Fund. It is not to be confused with a security of Atlantic.

Applicant, therefore, does not fall within the exclusionary provisions of Section 3(c)(8).

Section 3(c)(12).

Section 3(c)(12) excludes from the Act:

"Any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual."

Applicant urges that it is an affiliate of the Episcopal Church. That the record is replete with evidence to the [*25] contrary is of little con [Illegible Text] inasmuch as Trust Fund would appear to be operated for educational purposes.

But Section 3(c)(12) contains two conditions i.e., that education is the exclusive purpose of the organization and that none of its earnings inure to the benefit of its shareholders. Statutes enacted prior to this section and which contain identical conditions have been the subject of both judicial and administrative determinations discussed below.

In Better Business Bureau of Washington v. U.S., 326 U.S. 279 (1956) the court indicated that a single non-educational purpose of the organization seeking exemption from social security taxes, if substantial in nature, would destroy the exemption provided by the Social Security Act. S.E.C. v. American Foundation for Advanced Education of Arkansas, 222 F. Supp. 828 (U.S.D.C., W.D. La., 1963) presented a request by an organization selling a **scholarship plan** for exemption from registration under Section 3(a)(4) of the Securities Act. The court, citing Better Business Bureau v. U.S., supra, found the substantial non-educational purpose which negated exclusivity of the educational purpose in the [*26] fact that the profits of the foundation were returned to its members in the form of the payment of the college expenses of the members' children and that the element of profit was the principal motivation for the members' participation, which "makes the application of the registration requirements of the Securities Act [Illegible Text] necessary here."

The Internal Revenue Service considered an application for exemption from Federal income tax under Section 501(c)(3) of the Internal Revenue Code by an organization offering a **scholarship plan** similar in its pertinent aspects to that sold by CAP. The application was rejected on the ground that the agreements pursuant to which the organization paid scholarships to specifically named individuals designated by the subscriber served private rather than the public charitable and educational interests contemplated by the Code. n38

n38 Martens, Law of Federal Income Taxation, Revenue Ruling 67-367.

The Internal Revenue Code fathered the Social Security Act which was the subject matter of Better Business Bureau v. U.S., supra. n39 Although the legislative history of the Investment Company Act makes little reference to Section [*27] 3(c)(12), the identity of language

would indicate that that section also found its origin in the Code. It needs no extended discussion to demonstrate that CAP's plan, like those considered in S.E.C. v. American Foundation, supra and the Internal Revenue Ruling set forth above, lacks the exclusivity of educational purpose required by the Act since its ultimate end is the benefit of its private members. Section 3(c)(12) of the Act is, therefore, not available to applicant.

n39 At p. 284.

The **scholarship plan** has its genesis in the vastly increased cost of education at the college level in recent years and the inability of many parents to meet these financial burdens. Undoubtedly, solutions to this problem are urgently needed. However, where one possible solution involves the creation of an investment company as defined in the Act, exemptions from the Act and other relief sought by the investment company must be viewed in the context of the congressional declaration of policy set forth in Section 1 of the Act which expresses deep concern for the national public interest and the protection of investors. In enforcing this policy, the courts have consistently emphasized [*28] the need to effectuate the remedial purposes of securities legislation and, in that context, to construe it broadly in accordance with the "familiar canon of statutory construction," n40 to construe it "not technically and restrictively, but flexibly to effectuate its remedial purposes" n41 in order not to thwart the statutory policy. n42

n40 Tcherepnin v. Knight, supra; S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953).

n41 S.E.C. v. Capital Gains Bureau, 375 U.S. 180, 195 (1963); Prudential Insurance Co. v. S.E.C., supra; Cf. S.E.C. v. Joiner Corp., supra.

n42 S.E.C. v. Howey Co., supra.

Consideration of applicant's requests for exemptions from the requirements of various provisions of the Act would be aided by a review of certain aspects of applicant's history which have not been mentioned heretofore. In September 1965 ESF formed Nationwide Service Corporation ("N.S.C.") as the sales organization through which its **scholarship plan** would be offered to the public. Rev. Wyatt-Brown was its President and a director but was relatively inactive. Professional management personnel were employed to operate N.S.C. and originally the plan was sold through N.S.C.'s [*29] salesmen. Later the plan was sold through area agents and other organizations which were supposedly supervised by N.S.C. Apparently, however, both the N.S.C. management and the personnel engaged in selling the plan lacked suitable training or had other shortcomings. Some of the advertisements placed for the hiring of salesmen were "very bad" and it was evident that "mistakes"had been made by N.S.C. in the sale and distribution of the plan. n43 For these reasons Rev. Wyatt-Brown, upon the suggestion of his bishop, resigned his presidency of St. Anne's College and devoted his full time to N.S.C. to "bring some order into the sale of enrollments." n44

n43 Literature and advertising material were placed with various Florida newspapers, distributed through the mails and made available at churches and banks.

n44 Rev. Wyatt-Brown is no longer associated with N.S.C. in any capacity.

Under the original agreement N.S.C. undertook, among other things, to maintain enrollment and membership records and keep records of candidates' accounts. CAP's inter-office memoranda disclose that N.S.C. failed to satisfactorily furnish this service, for which it had been paid, leaving CAP in an embarrassing [*30] position as to year end 1966 figures which it required for distribution to its membership and others. CAP also had additional problems. But, with the exception of the representation of a scholarship award of $ 4,500 for each candidate, the errors in the past history of the **scholarship plan** as administered by ESF and CAP are not now of great moment since steps have been taken which appear on their face to be adequate to remedy those mistakes.

Rev. Wyatt-Brown and Mr. Sanson who administer the plan and Bishop James L. Duncan, a member of the board of directors, are people of high integrity, sincerely dedicated in their efforts to make higher education more readily available. They are now making a new and what they consider to be a genuine attempt to correct past faults in the sale and administration of the plan. To that end they have entered into agreements with an accounting firm in order to overcome their earlier bookkeeping shortcomings, with an actuarial firm to put to appropriate use the experience of the plan as the years progress and have stated that they will not enter into a sales agreement with any organization which is not a member of the National Association of Securities [*31] Dealers, Inc. ("NASD").

CAP's ability to maintain the accounting, actuarial and other necessary services is predicated upon an estimated 5,000 enrollees per year, each to pay the $ 175 enrollment fee. As indicated above, CAP's projections envisage that $ 60 of this fee will be retained by it for payment of costs of administration of the plan and the remaining $ 115 will be paid to a sales organization to cover expenses of sale of the plan. Applicant states that N.S.C., now under new management, will be given preferred consideration if it becomes a member of the [Illegible Text]. CAP also offers not to re-engage in business until such [Illegible Text] as proper new actuarial studies are made to update its [Illegible Text] figures. To the extent, however, that an enrollment of 5,000 [Illegible Text] members for each year is basic to the success of CAP's current [Illegible Text] for administrative services and to the extent that such an enrollment is essential to achievement, through increased numbers of forfeitures, of its representations of $ 4,500 scholarships, CAP offers little reason other than hope for its anticipation of enrollments in such numbers. Certainly, its past experience [*32] in Florida, Pennsylvania and Iowa does not warrant such expectations.

Section 6(c) of the Act authorizes the Commission to exempt persons from the provisions of the Act if and to the extent that such exemptions are necessary or appropriate in the public interest and consistent with the protection of investors and the policies of the Act.

Obviously, the representation of a $ 4,500 scholarship award is the major inducement to membership in the plan. n45 It is readily apparent, however, that this representation is not predicated upon the reasonable basis in fact required under the securities laws. n46 Nor does the fact that the representation is not couched in terms of guarantee offer exoneration. n47

n45 The plan's sales literature shows $ 1,700 and $ 1,400 as the current one year costs for southern and midwest state universities respectively, with the cost at private schools far exceeding these figures. Its literature projects the cost of 4 years of college by 1982 at $ 18,800.

n46 Alexander Reid & Co., Inc., 40 S.E.C. 986 (1962); Billings Associates, Inc., Securities Exchange Act Release No. 8217 (Dec. 18, 1967); Richard Bruce & Co., Inc., Securities Exchange Act Release No. 8303 (April 30, 1968); Norman Pollisky, Securities Exchange Act Release No. 8381 (Aug. 13, 1968).

n47 James DeMammos, Securities Exchange Act Release No. 8090 (June 2, 1967). [*33]

The computations which resulted in the $ 4,500 figure are set forth in a submission by CAP to the State of Florida. These computations purport to present an admixture of statistics and actuarial assumptions. They use a base of 1,000 and project the rate of survival of members and candidates in the plan, from year to year, based upon statistics as to parents who die, children who die, parents who quit the plan, grammar and high school dropouts, college enrollees and college dropouts. Insurance mortality tables are used for the death categories. The school dropout figures rest on statistics of the Department of Health, Education and Welfare ("HEW"). The projections for parents who quit the plan are derived from information indicating a 50% dropout rate for long-term annuity contracts. In utilizing this 50% or 500 figure, CAP's computations arbitrarily divide 500 by 16 years arriving at 31.25 parents who

will quit the plan each year. These computations were prepared in 1963 and submitted to the State about 1966.

In determining the reasonableness of the $ 4,500 representation, it is significant that the HEW statistics upon which CAP's projections were based covered the periods [*34] 1942-1950 through 1954-1962. These statistics showed that out of 1,200,000 high school graduates in 1950 about 32% entered college. However, they also demonstrated that out of 1,000 in the 1954-1962 period, 636 graduated from high school and 336 or over 52% entered college. Nevertheless, in its presentation to the State, CAP selected the 32% figure as the base for its projections obviously affording a potentially greater monetary realization for the scholarship award than use of the available statistics for the later period would have shown. It is also noted that statistical material received by Rev. Wyatt-Brown after CAP's filing with the State indicates that for the year 1965, 55.3% of high school graduates entered college, a still higher figure. Whatever may be CAP's justification for failure to use this material, it nevertheless is evidence of a continuing trend of a higher proportion of college entrants.

Further the national statistics utilized by CAP do not necessarily have any relationship or applicability to the persons who become members of CAP. The national statistics represent a cross-section of the general population without regard to specific desires or intentions [*35] of the people composing that cross-section to give their children a higher education. Where the incentive to do so is sufficiently alive to cause an individual to join CAP, it is reasonable to assume that the likelihood of his achieving that purpose is far greater than that shown by the national statistics. It follows that the computation of a $ 4,500 scholarship award based upon national statistics may not reasonably be expected to prove realistic. In addition, no justification appears for spreading the projected 50% of parents who would quit the plan equally throughout the 16 years of the plan. Ling testified he "would suspect" that such quitting would occur in the early years of the plan. Logic would support his suspicion and on this basis the amount available for the candidates as computed by CAP would be further reduced.

The foregoing supports the conclusion that CAP's representation to the public that $ 4,500 would be available to the eligible candidate was made without reasonable basis in fact and therefore, contrary to the requirements of the securities laws.

No matter how well-intentioned the principals of CAP may have been, it is fundamental that the securities laws [*36] must be administered for the benefit and protection of investors. To further that end it has been held, repeatedly, that because a security is "intricate merchandise," the proscription of the anti-fraud provisions of the securities laws extend beyond common-law fraud; n48 that in the public sales of securities the seller impliedly represents that his statements "are responsibly made on the basis of actual knowledge and careful consideration"; and that it is not a sufficient excuse that a seller of securities personally believes the representation made without adequate basis. n49 Moreover, since the success of the plan depends upon forfeitures, its very nature would appear to necessitate recommendation of the security to persons for whom it would be unsuitable n50 and, consequently, inconsistent with the well-established "basic obligation * * * to deal fairly with the investing public." n51

n48 Alexander Reid, 40 S.E.C. 986, 989.

n49 Ibid, pp. 990, 991

n50 Gerald M. Greenberg, 40 S.E.C. 133, 137 (1960); Cf. Rule 15b10-3 promulgated under the Securities Exchange Act of 1934.

n51 Richard Bruce & Co., Inc., supra.

In view of the foregoing, the circumstances surrounding [*37] the representation of a $ 4,500 scholarship award raise serious question whether the granting of any exemptions sought by applicant other than those of an entirely innocuous nature, as they relate to the interests of investors, would be in the national public interest.

As relevant here, Section 14(a) of the Act prohibits an investment company from making a public offering of securities unless it has a net worth of at least $ 100,000.

A letter from CAP to an official of the State of Florida dated April 22, 1968, states that the corpus of the trust (presumably all three plans) amounts to over $ 52,200 including contributions for the first quarter of 1968. The letter shows the following breakdown of trust funds as of December 31, 1967: Pennsylvania $ 700.60; n52 Iowa $ 5.55 and Florida $ 32,681.24.

n52 The CAP-Del plan was sold only in Pennsylvania

The Reports of the Senate and the House of Representatives both commented adversely on the fact that at that time little capital was needed to organize investment companies. n53 Section 14(a) was enacted "To put a brake on the irresponsible formation of investment companies * * *." n54 Thus, the basic purposes of Section 14(a) are [*38] something more than "simply to indicate a public acceptance of the responsibility of the promotors of investment companies," as applicant understands it. The intent of the section is, rather, to assure at least some element of financial responsibility of the promotors of an investment company and to afford investors the protection envisaged by the section despite themselves and without regard to the public acceptance to which applicant refers.

n53 Senate Report No. 1775, 76th Cong., 3rd Sess., June 6, 1960, p. 6 (Senate Report); House of Representatives Report No. 2639, 76th Cong., 3rd Sess., June 18, 1950, p. 8 (House Report).

n54 Senate Report p. 13.

Although Trust Fund is the investment company to which Section 14(a) is directed, CAP's financial condition is also relevant to the extent that it reflects the plan's prospects for the future. CAP's liquid assets are minimal. Its balance sheet as of March 31, 1968 shows an overall deficit of $ 13,096.94 and includes assets of $ 15,858.92 consisting of furniture and fixtures and accounts receivable of $ 8,260.04, both of doubtful value. Under the Florida Statutes n55 CAP is required to deposit with the Insurance Commissioner [*39] securities of the value of $ 50,000 to assure performance of its obligations to its members; $ 25,000 in such securities on or before April 1, 1968 and a similar amount on or before April 1, 1969. CAP has no securities of the nature contemplated by the State's deposit requirements. It has requested the State to waive the first deposit in view of its inoperative status. As of the close of the record the State had not responded. n56

n55 Section 617.561.

n56 Since the statute requires the deposit to be made by the corporation rather than Trust Fund a deposit of $ 50,000, rather than that of $ 150,000 asserted by the Division, would suffice even if the CAP-Del and CAP-Iowa trust agreements should be approved.

In view of the limited assets of Trust Fund for the Florida plan, the minute assets of the Iowa and Pennsylvania plans and the precarious financial condition of CAP, the granting of an exemption from Section 14(a) would nullify the protections of the Act and adversely affect the interests of investors. Accordingly, the request for exemption from the provisions of Section 14(a) of the Act is denied.

Section 16(a)

This section provides that all directors of a registered [*40] investment company be elected by shareholders of the company at an annual meeting or a special meeting called for that purpose. Applicant seeks exemption from Section 16(a) to the extent that the Florida law requires that four organizations, i.e., the Florida Congress of Parents and Teachers, Florida Education Association, Florida Bankers Association and Florida Savings and Loan League each have the right to appoint a representative on CAP's board of directors.

Trust Fund is a registered management company. n57 It is unincorporated and has no board of directors. Under these circumstances, Section 10(h) of the Act requires, among other things, that the depositor shall have a board of directors no more than 60 per centum of the members of which are officers or employees of the depositor. CAP's charter provides for not less than 7 or more than 18 directors. So long as the duly elected members of CAP's board constitute a majority, CAP's "corporate democracy," to which the Division refers, will be preserved. CAP should insure, by amendment to its by-laws, a continuing majority of elected members in the event the above named organizations decide to exercise their right to appoint [*41] members to CAP's board. In other respects CAP's board should observe the provisions of Section 10(h), where applicable. Moreover, applicant has undertaken not to deviate from the investment policies described in its application n58 without an order of the Commission permitting such deviation as well as the majority vote of its membership as provided by Section 13 of the Act.

n57 Section 4 of the Act classifies investment companies as either a face-amount certificate company, a unit investment trust or a management company. Trust Fund is not a face-amount certificate company. (See fn. 18). Trust Fund is not a unit investment trust which, by definition in Section 4(2) of the Act, issues only redeemable securities. The plan's forfeiture provisions are patently inconsistent with the concept of a redeemable security. Under Section 4(3), if trust company is neither of the others, it is a "management company."

n58 The application states:

"It is intended that Applicant's assets will continue to be invested in United States Government Securities, including securities issued by agencies of the United States and/or fully guaranteed or insured by such agencies and in Certificates of Deposit of Federally insured banks * * *;" and, if its pending request of the Internal Revenue Service for exemption from Federal income taxation is denied, Applicant reserves the right to invest in tax-exempt municipal bonds. [*42]

The conflict anticipated by the Division if the Bankers Association and the Florida Savings and Loan League should appoint members to the board would be de minimus in view of Trust Fund's investment policies. Further, if the majority vote of the membership is obtained for a change in investment policy pursuant to Section 13 of the Act, an order of the Commission approving such change should not be required. Exemption from Section 16(a) of the Act on the conditions indicated above including the applicant's undertaking would not adversely affect the interest of investors. The exemption is, therefore, granted.

Section 27(c)(1)

This section declares it to be unlawful for any registered investment company issuing periodic payment plan certificates, or for any depositor for such company to sell such certificates n59 unless they are redeemable securities. Applicant urges that the effect of the literal application of Section 27(c)(1) would be to destroy the entire contractual arrangement and seeks an exemption from the provisions of that section.

n59 It is immaterial whether shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets of the enterprise. S.E.C. v. Howey Co., supra. p.



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299. [*43]

Since, as hereafter demonstrated, it is inherent in the plan that its success depends upon forfeitures, its securities are not redeemable. Such forfeitures, occurring late in the life of a member's plan when large amounts have been invested, would enhance the posibilities of success of the plan. Indeed, it is doubtful whether the plan would have even the barest chance of success if all or most forfeitures took place when the members' losses would be minimal. It is also noteworthy that the amount of a member's overall loss through forfeiture would include not only the interest from his savings account but, also, his $ 175 enrollment fee.

The legislative history of the Act reflects the deep concern of the Congress with the matter of forfeitures. In testimony before the Senate n60 at least two witnesses condemned the forfeitures resulting from investments in face amount installment certificates. The Reports of both the Senate and the House n61 took cognizance of the practices which resulted in forfeitures and substantial losses, pointing to companies which sold to investors in low income brackets who invariably had great difficulty meeting their installment payments and to the [*44] high lapse experience of investors. In enacting Section 27(c)(1) the Congress made appropriate provision to relieve this situation by prohibiting forfeitures, admonishing that "Periodic payment plan certificates must be redeemable securities." n62

n60 Hearings on S. 3580 Before a Subcommitee of Senate Committee on Banking and Currency, 76th Cong., 3rd Sess. ("Senate Hearings") p. 300.

n61 Senate Report p. 10. House Report p. 8.

n62 Senate Report p. 19.

To grant applicant's request for exemption from the provisions of Section 27(c)(1) would serve only to perpetuate the incidence of forfeitures which the Congress decried. It is not enough to say, in respect of forfeitures, that the investor is aware of the risk he takes. To whatever extent and under whatever conditions full disclosure may be the sine qua non of the federal securities laws, here the Congress specifically excluded forfeitures from any periodic payment plan as adverse to the national public interest and the interest of investors. Applicant's assertion that the members' savings accounts are always available to and redeemable by the members carries little persuasion since it was never intended that these [*45] savings accounts would be at risk and they do not constitute assets of Trust Fund.

In the light of the foregoing and the manifest adverse effect of forfeitures on the interests of investors, exemption from the provisions of Section 27(c)(1) is denied.

Section 26(a)(2)(A) and 26(a)(2)(B)

The pertinent provisions of this section prohibits the sale of securities issued by a registered unit investment trust unless the trustee, if not otherwise remunerated, may charge against or collect from the income or corpus of the trust fees for its services and remuneration for its expenses theretofore performed or incurred. Section 27(c)(2) requires any registered investment company issuing periodic payment plan certificates to deposit the proceeds of such payments with a trustee under an indenture or agreement containing, in substance, the provisions required by Section 26(a)(2). n63

n63 The application for exemption concedes that Section 27(c)(2) makes Section 26 applicable to applicants trust agreement.

Under the Florida statutes, n64 the trust funds shall "be used exclusively and solely for scholarships * * *". CAP's by-laws [Illegible Text] limit the use of the trust funds and [*46] the trust agreements exempt the trust funds from use for payment of the trustee's fees and

charges, such payment being assumed by CAP out of the administrative fees paid by the members.

n64 Section 617.56.

Section 26 was designed to remedy the situation in which a sponsor abandons the enterprise and no provision is made for remuneration of the trustee, thus creating an "orphan trust". n65 But, CAP and the Trust Fund are supervised by the State under a statute specifically designed to cover enterprises engaged in the sale of educational plans. The statute includes remedies which adequately protect against the possibility of an orphan trust. n66 Under these circumstances the congressional intent is preserved and the interest of the investor protected by the Florida law. A requirement for a change in the trust agreement which would conflict with that law appears unnecessary. Accordingly, the exemption is granted.

n65 Senate Hearings, p. 300; Senate Report, p. 19; House Report, p. 22.

n66 The Statute requires (1) the $ 50,000 deposit referred to above; (2) deposit of additional sums if the $ 50,000 deposit is deemed insufficient (Section 617.62); the filing of annual financial statements (Section 617.58); and institution of liquidation proceedings by the Commissioner of Insurance when the corporation is insolvent or the further transaction of business is hazardous to the public, the members or the trustees (Section 617.60). [*47]

Section 30(d)

This section requires the transmission of semi-annual financial reports by Trust Fund to the members of the plan.

Section 30(a) requires the filing of annual reports with the Commission and Florida law provides for the filing of annual reports of financial condition with the Insurance Commissioner. Applicant says this is enough; that the filing of a semi-annual report would add unnecessary expense and contribute no meaningful information to the members. But applicant overlooks the poor financial condition of CAP and the various problems raised for it by this proceeding. Until such time as the plan and Trust Fund become stabilized, the membership should be furnished financial information as often as is feasible in order that they may be in a position to reach an independent judgment as to the plan's prospects for success. The request for exemption is denied.

Section 18(i)

This section, as relevant here, requires that every share of stock issued by a registered closed-end company shall have equal voting rights. Applicant requests that the Commission issue an order permitting voting rights as set forth in CAP's by-laws which provide that each member have [*48] one vote for each candidate he sponsors. Division opposes the request asserting that the by-laws do not permit members to vote in relation to the amounts they have invested.

A perusal of the installment deposit schedules discloses that the amount invested by each member utilizing the installment plan would, of necessity, change frequently. Furthermore, these changes would vary depending upon the type of plan the member followed -- monthly, quarterly or annual. Thus, the number of votes of each member would be subject to such constant variation as to make adherence to Section 18(i) cumbersome and unwieldy, if at all possible.

The **scholarship plan** is far removed from the usual investment concept contemplated by Section 18(i). The goal of each member is the realization of the scholarship award for his candidate. The trust funds may not be used for any other purpose. Since each member who

fully complies with the plan will ultimately invest the same amount for each qualified candidate, the public interest would not be affected adversely by acceptance of the plan's voting provisions in lieu of the virtually unmanageable arrangement which would result from compliance with Section [*49] 18(i). Applicant's request for an appropriate order is granted.

Section 23(b)

Applicant requests an order permitting it to sell its shares below net asset value, contrary to Section 23(b) of the Act, until its next annual meeting at which time it will seek its members' approval of continuation of the present selling procedure. Division argues that the section was designed to prevent dilution of existing shareholders' interest in closed-end companies by sales below net asset value and that new investors would participate in applicant's assets and earnings without paying a pro-rata share.

However, as shown above, a member may not realize on any of Trust Fund's assets or earnings until his candidate has qualified for the scholarship award. The investment of all members sponsoring successful candidates would be identical. Although the Division's position would have substance where marketable securities are issued, enforcement of Section 23(b) under the circumstances present here would not appear to add to the protection of investors.

Applicant's request, conditioned on membership approval of present selling procedures at the next annual meeting, is granted. Accordingly, [*50]

IT IS ORDERED that applicant's request that it be declared not to be an investment company within the purview of Section 3(a) of the Act be, and it hereby is, denied; and

IT IS FURTHER ORDERED that applicant's request for exception from investment company status under Sections 3(c)(3), 3(c)(8) and 3(c)(12) of the Act be, and it hereby is, denied; and

IT IS FURTHER ORDERED that applicant's request for exemption from the provisions of Sections 14(a), 27(c)(1) and 30(d) of the Act be, and it hereby is, denied; and

IT IS FURTHER ORDERED, pursuant to Section 6(c) of the Act, that

(A) applicant's request for exemption from the provisions of Section 26(a)(2)(A) and 26(a)(2)(B) of the Act be, and it hereby is, granted.

(B) applicant's request for exemption from Section 16(a) of the Act be, and it hereby is, granted to the following extent:

(1) on condition that CAP amend its by-laws to insure (a) a continuing majority of elected members of its Board of Directors, and (b) that no more than 60% of the members of its Board of Directors shall be officers or employees of CAP, and (c) on condition that CAP shall conform to such other provisions of Section 10(h) of the Act as may become applicable; [*51] and

(2) on the further condition that applicant shall not deviate from the investment policies set forth in its application.

(C) in respect of Section 18(i) of the Act, voting rights of members as presently set forth in CAP's by-laws, i.e., each investor has one vote for each candidate he sponsors, be, and they hereby are, permitted.

(D) in respect of Section 23(b) of the Act, CAP's present procedure of selling memberships



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below asset value be, and it hereby is, permitted until the next annual meeting of the membership at which time the members' approval of such procedure will be sought and may be continued only in the event such approval is obtained. n67

n67 To the extent that the proposed findings and conclusions submitted to the Hearing Examiner are in accord with the views set forth herein they are accepted, and to the extent they are inconsistent therewith they are expressly rejected. Division's brief requests that no exemption be granted from the provisions of Sections 22(d), 27(a)(1), 27(a)(2) and 27(a)(3). However, these requests have not been considered. Neither the application nor the order for proceedings refer to these sections and although the order authorizes specific additional matters and questions, the matters covered by these sections were not raised during the course of the hearing. [*52]

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to Rule 17(b) of the Commission's Rules of Practice, a party may file a petition for Commission review of this initial decision within 15 days after service thereof on him. Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party unless he files a petition for review pursuant to Rule 17(b) or the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition to review or the Commission takes action to review as to a party, this initial decision shall not become final as to that party.

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## Appendix II

### U. S. SEC Scholarship Plan Findings, Opinions and Cases

1. *In the Matter of The Trust Fund Sponsored by the Scholarship Club, Inc.*, Findings and Opinion of the Commission, ICA Rel. No. 5524, (1968 SEC LEXIS 563) (October 25, 1968);

2. *In the Matter of The Trust Fund Sponsored by the Scholarship Club, Inc.*, Notice of Application Pursuant to Section 6 ( c) for Exemption from Section 27 (a) (3) of the Act and for Amendment of Previous Order, ICA Rel. No. 6250, (1970 SEC LEXIS 156) (November 17, 1970);

3. *In the Matter of The Trust Fund Sponsored by the Scholarship Club, Inc.*, Order for Exemption and Amendment of Previous Order, ICA Rel. No. 6293, (1970 SEC LEXIS 198) (December 16, 1970);

4. *In the Matter of the Trust Fund Sponsored by the Episcopal School Foundation College Award Program, Inc.*, Initial Decision of Hearing Examiner Sidney Gross, AP File No. 3-1374, 812-2229 (1968 SEC LEXIS 2734) (October 24, 1968)

5. *SEC v. International University Foundation, Ltd., et al.*, Lit. Rel. No. 4327 (1969 SEC LEXIS 1227) (May 27, 1969).

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*1968 SEC LEXIS 2734, **

In the Matter of THE TRUST FUND SPONSORED BY THE EPISCOPAL SCHOOL FOUNDATIC COLLEGE AWARD PROGRAM, INC., c/o Episcopal School Foundation College Award Progra Inc., (Sponsor), 3100 East Oakland Park Boulevard, Fort Lauderdale, Florida, (Investme Company Act of 1940)

Admin. Proc. File No. 3-1374; 812-2229

SECURITIES AND EXCHANGE COMMISSION

1968 SEC LEXIS 2734

October 24, 1968

**CORE TERMS:** candidate, trust fund, exemption, saving, investor, forfeiture, deposit, membership, enrollment, issuer, savings account, certificate, trust funds, statistics, by-law public interest, invested, earnings, annual, regulation, depositor, dropout, high school, redeemable, registered, Securities Act, variable annuity, face-amount, computation, sophomore

**COUNSEL:** [*1]

Appearances:

Lewis J. Mendelson and Allen B. Witz for the Division of Corporate Regulation

Frank E. Freeman for The Trust Fund Sponsored by the Episcopal School Foundation Colleg Award Program, Inc.

**TEXT:** INITIAL DECISION

Before: Sidney Gross, Hearing Examiner

This proceeding was instituted by the order of the Securities and Exchange Commission ("Commission") dated April 17, 1968, directing that a hearing be held on an application file by The Trust Fund Sponsored by The Episcopal School Foundation College Award Program, Inc. ("applicant") pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act")

The application and an amendment thereto filed during the course of the hearing assert th applicant is not an investment company within the meaning of the Act by virtue of the various exceptions provided by Section 3 of the Act. In the alternative, the application seek exemption from certain sections of the Act, orders under other sections of the Act and complete exemption from registration under Section 6(c) of the Act. n1

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1969 SEC LEXIS 1227, *

SECURITIES AND EXCHANGE COMMISSION

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LITIGATION Release No. 4327

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1969 SEC LEXIS 1227

May 27, 1969

**CORE TERMS:** registration, trust fund, offering, enjoin, registration statement, mandatory injunction, misleading, violating, antifraud, investors, selling

TEXT: [*1]

The Securities and Exchange Commission announced today the filing of a complaint in the United States District Court, Southern District of Florida, seeking to enjoin International University Foundation, Ltd., a company chartered under the laws of the Bahamas, Robert B. Downes and Gardner P. Mulloy from violating the registration provisions of the Securities Act of 1933, the antifraud provisions of that Act and the Securities Exchange Act of 1934 and the registration provisions of the Investment Company Act of 1940. The complaint also seeks a mandatory injunction directing Messrs. Downes and Mulloy and American College Foundation, Inc., a Florida corporation, to comply with the registration and reporting requirements of the Investment Company Act.

The complaint alleges that International, which is offering a "**scholarship plan**" to United States investors, is an investment company not organized or otherwise created under the laws of the United States or of a State, which has been offering to sell and selling securities without a Commission order allowing International to register as an investment company, in violation of Section 7(d) of the Investment Company Act. The complaint further [*2] alleges that the securities are being offered and sold in violation of the registration provisions (Sections 5(a) and 5(c)) of the Securities Act of 1933.

The complaint charges that the materials sent by International to United States investors soliciting their purchases are false and misleading in that they make untrue statements of material facts and omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

As to American College Foundation, Inc., the complaint alleges that it sponsors a trust [illegible] which registered as an investment company under the Investment Company Act on December 24, 1967. The complaint further alleges that no registration statement has been filed with the Commission for the trust fund as required by Section 8 of the Investment Company Act, and that any quarterly and semi-annual reports required by Section 30 of the Investment Company Act have not been filed with the Commission, nor have [illegible]

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The complaint asks that the court enjoin Messrs. Downes and Mulloy, and International University Foundation, Ltd., from offering and selling securities until the registration [*3] requirements of both the Securities Act of 1933 and the Investment Company Act of 1940 have been complied with. The complaint further asks the court to enjoin the above named defendants from violating the antifraud provisions of both the Securities Act of 1933 and the Securities Exchange Act of 1934. Finally, the complaint asks the court to enter a mandatory injunction requiring Messrs. Downes and Mulloy, and American College Foundation, Inc., to file a registration statement for the trust fund sponsored by American College Foundation as required by Section 8(b) of the Investment Company Act, and further requiring the above described defendants to file such reports for the trust fund as are required of it by the Investment Company Act and the Commission's rules and regulations promulgated thereunder.

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1970 SEC LEXIS 198

In the Matter of THE TRUST FUND SPONSORED BY THE SCHOLARSHIP CLUB, INC., 15 E. Broward Boulevard, Fort Lauderdale, Florida 33301

Admin. Proc. File Nos. 3-3720, 812-2794

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940, Release No. 6249

1970 SEC LEXIS 198

December 16, 1970

**CORE TERMS:** previous order, exemption, Act Release, notice, issue

**TEXT:** [*1]

ORDER PURSUANT TO SECTION 6(c) OF THE ACT FOR EXEMPTION FROM SECTION 27(a)(3) OF THE ACT AND FOR AMENDMENT OF PREVIOUS ORDER

The Commission on November 17, 1970 issued a notice of the filing of an application (Investment Company Act Release No. 6250) by The Scholarship Club, Inc. ("Club"), The Trust Fund Sponsored by the Scholarship Club, Inc. ("Fund"), and Scholarship Services Inc. (Services), for an order exempting them from the provisions of Section 27(a)(3) of the Act and allowing a sales load to be charges upon the sale of Fund's investment plans which is greater than the load presently permitted by a Commission order (Investment Company Act Release No. 5524).

The notice gave interested persons an opportunity to request a hearing and stated that an order disposing of the application might be issued upon the basis of the information stated therein unless a hearing should be ordered. No such request has been filed and the Commission has not ordered a hearing.

The Commission has considered the matter and finds that the granting of the requested exemption and the amendment of its previous order is appropriate in the public interest and consistent with the protection of investors [*2] and the purposes fairly intended by the policy and provisions of the Act.

IT IS ORDERED, pursuant to Section 6(c) of the Act, that the application for exemption from Section 27(a)(3) and for amendment of the Commission's previous order is hereby granted, effective forthwith subject to the condition that [illegible] the Commission [illegible] a statement of the number of scholarship plans [illegible] issued [illegible] the Act

calendar year broken down by years of participation in the plans.

For the Commission, by the Division of Corporate Regulation, pursuant to delegated authority.



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1968 SEC LEXIS 563, *

In the Matter of THE TRUST FUND SPONSORED BY THE SCHOLARSHIP CLUB, INC., Fort Lauderdale, Florida

Admin. Proc. File Nos. 3-1240, 812-2158

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940, Release No. 5524

1968 SEC LEXIS 563

October 25, 1968

**CORE TERMS:** investor, exemption, beneficiary, savings account, earnings, forfeiture, loa planholder, deposit, prospectus, periodic payment, certificate, transferred, issuer, savings, semi-annual, completion, qualify, administrative fees, monthly payment, public interest, n asset value, presentation, disclosure, redeemable, acquire, by-laws, Act Release, lump sum remuneration

**ACTION:**
[*1]

INVESTMENT COMPANIES

Unincorporated Fund

Periodic Payment Plans

Where interest earnings on investors' individual savings accounts periodically transferred t a fund are invested in securities pending ultimate distribution for college expenses of qualifying beneficiaries, held, fund is an investment company.

Voting Rights

Request for exemption from voting requirements of Sections 16(a) and 18(i) to allow investors acquiring periodic payment plans to elect majority of directors and to have one vote per plan owned, granted, as not inconsistent with basic objective of giving investors voice in management.

Redeemability

Exemption from Section 22(d) to permit periodic payment plans intended to provide for



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212

for college expenses which are not fully redeemable, granted, in view of inherent nature of plans and fact prospectus and sales literature will be subject to review and examination to insure full, adequate and informative disclosure.

Deduction of Sales Load from Payments

Exemption from Section 27(a)(3), granted to permit deduction of amounts of sales load to be made over three-year period although amounts deducted in third year differ proportionally from amounts deducted [*2] in first two years.

Other Exemptions

Where assets of trust will be distributed only in payment of college expenses of those beneficiaries who qualify, held, appropriate under all circumstances to grant exemptions from Section 23(b) relating to sales at net asset value and from Section 26(a)(2) relating to right of trustee to collect expenses from trust assets.

Semi-Annual Reports

Request for exemption from Section 30(d) to relieve fund from requirements of supplying semi-annual reports, denied.

**COUNSEL:** Harry Heller and Marc A. White, of Simpson Thacher & Bartlett, and Jack Yeslow, of Salter, Yeslow and Burnstein, for the applicant.

Lewis J. Mendelson and A. Barry Witz, for the Division of Corporate Regulation of the Commission.

**TEXT:** FINDINGS AND OPINION OF THE COMMISSION

These are proceedings with respect to an application, filed by The Trust Fund Sponsored by the Scholarship Club, Inc. ("Fund" or "applicant") requesting exemptions from certain provisions of the Investment Company Act of 1940. After appropriate notice, public hearings were held. An initial decision was waived, proposed findings and briefs were filed by the applicant and by our Division of Corporate Regulation, and we heard [*3] oral argument. Our findings herein are based on our independent examination of the record.

The Scholarship Club ("Sponsor") is a non-profit Florida corporation organized in November 1961 to promote and operate plans designed to provide funds to be used to pay college expenses of students. n1 An investor joins the Sponsor by agreeing to establish a **"scholarship" plan** for the benefit of a named child. In general, under the terms of such a plan, the investor agrees to open and pay either a lump sum or monthly deposits into a savings account in his own name in a federally insured bank or savings and loan association, and agrees that all earnings accruing on such account will vest in and be transferred to the Fund and will through the medium of a bank trustee, be invested and ultimately distributed for the benefit of college student beneficiaries of planholders. The principal of the investor's savings account remains under his control and he may withdraw from the plan and obtain such principal at any time. Such a withdrawal prior to the completion schedule set forth in his plan, however, will result in the forefeiture by the investor of the earnings on his account which were theretofore [*4] transferred to the Fund and the elimination of the investor's designated beneficiary from any participation in the assets of the Fund. Similarly, if the child designated as a beneficiary dies prior to entering college, n2 or does not enter college, or does not satisfactorily complete the first year (or any subsequent year) of college, the investor's interest in the Fund's assets is terminated.

n1 The State of Florida has adopted legislation authorizing this type of operation and subjecting it to certain regulation. Florida Statutes, Chapter 517, Part II.

n2 If a beneficiary child dies prior to entry into a college or university, the investor may designate a younger brother or sister of the deceased child as the beneficiary of the plan a continue the plan. If an investor dies prior to completion of the plan, any other person may be substituted for the purpose of completing the plan with the approval of the Sponsor.

The plans contemplate that if they are carried to completion the principal amount of the investor's savings account will be available to be applied towards the beneficiary's first yea college expenses, and that sums from the Fund's assets will be provided [*5] to be applie towards the succeeding three years' tuition and other expenses so long as the beneficiary continues his eduction in an accredited college or university. There is no assurance, howeve that a qualifying beneficiary will receive all or any fixed part of his college expenses. A distinctive feature of the plans is that they embody the possibility that the Fund's assets m include amounts forfeited by the failure of investors to complete their payments and by the failure of beneficiaries to enter or complete their college programs so that an investor's beneficiary who does enter and continue in college may receive more than the amounts pai by that particular investor plus the earnings on such amounts.

According to a proposal made after the filing of the application, under the installment plan the investor would make monthly payments for 11 years, $40 the first month and $20 per month thereafter. These payments would include the sales load and administrative fees which, as in the case also of the lump sum plan, total $160. n3 The net payments would be deposited in the investor's individual savings account, with earnings accruing on such account to be paid to the Fund [*6] at the end of each year. n4

n3 The sales load, in the amount of $112, would be paid through deductions at the rate of 20% of each monthly payment for two years, a total of $52 in the first year and $48 in the second year, plus deductions of $12 in the third year at the rate of 5% of each monthly payment. Administrative fees of $48 would be paid through deductions at the rate of 8% or $20.80 from the first year's payments, at the rate of 5% or $12 from the second year's payments, at the rate of 3% or $7.20 from the third year's payments, plus $1 to be deducted from the first payment of each year for the remaining eight years. Under contract entered into with the Sponsor, Scholarship Services, Inc. ("Services") will act as the exclusive selling organization for the sale of fully paid and installment plans and Security, Inc. ("Security") will perform administrative functions and services for the Sponsor.

n4 Earnings accruing on installment plan accounts would not be transferred to the Fund unt January 1 of the second year following the investor's joining the plan.

Assuming all payments were made as contemplated and the savings account paid 4% interest, the investor would deposit a total of $2,500 in his savings account, and interest payments into the Fund would total approximately $566. The fully paid plan would involve a lump sum investment of $1,760, of which $160 would constitute the sales load and administrative fees. The investor would deposit the remaining $1,600 in his individual savings account which he would maintain for eight and one-half years, during which time interest of approximately $564 accrued in such account would be transferred to the Fund. [*7]

Status of Applicant

Sections 3(a)(1) and (3) of the Act define an investment company as any issuer which is or holds itself out as being primarily engaged or proposes to engage primarily in the business investing, reinvesting or trading in securities; or is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per cent of such issuer's total assets exclusive of Government securities and cash items. n5



214

n5 Section 3(a) defines investment securities to include all securities except Government securities, securities issued by employees' securities companies, and securities issued by majority-owned subsidiaries of the owner which are not investment companies.

Section 2(a)(2) defines issuer to mean every person who issues or proposes to issue any security, or has outstanding any security which it has issued. No question has been raised to applicant's being an issuer.

Over the past several years, amounts received by the Fund have been retained as cash or placed in bank savings accounts or certificates of deposits or in United [*8] States Government securities; at present such funds are held in time deposits with the Trustee bank. Applicant believes it is desirable to invest its receipts in conservative securities including tax-exempt bonds, and states that if the necessary exemptions are granted it intends to broaden its investment policies to do so. It further recognizes that with such broadening of investment policy it would clearly be an investment company, and it does no under the circumstances dispute its status or seek to avoid regulation under the Act. It has therefore registered under the Act, describing itself as a non-diversified closed-end management investment company, and has filed the instant application requesting exemptions from specific provisions of the Act. We accordingly turn to a consideration of th requested exemptions.

Exemptions Sought

Section 6(c) of the Act authorizes us to exempt any person from any provision of the Act if we find that such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy ar provisions" of the Act. The broad exemptive power provided in Section [*9] 6(c) was designed to enable us to deal equitably with situations which could not be foreseen at the time the legislation was enacted. n6 We have noted, however, that the power under that Section to free any person from any provision of the Act is one which must be exercised wit circumspection and with full regard to the public interest and the basic purposes of the Act. n7 The showing required in order to meet the public interest and related standards set forth in Section 6(c) is that the compliance from which exemption is sought is not necessary to accomplish the Act's objectives and policies. n8

n6 See, e.g., The Great American Life Underwriters, Inc., 41 S.E.C. 1, 4 (1960).

n7 Ibid, 5; see also Variable Annuity Life Insurance Company of America, Investment Company Act Release No. 4686, p. 4 (August 25, 1966).

n8 First National City Bank, Investment Company Act Release No. 4538, p. 6 (March 9, 1966).

The Division in opposing the application argues that applicant's plans are inherently deceptive because based on the contradictory assumptions that the planholder's benefician will qualify for and complete college and that there will be a very large number [*10] of forfeitures because many beneficiaries will not, and on the expectation, which will not be borne out if forfeitures are low or college expenses increase, that the plans will provide for all college expenses. It asserts that Sponsor has sold plans on the basis of inaccurate and inadequate information, including advertisements which, despite the lack of sufficient experience with plans of this kind to establish any actuarial basis for predictions, refer to ar "Anticipated $4500 Scholarship" in addition to the principal in the planholder's savings account, an amount that could be achieved only if there were a very large number of forfeitures. It also argues that the plans unfairly favor the group of investors whose beneficiaries qualify for distributions over those who do not. It raises various other objections to the granting of any exemption, including the fact that the Fund has not established a specified plan of distribution of scholarship funds.

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Applicant argues that the grant of its application would serve the public interest in encouraging savings plans for educational expenses, and argues that the fact that lapses : forfeitures may benefit surviving participants does [*11] not make the plans illegal or fraudulent. It defends the costs of joining the plan, the loss of earnings from savings accounts when investors terminate their plans, and the possibilities of benefits beyond the amounts of their own savings if the plans are completed, as features which serve to deter lapses and forfeitures and aid the desirability of the plans. n9

n9 It is also stated that the Sponsor has under consideration the possibility of obtaining "completion insurance" providing for the completion of the remaining payments by an insurance company in the event of the death of a planholder.

It contends that the sales literature used in the past was not misleading and additionally states that the Sponsor does not intend in the future to use any specific figures of the anticipated amount which may become available for a student beneficiary, but will use sal literature which will make it clear that it is not possible to determine such amount and tha may in fact be no more than the amount available from the investor's own savings accoun less the fees connected with the plan. Applicant undertakes to amend the prospectus whic it has filed as part of a pending registration [*12] statement under the Securities Act of 1933 in whatever way is necessary to make clear the terms of the plans and the effect of forfeitures.

The Division has raised serious questions about the merits of applicant's plans. We have n in considering the present application, undertaken to determine whether or not the applicant's proposed operation is a good way for parents to provide for the college educati of their children. As noted by the applicant, we shall have jurisdiction to consider the adequacy and accuracy of the disclosures to be made in the Securities Act prospectus and sales literature to be used by the Sponsor. n10 We are not prepared to assume, in advanc that it will not be possible to arrive at a proper presentation, in the prospectus and sales literature as well as in the terminology of the plan agreements, which will give adequate, accurate and explicit information, fairly presented, as to the nature of the plans.

n10 Our action herein does not constitute approval of the past advertisements nor does it course affect the rights of any persons to whom a material misstatement or omission may have been made to seek rescission or other relief.

So far [*13] no distributions have been made from the Fund and none will be due for a number of years. n11 The Sponsor has believed it desirable not to commit the plans at this time to a specific method of distribution but to wait until about the time of the initial distribution when additional experience and statistics would be available. Applicant, however, points to testimony in the record that the method of distribution is not an actuar problem, and that it is possible to devise a feasible method of equitable distributions now classifying beneficiaries by the year in which it is anticipated they would enter college and dividing annually among the qualifying beneficiaries the total amount determined to be available for each class in accordance with existing accounting techniques. We think that a fair presentation of the essentials of the plans must include some description of a feasible and fair plan of distribution, and the applicant and the Sponsor have undertaken to devise such a plan which will meet with the approval of the Florida authorities and which we woul expect to be included in the prospectus and sales literature. n12

n11 From 1962 until 1967 approximately 9,500 plans were sold. In January 1967 sales of plans were discontinued pending determination of the Fund's status and registration under the Act and the Securities Act.

n12 The Sponsor's by-laws provide that the amount to be made available to a student beneficiary is to be determined upon a fair, reasonable and actuarially sound basis by a



216

method approved by the Treasurer of the State of Florida. [*14]

Accordingly, on the assumption that it will be possible to devise a prospectus and other literature which will adequately and fairly describe the operation of the plans and the prospects and risks relating to them we turn to a consideration of the specific requests for exemption. n13

n13 After oral argument the Division moved to reopen the record to permit it to present the testimony of a consulting actuary. It states that the actuary's firm had been employed by another organization to prepare a study of **scholarship plans** and he had also been employed by applicant, and that the Division had not been aware of these facts during the hearings. Applicant opposes the motion on the ground that the Division had an opportunity to examine a consulting actuary who did testify during the hearings, and applicant in addition has presented an affidavit from the proposed witness denying that he would testify as expected by the Division. The Division argues that the proffered testimony would be material as bearing on the suitability of the plans and their dependence for success on the forfeiture feature. Since we have already concluded that these are matters relating to the necessity for a full disclosure in the sale of the plans rather than reasons for denying the exemption application, and in view of the advanced stage of the proceedings, and the testimony already in the record, we deny the Division's motion to reopen the record. [*15]

Voting Rights and Election of Directors

The Sponsor's by-laws provide for eleven directors of whom seven will be elected by investors, and the other four, as required by Florida law, will consist of one nominee of each of four Florida organizations if they so request, n14 and the Sponsor's board presently contains nominees of three of such organizations. Also, the Sponsor's by-laws provide that in the election of directors each investor shall have one vote for each beneficiary of a plan he owns, regardless of any variation in the amount of one plan as against another. Applicant seeks exemptions, to the extent necessary to permit the above procedures, from the requirements of Section 16(a) that directors of a registered investment company be elected by the holders of its outstanding voting securities and of Section 18(i) that every share of a management company have equal voting rights with every other share. In support of the requested exemption from Section 16(a), applicant states that it will invest in a narrow range of securities and agrees, if we so require as a condition to the exemption, that it will not deviate from the policy of maintaining its assets solely in cash, [*16] United States Government securities, time deposits, certificates of deposit in banks, or tax-exempt municipal bonds, without our prior approval as well as the vote of investors required by Section 13 of the Act.

n14 The organizations are the Florida Congress of Parents and Teachers, the Florida Education Association, the Florida Savings and Loan League, and the Florida Bankers Association.

Section 1(b) states that the policies and purposes of the Act include the elimination of inequitable methods or distribution of control of investment companies, and the elimination of the operation and management of an investment company in the special interests of certain groups, including persons engaged in other lines of business, rather than in the interest of all its securityholders. Sections 16(a) and 18(i) are designed to combat these evils by ensuring that the holders of the investment company have the power to select its management. n15 We are satisfied, however, that in this case granting the requested exemptions would not impair the important statutory objective of keeping control of investment companies in the security-holders. The maximum of four members of the board not elected [*17] by investors would be a minority and at least two would be nominees of organizations having no motivations that might involve conflict with the general interests of the planholders. And it would appear that the possible variations in the amounts of different plans are not so substantial as to make it unreasonable as a practical technique to permit

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217

one vote per plan. n16 We conclude that the exemptions from Sections 16(a) and 18(i) are justified, subject to the condition agreed to by the applicant.

n15 Insured Accounts Fund, 38 S.E.C. 123, 126 (1957); see also Securities Corporation General, 40 S.E.C. 427, 432 (1960).

n16 The record indicates that in setting up the details of different plans the general purpos is to bring into the Fund about the same amount of earnings for each plan.

Redemption and Sales Load

Section 27(c)(1) of the Act provides that a registered investment company issuing periodic payment plan certificates may not sell such certificates unless they are redeemable securities. n17 Applicant contends that no periodic payment plan certificate as defined in th Act n18 is created by the transfers of savings account earnings to the plans, arguing that [*18] the investor acquires no undivided interest in applicant's assets and his beneficiary acquires an interest therein only when he qualifies for a "scholarship", at which point his interest is in effect redeemable since applicant is obligated to pay his allocable share towar his college expenses. Applicant further asserts that to require that every investor have the right upon presentation to withdraw his allocable share of applicant's funds, would defeat th entire objective of the Fund, and it requests an exemption from Section 27(c)(1) to the extent necessary to permit the operation of the plans.

n17 Section 2(a)(31) defines "redeemable security" to include any security under the terms of which the holder is entitled to receive, upon presentation to the issuer or its designees, approximately his proportionate share of the issuer's net assets or the cash equivalent.

n18 Section 2(a)(26) of the Act defines a periodic payment plan certificate as meaning a security providing for a series of periodic payments by the holder and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with proceeds of such payments. [*19]

While we do not accept applicant's arguments regarding the nature and redeemability of the investor's interest in the Fund's assets, we recognize that the applicant in this case is substantially different from the conventional management investment company, and that th securities represented by the **"scholarship" plans** differ from conventional periodic payment plan certificates. An investor will always retain a right to the principal in his saving account, and only the earnings payments that have been transferred to the applicant are non-redeemable.

While it is thus possible for an investor who does not complete his plan or whose beneficiary does not complete his college education to lose all or part of the amounts earned on his savings account, under the particular circumstances of this case we consider it appropriate to grant the exemption from Section 27(c)(1) necessary to allow applicant's plans to operate. n19 Again without expressing an opinion as to the desirability or efficacy of such plans, we believe that the critical requirement here, as we have indicated earlier, is that of a full disclosure of the features of the plans with respect to the forfeiture provisions and [*20] their consequences.

n19 Cf. The Prudential Insurance Company of America, 41 S.E.C. 335, 354 (1963).

Applicant also requests an exemption from the provisions of Section 27(a)(3) which require the same proportionate deduction of sales load from all payments after the first year. As previously noted, applicant proposes that the deductions for sales load would be paid over a period of three years, consisting of 20% of each monthly payment during the first two years and deductions of 5% of each monthly payment in the third year. Applicant stresses that spreading the deductions for sales load over a period of three years ameliorates their impact



218

on investors who withdraw or abandon their plans during such years. The Division has not raised any specific objections to an exemption from Section 27(a)(3) but rests primarily on the general proposition that it is not appropriate to grant applicant any exemptions pursuant to Section 6(c) of the Act. Under the circumstances of this case we conclude that it is appropriate to grant the requested exemption from Section 27(a)(3). n20

n20 Cf. The Prudential Insurance Company of America, supra, p. 356; Variable Annuity Life Insurance Company of America, Investment Company Act Release No. 4217 (April 7, 1965). [*21]

Other Requested Exemptions

Section 23(b) of the Act in general prohibits a closed-end investment company from selling its shares below current net asset value. Applicant states that it is difficult to determine the value of the interest in the Fund's assets which a new investor acquires, since the extent to which the investor's designated beneficiary may participate in those assets is dependent, among other things, on the extent of the contributions and forfeitures by other planholders and on the number of beneficiaries who will qualify to receive distributions. Noting that Section 23(b)(2) permits a closed-end company to sell securities below net asset value with the consent of a majority of its common stockholders, applicant requests a temporary exemption from Section 23(b) until it can obtain the consent of investors, which it intends to seek annually, to the continuous sales of applicant's securities under its present arrangements.

The difficulty of ascertaining an exact current net asset value is inherent in the nature of applicant's structure and operations, and is another reason why a full and meaningful disclosure of the plans, including a description of a specific [*22] method for determining the amounts of distributions to beneficiaries, is of the utmost importance. Under all the circumstances, however, and recognizing that we will be in a position to examine and review the prospectus and sales literature pertaining to the plans, and that the plans will be structured insofar as practical so as to result in equal deposits of savings account earnings into the Fund by the various planholders, we conclude that the requested exemption from Section 23(b) may be granted.

Sections 26(a)(2)(A) and (B) would require that the agreement with the trustee bank provide in substance (A) that the trustee, if not otherwise remunerated, may charge against and collect from the income of the trust, and from the corpus if no income is available, such service fees and such reimbursement for its expenses as are provided for in such instrument and (B) no such charge or collection shall be made except for services theretofore performed or expenses theretofore incurred. Applicant asserts that these provisions are not needed, since the trustee bank's remuneration is otherwise provided for by direct administrative fees payable by investors and under the Florida law no such [*23] charges may be made against or collected from the corpus or income of the applicant. It contends that the regulatory authority and jurisdiction of the Florda State Treasurer affords essential protections against orphanage of the trust by the Sponsor which Section 26(a)(2) was designed to provide, n21 and it points out that the Florida law requires the Sponsor to maintain on deposit with the State Treasurer securities in the amount of $50,000 as security for performance of its obligations. It further represents that if the application is granted sufficient funds will be supplied to pay for administrative functions until the administrative fees received are sufficient to pay for them and that the Sponsor's by-laws will provide that if additional fees become necessary to maintain administration of the plans, the beneficiaries then in college might be required to pay dues not exceeding $5 per year for such purpose. Applicant also consents to a condition that contracts for administrative services shall not exceed such reasonable amounts as we shall prescribe.

n21 Variable Annuity Life Insurance Company of America, 39 S.E.C. 680, 702 (1960).

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219

Under the circumstances we conclude [*24] that we may appropriately grant the requeste exemption from Sections 26(a)(2)(A) and (B), and we shall reserve jurisdiction with respec to the reasonableness of charges for administrative expenses.

Finally, applicant has requested exemption from the provisions of Section 30(d) of the Act. which would require it to transmit to the planholders, at least semiannually, a report containing, among other things, statements in the nature of a balance sheet and income statement, a list of securities owned and a statement of the remuneration paid to certain affiliated persons. Applicant states its willingness to file an annual report of its operations and such other information concerning the Sponsor as we might deem desirable, and notes that Florida law already requires the Sponsor to make an annual report to the State Treasurer concerning its and applicant's operations. It argues that a semi-annual report is not essential to the protection of investors in view of the limited portfolio activity contemplated and other factors. n22

n22 Under Section 30(d)(6), semi-annual statements of purchases and sales of securities need not cover government securities and applicant states that a substantial part of its assets will be held in government securities. Applicant also asserts that the information required in semi-annual reports pursuant to Section 30(d)(5) regarding remuneration to certain affiliated persons would be substantially inapplicable, because the Sponsor's officers and directors will receive only nominal fees for attending meetings and may not and will no have any affiliation with the selling organization. [*25]

In enacting Section 30(d), Congress balanced the needs for curing the evils resulting from the failure to give investors full information against the expense involved in reporting, and resolved the question in favor of requiring semi-annual reports. n23 We are not satisfied tha a departure is warranted in this case, and we shall accordingly deny the requested exemption from Section 30(d).

n23 Prudential Insurance Company of America, supra, p. 356.

An appropriate order will issue, granting the exemptions to the extent and on the conditions specified in the application and in these findings, on the basis of the proposals submitted by the applicant during the course of these proceedings.

By the Commission (Chairman COHEN and Commissioners OWENS, BUDGE, WHEAT and SMITH).

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Appendix III

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

SUMMARY OF REPORT

ON

FACE AMOUNT CERTIFICATE COMPANIES

September 1969

## SECURITIES AND EXCHANGE COMMISSION
## SUMMARY OF REPORT ON FACE-AMOUNT CERTIFICATE COMPANIES

### Section I: Introduction

On May 27, 1969, Senator John Sparkman, Chairman of the Committee on Banking and Currency of the United States Senate, wrote the Commission and requested that it conduct an in-depth study of face-amount certificate companies and report back to the Committee within three months.

Chairman Sparkman indicated that the study should reveal the current redemption rates on face-amount certificates, the percentage of investors who suffered losses on their purchases of these certificates, the sales techniques used by face-amount certificate companies and the economic classifications of those persons purchasing such certificates, the after-tax yields obtainable on similar alternative investments, and the economic impact on the securities industry which would result if the front-end load on face-amount certificates were abolished.

Chairman Sparkman requested that the Commission, on the basis of this study, recommend whether the front-end load be abolished or continued, or suggest such alternative forms of action as the Commission may recommend regarding face-amount certificates.

### Section II: The Relationship of Face-Amount Certificates to the Securities Industry

Face-amount certificate companies are a small fragment of the investment company industry. As of June 30, 1969, there were 1,167 registered investment companies; only eight were face-amount certificate companies, of which only four were active. Total estimated investment company assets on that date were almost $73 billion and face-amount certificate companies accounted for slightly less than $1 billion. Thus, their assets represented 1.4 percent of estimated investment company assets and less than 0.2 percent of the $733 billion value of stocks listed on all registered securities exchanges at the end of 1968.

Face-amount certificate assets are also insignificant when compared to the amounts represented by savings deposits and United States government Series E bonds which may be considered alternatives to face-amount certificate accumulation programs. Face-amount certificate assets were less than 0.2 percent of the total of Mutual Savings Bank deposits, Savings and Loan Association deposits, deposits in Commercial Savings Banks and Series E bonds as of December 31, 1968.

One company, ISA, a wholly owned subsidiary of IDS, accounted for 94 percent of face-amount certificate company assets at June 30, 1969, and 96 percent of the total face value of 1968 face-amount certificate sales. Moreover, a large portion of the assets of face-amount certificate companies are not invested in securities. Only 48.5 percent of ISA assets were invested in securities as of December 31, 1968.

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1/ See Table II-2, p. II

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222

Total cumulative receipts of installment face-amount certificates in 1968 were approximately $90 million which is 1.3 percent of the $6.8 billion total 1968 sales of the members of the Investment Company Institute (not including face-amount certificate sales). The total amount paid in on face-amount installment sales made only in 1968 was $5.7 million. This is 0.08 percent of 1968 Investment Company Institute sales and .002 percent of the total 1968 volume of securities traded on the registered securities exchanges in the United States ($194 billion).

Consequently, this report does not deal with the securities industry generally. It is mainly about a diversified financial service organization, IDS, and one of its subsidiaries, ISA.

In October 1965, ISA discontinued the 6, 10, 15, and 20 year face-amount certificates it had previously issued and discontinued the 50 percent first year front-end load. It began selling two new installment face-amount certificates which have a 20 percent front-end load on each of the first three years' payments: the Series 15A certificate that matures 15 years after the date of issue, and the Series 22A certificate that matures 22 years after the date of issue. Since ISA began issuing its new certificates, the Series 22A certificate has accounted for 58.8 percent in number of certificates and 70.7 percent in face value of ISA's installment certificate sales. In 1968, single payment certificates accounted for 9.9 percent (by number of certificates) and 9.4 percent (by face value), and 11.8 percent of ISA's total certificate receipts.

## Section III: Features of the Face-Amount Certificate

The feature which differentiates the face-amount certificate from an equity security is the certificate's insulation from market fluctuations. The face-amount certificate is a contract under which the issuer agrees to pay on a certain date a specified amount shown on the face of the certificate. Unlike securities issued by other types of investment companies, if the value of the assets of the issuing company declines, the certificate will not be worth less than its face-amount. Thus, the installment face-amount certificate offers a planned and systematic program for accumulating a sum of money and the certainty that, if payments are made as scheduled, the plan will provide a certain amount of dollars on a certain date in the future.

The yield to maturity on an installment face-amount certificate will vary slightly according to the frequency of payment chosen -- monthly, quarterly, semiannually, or annually. Most installment face-amount certificates are sold on a monthly payment basis. In 1968, 82 percent of ISA installment face-amount certificates were sold on a monthly payment basis and only 6 percent on an annual basis. If payment is made on a monthly basis on ISA's Series 22A certificate, the yield to maturity

is 3.01 percent; on ISA's Series 15A certificates, it is 2.32 percent. 2/ Of course, the total yield to maturity, the amount stated on the face of the certificate, will not be paid as scheduled if the investor fails to make his payments when due.

If the investor surrenders his face-amount certificate in its early years, he will lose a substantial portion of his investment as a result of the front-end load charged. On most of the certificates currently being sold, the breakeven point is not reached until after 8 years. 3/ The achievement of the investor's objective might also be frustrated if he surrenders his certificate after the breakeven point but prior to its scheduled maturity date.

The basic yield on a face-amount certificate may be enhanced by additional credits which may be declared in the discretion of the Board of Directors. Additional credits are paid on the surrender value of the certificate on its "anniversary date." The anniversary date is not a calendar year; rather, it is the date on which each 12th monthly payment or its equivalent is reached. 4/

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2/ The corresponding yields, if payments are made on an annual basis, would be 3.09 percent for the Series 22A certificate and 2.66 percent for the Series 15A certificates.

Although First Home Investment Corporation of Kansas, Inc. ("First Home") charges a 7 percent level load, it also exacts a surrender charge of $20 per $1,000 unit or 15 percent of the reserve maintained under the unit, whichever is less. As a result of a combination of the level load with the surrender charge, an investor who surrenders his certificate in its early years will lose a substantial portion of his capital investment. In fact, during the first three years after purchase, the percentage lost would be greater on the First Home "level load plan" than it would be on ISA's front-end load plan. Moreover, the breakeven point on the First Home level load certificate is not reached until the eleventh year after the sale.

3/ If payments are made on an annual basis, the breakeven point is reached after seven years, eight months.

4/ Certificate holders may pay amounts due on their certificate in advance. At present, any money paid on an ISA certificate in excess of the annual requirements or 12 monthly payments will accrue interest at the rate of 3 percent until applied against the scheduled payment. In the discretion of the Board of Directors, additional credits may also be applied on such advance payments. Since advance payments are not required, they represent an additional investment by the certificate holder and any return on them would be a return on that additional investment.

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In 1968-1969, ISA paid additional credits of one percent on cash surrender values. 5/

Other features of the face-amount certificate include deferred taxation, loan values, death and disability features, and settlement options which permit the certificate holder to extend the maturity of his certificate for as much as 10 years (on the Series 22A) and to select payment plans which would permit him to defer receipt of the value of the certificate for an additional 20 years.

Face-amount certificate companies also issue single payment certificates. ISA's may be purchased for a minimum of $500 each, and mature 20 years from the date of issuance paying $903.06 at maturity, a yield to maturity of 3 percent. 6/ Since the total sales charge (3.4 percent) on a single payment certificate is deducted in full from the single payment, the cash surrender value on a single payment certificate exceeds, generally, the amount paid in after the first year. 7/ Although single payment certificates have many features similar to installment certificates, they have higher immediate cash values and thus the risk of loss on them is less than on installment face amount certificates.

Section IV: Sales Techniques

Face-amount certificates are sold by personal selling effort. IDS's success in this field may be explained by the large numbers of salesmen it continuously enlists and trains to carry out its selling processes. At the end of 1968, IDS's active full-time sales force was 3,900 persons. However, at the end of 1968, more than one out of four members of the IDS sales force had been with IDS for less than one year, and roughly 40 percent for less than three years.

The median income of IDS' active sales representatives in 1968 was $7,716. However, 34.9 percent earned less than $6,000 in 1968. IDS sales representatives are paid on a commission basis which does not vary according to the product sold. The amount of the Commission depends upon the size of the periodic payment made. On payments of $20 per month, the sales representative's total commission is $85.80, payable over the first three years of the plan, whether he sell a $3,000 investors accumulation plan, a $4,400 Series 15A installment certificate or a $7,500 Series 22A installment certificate.

IDS trains its sales representatives to sell installment face-amount certificates by means of a "canned interview" which it instructs them to practice until it has become mechanical. It focuses on the purchaser's financial goals and objectives ("retirement, college education for his family, business protection, business opportunities, travel, and emergencies and opportunities"), ISA's experience

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5/ Unified Funds, Inc. sells a ten-year installment single payment certificate, on which the yield to maturity is 1.80 percent if payments are made on a monthly basis and 2.20 percent if payments are made on an annual basis. Additional credits declared by Unified Funds, Inc. from 1964 through 1968 have averaged 2.50 percent, the most recent being 3 percent.

6/ Unified Fund's ten-year single payment certificate has a maximum yield of 3.04 percent and State Bond and Mortgage issues a 5-year single payment certificate which has a maximum yield to maturity of 3.05 percent.

7/ On single payment certificates issued by Unified Funds, the breakeven point may be later because the maximum sales commission is 6.5 percent.

("ISA offers a time tested proven plan that provides known results,") 8/ and the importance of financial planning. Face-amount certificates are the "third cornerstone of IDS' four cornerstones of balanced financial planning." 9/

In 1968, ISA's average installment face-amount certificate sale was $11,470 (face amount). The average ISA Series 22A certificate sale was $13,000 and the average Series 15A certificate sale was 17,900. Average monthly payments were estimated by IDS to be about $35. In 1967, three out of four sales of ISA installment certificates to individuals were for monthly payments of $25 or less. More than 42 percent of 1968 purchasers were younger than 30. Almost 30 percent were between 30 and 40. Thus, 72 percent of ISA certificate purchasers were under 40. More than half of ISA's installment certificate purchasers were in professional, technical and managerial groups, including technical and kindred workers.

A recent sampling of IDS customers revealed the following about its face-amount certificate purchasers: 25.7 percent have an annual family income of less than $7,500 and 53.5 percent have an annual family income of less than $10,000. Their median family income was $9,750 and the median cash reserve was $1,336. Their median holding of life insurance was $17,639 and the median holdings of other stocks and bonds was $146.

Face-amount certificates are owned by persons in every state. However, those living in four states accounted for one-third of the total face-amount certificate accounts now in force on the basis of face amount to maturity. 10/

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8/ The Big Moments in Your Life; IDS Sales Literature, June 1967.

9/ Balanced Financial Planning; IDS Sales Literature, p. 2, February, 1969. The first cornerstone is a cash reserve to help meet current needs. IDS calls these "put and take" dollars to cover small everyday emergencies. For this it recommends bank accounts, savings and loan or credit associations. The second cornerstone is "adequate insurance and business and family protection." It covers emergencies created by death readjustment, and emergencies. The fourth cornerstone, investment in equities, is to provide professional management, diversification, marketability, potential growth and additional income for those goals highlighted under the 3rd cornerstone. Its emphasis is upon participation in the growth of the economy and helping to provide a hedge against inflation.

10/ The four states are Illinois, Michigan, Ohio, and Pennsylvania.

Section V: Surrender Experience

In the Mutual Fund Report, the Commission examined ISA's surrender experience as of the end of 1961 for 2,000 15-year face-amount certificates sold during July 1941 and January 1945. It found that 55 percent of those certificates had been surrendered prior to the breakeven point and that 32.1 percent had been held to maturity, or, stated differently, that about 67 percent were surrendered before maturity.11/ The ISA Series 20 certificates sold in 1945 through 1960, the data for which was collected for this study, were also surrendered prior to the breakeven point at about the same rate (between 50.7 and 56.1 percent on a face value basis of each year's sales).12/

The Series 15 certificates which ISA sold in each year from 1945 through 1960 have been surrendered prior to the breakeven point at fairly constant rates. However, they are a few percentage points less in relationship to face values of net sales (median rate 49.7 percent) 13/ than on the number of certificates basis shown in the Mutual Fund Report. For Series 15 sales made in the years 1957 through 1960, the rate of surrenders prior to the breakeven point has been just over 50 percent ( on the basis of face values).

Complete data 14/ through the date of scheduled maturity is available for the ISA Series 20 certificates sold from 1945 through 1948. It reveals that only from 10.9 to 15.4 percent (on a face value basis) 15/ of the Series 20 certificates scheduled to mature in 1965 through 1968 actually do so as scheduled. From 77.3 to 81.8 percent of those Series 20 sales were surrendered prior to maturity. In other words, the current data reveals that on a face value basis, there have been even more Series 20 surrenders prior to maturity than the almost 67 percent shown for the Series 15 certificates examined in the Mutual Fund Report. 16/

The complete data 17/ through the date of scheduled maturity for the Series 15 certificates sold from 1945 through 1953 is similar to the data contained in the Mutual Fund Report with respect to the percentages of each year's sales reaching maturity. The percentage of Series 15 sales (by face value) from 1945 through 1953 which was surrendered prior to maturity ranged from a low of 64 percent for 1950 sales to a high of 71.2 percent for 1946 sales. The percentage (on a face value basis) of those certificates which reached maturity on schedule ranged from a low of 21.1 percent for certificates sold in 1945 to a high of 31.1 percent for certificates sold in 1950.18/

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11/ Mutual Fund Report, pp.248-9.
12/ See Table V-1, p. V 4.
13/ See Table V-2, p V 9. Series 15 certificates sold in 1950 had a better initial persistency. Only 41.9 percent ( on a face value basis) of 1950 Series 15 sales were surrendered prior to the breakeven point.
14/ In relationship to net sales on a face-amount basis.
15/ See Table V-1, p. V 4, and Chart V-3, p. V 2
16/ Mutual Fund Report, pp. 248-9
17/ In relationship to net sales on a face-amount basis.
18/ See Table V-2, p. V 9.

On October 1, 1965, in an effort to develop a "more saleable and retainable" certificate, ISA discontinued the Series 20 and Series 15 certificates and began issuing the Series 22A and 15A certificates which had lower front-end loads, improved yields to maturity, and improved first year and immediate minimum cash values. Although this change reduces the amount and percentage of loss on those certificate holders who surrender prior to the breakeven point, 19/ the surrender experience on the new certificates does not indicate any lessening of the rate of surrenders.

The current redemption experience on ISA certificates prior to the breakeven point is no better than its earlier experience. A comparison of surrender experience through 1968 of the Series 20 certificates sold from 1960 through September 1965 with that of the Series 22A certificates sold commencing October 1, 1965, reveals that (on a consolidated number of certificates sold basis) two years after the year of sale, 26.8 percent of the Series 20 certificates and 28.2 percent of the Series 22A certificates had been surrendered. Three years after the sale the rate of surrenders for the Series 20 certificates was 34.4 percent and for the Series 22A certificates was 36.5 percent. Moreover, the pattern of surrenders of the two series for the first three years after the year of sale is almost identical.

The certificates surrendered by the third year after the year of sale have significant impact on the total surrender experience prior to the breakeven point. If surrenders of Series 22A certificates from the fourth year after the sale through the breakeven point were to continue at only half the rate (on a consolidated basis) of the Series 20 certificates for the comparable period, 45.1 percent of the Series 22A certificates would be surrendered prior to the breakeven point; if such surrenders were to continue at the same rate as the consolidation for the Series 20 certificates for that period, 59.1 percent of the Series 22A certificates would be surrendered prior to the breakeven point. 20/

Comparisons of current redemptions for the Series 15 and Series 15A certificates reveal almost the same picture relative to each other as does the comparison of current redemptions of the Series 20 and 22A certificates. However, the Series 15 and 15A certificates are being surrendered at a lower rate than the Series 20 and 22A certificates. Two years after the year of sale (on a consolidated basis), 20.5 percent of the Series 15 certificates and 23.2 percent of the Series 15A certificates (by numbers of certificates) had been surrendered. Three years after the year of sale, 31.[illegible] percent of the Series 15A certificates and 27.0 percent of the Series 15 certificates have been surrendered. 21/

The pattern of surrenders on a consolidated basis for the first three years after the year of sale is also similar. If surrenders of Series 15A certificates continue from the fourth year to the breakeven point at half the rate (on a consolidated basis) of the Series 15 certificates sold from 1960 through September 1965,

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19/ See Chart V-G, p. V-[illegible].
20/ Ibid.
21/ See Chart V-L, p. V-[illegible].

it would result in 40 percent of the Series 15A certificates being surrendered prior to the breakeven point. If the rate for the Series 15A certificates continues at the same rate as the rate for the Series 15 certificates for the comparable period, it would result in 54.9 percent of the Series 15A certificates being surrendered prior to the breakeven point. In fact, on a consolidated basis, the rate of surrenders through 1968 of the Series 15A certificates sold from October 1965 through 1968 has not been less than the rate for the Series 15 certificates sold from 1960 through September 1965; if anything, it has been slightly higher. 22/

State Bond and Mortgage Company also issues a 15-year certificate, Series 215, which is sold with a 50 percent front-end load. The rate of surrenders for the State Bond Series 215 certificates sold in 1965 follows the same pattern as the surrender experience for ISA's 15 and 15A certificates. However, its rate of surrenders is lower, year by year and in total, than ISA's experience for the comparable period. 23/. Thus, it would appear from the comparison of the surrender experience for the same period of ISA's Series 15 and State Bond's Series 215 certificates, both sold with a 50 percent front-end load, with that of ISA's Series 15A certificates, sold with a 20 percent front-end load, and the comparison of ISA's Series 20 certificates sold from 1960 through September 1965, with a 50 percent front-end load, and its Series 22A certificates sold from October 1965 through 1968, with a 20 percent front-end load, that reducing the front-end load from 50 percent of the first year's paymants to 20 percent of payments made in the first three years will not result in a decreased rate of surrenders.

In summary, the most significant factors that are revealed by our detailed study of face-amount certificates' surrender experience are that, generally speaking, (on a face value basis) the face-amount certificates sold by IDS between 1945 and 1960 that have been surrendered prior to the breakeven point at a loss approaches, if not exceeds, a majority of the amount sold; and that less than one-third of the amount sold actually reaches maturity on schedule.

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22/ See Charts V-K and V-1 and pp. V 28-31, 37-9.

23/ Three years after the year of sale, 21.2 percent of State Bond's Series 215 certificates had been surrendered; 28 percent of ISA's Series 15 certificates and 27.9 percent of ISA's Series 15A certificates sold in 1965 had been surrendered.

Section VI: Yield

The basic yield to maturity on ISA Series 15A and 22A certificates depends upon the type of payment schedule and the maturity period chosen. On a monthly payment basis it is 2.52 percent for the Series 15A certificates and only 3.01 percent for the Series 22A certificates.24/ However, on the average, only 13.3 percent of the Series 20 certificates sold between 1945 and 1948 actually matured as scheduled and 27.4 percent, on the average, of the Series 15 certificates sold between 1945 and 1953 actually matured as scheduled. The yield to maturity on the ISA single payment certificate is 3 percent.

ISA has declared additional credits on its certificates every year for the past 28 years. Since 1948, they have ranged from 0.25 percent to 1.50 percent, and they have averaged 0.65 percent per year on the certificates issued from 1948 through 1965 and 0.94 percent per year on the certificates issued since 1965.

The before-tax yield to maturity on ISA certificates (including additional credits) has historically lagged behind the yields on Series E United States Savings Bonds.25/ The Series E bonds, which mature in one-third the time, would yield 0.15 of one percent more than the combined yield to maturity of ISA's Series 20—22A certificates, ISA's best yielding and best selling certificates. Since 1961, the combined before-tax yield (including additional credits) of ISA's Series 20 and 22A certificates has also been less than the weighted average annual yield on savings deposits. In 1967, the combined yield for the ISA Series 20 and 22A certificates was 0.49 percent less, on an absolute basis, and 10.9 percent less, on a relative basis, than the weighted average annual yield on savings deposits.26/ Since 1966, ISA's Series 22A certificate (including additional credits) has paid lower average annual yields than United States Government Series E savings bonds, savings and loan associations, mutual savings banks and commercial banks.27/

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24/ On an annual basis it would be 2.66 percent for a Series 15A certificate and 3.07 for a Series 22A certificate.

25/ See, Chart VI-A.

26/ See Table VI-1 and the accompanying text

27/ Ibid.

The after-tax yields on an ISA Series 20 certificate (including additional credits) would be as follows:

| Tax Bracket at Time of Maturity | Percentage After-Tax Yield |
|---|---|
| 20% | 2.7[illegible] |
| 30 | 2.4[illegible] |
| 40 | 2.1[illegible] |

The after-tax yields on ISA's Series 20 certificates, including additional credits, (assuming no change in an investor's tax bracket) fall below the median yield (compounded) of the other savings media examined for investors in the 20 and 30 percent tax brackets and equal median yield for those in the 40 percent tax bracket. However, if the after-tax yield on an ISA Series 20 certificate is compared with the weighted average annual yield (compounded) on savings deposits from 1948 through 1967, assuming a constant tax rate over the period, the yield on the certificate would be greater than the yield on a weighted average.

The tax deferral feature of the ISA certificate would be of particular benefit to the investor who is in a high tax bracket at the time of accrual and in a substantially lower bracket when the certificate is surrendered or its maturity is reached.28/

A sampling of ISA's customers' records during 1968 revealed that 25.7 percent had an annual family income of less than $7,500 and 53.5 percent of less than $10,000. The median family income was $9,697. Also, more than 42 percent of ISA's installment certificate purchasers in 1968 were under 30 years old. If these purchasers were to be in a higher tax bracket at the date of maturity of their certificates than at the time interest accrued on them, the tax deferral feature would be disadvantageous to them.29/

Like all fixed dollar investments, face-amount certificates offer protection against deflation. However, if inflation occurs, their "real" value in terms of purchasing power is diminished. The Consumer Price Index has risen by 140 percent over the period between 1939 and 1967.30/ It has fallen in only two years during that period and each time the decline has amounted to less than 1 percent. An investor who purchased an ISA Series 20 certificate in 1947 would have received an average annual yield of 2.81 percent through the life of the certificate (including additional credits). However, since prices rose during this period, on the average, by 2.42 percent per year, the average "real" yield on this investment would have been 0.38 percent per year.

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28/ See Table VI-3 and the accompanying text.

29/ See Table VI-1 and the accompany text.

30/ See Chart VI-B.

Section VII: Impact of the Elimination of the Front-End Load

Four companies are currently selling installment face amount certificates; the largest by far is IDS. While certificate operations still account for the majority of IDS' net operating income,31/ the lines of business which IDS has been developing since 1940 have made increasingly larger contributions to IDS' net operating income.

Since the organization of its first fund in 1940, IDS' fund operations have grown to the point where it is now the investment adviser and principal distributor of the largest investment company complex in the United States.32/ As these funds have grown so has their importance as sources of IDS' net operating income. Between 1963 and 1968, the contribution of fund operations to IDS' net operating income increased by over 50 percent from $4.1 million to $6.7 million.33/

During the 1950's, IDS, through a wholly owned subsidiary, entered the insurance business. Between 1963 and 1968, insurance operations doubled their contribution to IDS' net operating income, rising from $0.6 million a year to $1.2 million.34/ During the 1960's, IDS organized or acquired a group of companies in various aspects of the financial field. This Finance Group more than tripled its contribution to IDS' net operating income, increasing from $0.6 million to $1.9 million, between 1963 and 1968. IDS estimates that the recent acquisition of Jefferies & Co., Inc., a broker-dealer which engages in over-the-counter business, will add $3.2 million to IDS' current after-tax income.

While the total net operating income of IDS has been growing at approximately 5.6 percent per year since 1963, certificate operations' contribution to this

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31/ See Table VII-2.

32/ The funds advised by IDS had assets of over $6.3 billion as of June 30, 1969.

33/ See Tables VII-1 and VII-2 and the accompanying text.

34/ In 1968, IDS' insurance subsidiary ranked among the top 5 percent of life insurance companies in the United States according to dollars in force.

income has been growing at only 1.7 percent per year. Thus, as the diversification of IDS has proceeded, the relative importance of the certificate operations has decreased. While in 1963 certificate operations accounted for $11.7 million, or 65.4 percent of IDS' net operating income, by 1968 they accounted for $12.7 million, or 54.3 percent.

The $12.7 million is composed of net operating income for ISA, IST & G and IDS (the Company). ISA's net operating income accounted for approximately $8.5 million. Advisory, service and distribution fees paid by ISA to IDS accounted for an additional $3.4 million of IDS' net operating income. IDS lost approximately $0.3 million on certificate distribution in 1968, leaving investment income and service and advisory fees which directly accounted for the profitability of its certificate operations.

An additional $0.8 million of IDS' net operating income from certificate operations was accounted for by fees and investment income received by IDS from IST & G certificate operations and IDS' own certificate operations. Investment income and fees from these assets would not be affected by the recommendations concerning the front-end load.

Ultimately, the effect on the IDS Group of any recommendation with respect to the front-end load on face-amount certificates would depend on what happens to ISA's $930 million asset and investment base. Any changes in the size of this base will depend upon changes in the value of ISA's underlying portfolio, and changes in its sales and redemption rates. Although in the long run the recommendation concerning the front-end load could accelerate the diversification of IDS's sources of income which started in 1940, such a recommendation should not cause a sudden or abrupt decline in IDS' income.

In 1941, when IDS discontinued the sale of its own face-amount certificates, its asset base was $989 million. At that time its investment income from these assets was approximately $7.9 million. Twenty years later, its investment income was still approximately $6.2 million.

Face-amount certificate assets represent only 1.4 percent of investment company assets at June 30, 1969; and were less than 0.2 percent of the value of stocks listed on all registered securities exchanges at the end of 1968. Whether the elimination of the front-end load would end all sales of installment face-amount certificates is conjectural. But even if such sales were to be entirely halted, the effect would be felt by only a very small fragment of the securities industry and even this effect would be a gradual one.

## CONCLUSIONS

Approximately 20,000 installment face-amount certificates were sold in the United States in 1968--for which investors paid in over $5.7 million in that year alone. Cumulative installment certificate payments in 1968 are estimated at $90 million. There were over 370,000 installment face-amount certificate accounts in force at June 30, 1969, and the total face value of these installment certificates outstanding at the end of 1968 was over $2.2 billion. The average installment certificate account of the dominant company in this area has an estimated face value of $11,470. Thus, individually and in the aggregate, hundreds of thousands of persons in the United States are concerned with face-amount certificates.

Experience has shown, however, that a large portion of the people who buy face-amount certificates lose money. Such losses are caused by the deduction of the front-end load from the early years' payments. As a result of such charges, an investor does not reach the breakeven point on most of the certificates presently sold until after the payments required on the first 8 years of the certificate have been made. Of those persons who purchased the most popular face-amount certificate sold by the dominant company in this area, more than 55 percent lost money. The surrender rate on certificates sold during 1966 through 1968 by that company has continued at about the same rates as for certificates sold prior thereto, despite the fact that the newer certificates have a lower front-end load and higher immediate cash values.

The losses are particularly significant in view of the economic classification of the investors. According to a recent sample, the medium annual family income of purchasers of the best selling company's certificates in 1968 was $9,750. Some 25.7 percent of such certificate purchasers had an annual family income of less than $7,500 and 53.5 percent had an annual family income of less than $10,000. More than 72 percent of the certificate purchasers were under 40 years old.

The front-end load helps to support highly structured personal selling effort in which salesmen are trained to sell generally by means of a "canned interview". Moreover, salesmen are paid on a commission basis which depends upon the size of the periodic payment which the investor makes and does not vary according to the product sold. In general, salesmen receive the same amount for selling an equity investment as a face-amount certificate requiring the same monthly payments.

The investment yield on face-amount certificates held to maturity (including additional credits) is less than that realized from other savings programs. The after-tax yield on the dominant company's best yielding certificate fell below the median average annual yield on United States Savings



234

Bonds (Series E), savings associations, mutual savings banks and commercial banks for investors in the 20 or 30 percent tax brackets throughout the life of a 20-year certificate and equal the median yield for those remaining in the 40 percent tax bracket over the life of the certificate. Thus, if the elimination of the front-end load should result in face-amount certificates being sold with less intensity than at present, alternative accumulation programs with comparable after-tax benefits would still be available.

Whether discontinuing the front-end load on sales of installment face-amount certificates would end the sale of such certificates is conjectural. Even if this were to occur however, the economic impact, if any, on the securities industry would be negligible and even that effect gradual.

## RECOMMENDATION

As the study indicates, the investment yield on face-amount certificates held to maturity is less than that realized from other savings programs. Furthermore, a vast majority of purchasers of installment face-amount certificates do not continue payments under the plans to their stated maturity dates. It is the practice of those companies selling face-amount certificates to impose a substantial commission on the early payments made by the investors, commonly referred to as the front-end load. Accordingly, early redemption results in a loss to the investor.

In our December, 1966 Mutual Fund Report, at page 250, we expressed our dissatisfaction with the imposition of a front-end load as it relates to face-amount certificates. Our present study confirms the basis for our original position. We therefore reassert our earlier belief that the front-end load on installment face-amount certificates is contrary to public interest and the interest of investors; accordingly, we recommend that such practice and the practice of equivalent surrender charges be discontinued.

Thank you for the opportunity to comment on PERA on such short notice. At the outset, I would like to express support of the passage Sen. Magsaysay's bill on PERA.

I would, however, recommend one fundamental change. Registered investment companies or mutual funds should be added to serve as funding vehicles of the PERA so that all Filipinos will be able to invest for their retirement through mutual funds.

The Individual Retirement Account (IRA) experience in the US has benefited millions of retirees. It has become a powerful tool for the formulation of capital of the American economy as well as a means for providing long term savings to retirees.

In the US, the mutual fund industry pioneered in the development of the IRA and "401 (k) Plans". Millions of Americans and the US economy have benefited from retirement accounts. Through their IRAs, they have been able to invest and share in the profits of the great companies --- the Microsofts and the Intels -- that are creating millions of new jobs and developing the new technologies that are revolutionalizing our lives. Sen. Magsaysay's bill on PERA can help Filipinos to do the same thing.

Registered investment companies, mutual funds, should be included as a funding medium in the bill because mutual funds can provide a means of participation in the securities market that will allow an uninitiated investor to limit the degree of risk he/she wishes to take. The mutual fund is a relatively safer securities investment because its investment

objectives are clearly stated. It permits the investor to own a share of diversified portfolio of securities which is professionally managed at a relatively low cost. Moreover, it provides many administrative conveniences, liquidity, ease of purchase and redemption, regular account statements and transparency. Investors receive a prospectus and annual and semi-annual reports and their fund is subject to regulation and oversight by the Securities and Exchange Commission.

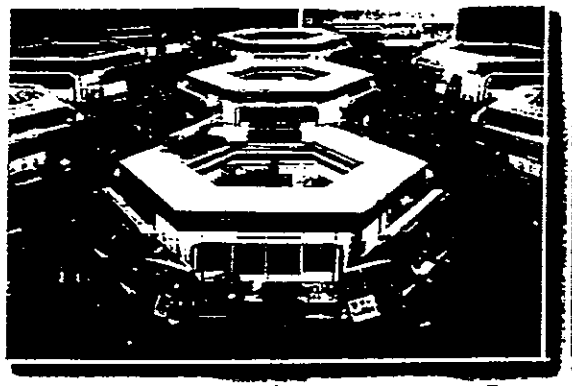
Mutual funds educate investors, and marshal and channel investments into the securities market. As disciplined sophisticated investors, they can exert a stabilizing influence on the market. A successful mutual fund industry can be a catalyst to the development of the capital market ---- an engine for its long term growth and development. By adding liquidity to the secondary market, mutual funds help encourage new public offerings, and improve intermediation, capital formation and allocation; ultimately spurring the development of the economy.

SBN 1088, otherwise known as "Personal Equity Retirement Account (PERA) Act of 1998" authored by Sen. Magsaysay provides an avenue to expand the investment alternatives of Filipinos investing for their retirement and for the development of the mutual fund industry in the Philippines.

The Philippine mutual fund industry accounts for the less than .5% of the market capitalization compared to the US which comprises more than 40%. This means that the mutual fund industry in the Philippines is still underdeveloped and requires policy

reforms to develop and regulate the industry. I would welcome the entry of banks into the fund industry. I would like to see them actively involved in promoting and adding their expertise and distribution networks to the development of the mutual fund industry. The industry, if properly developed and as a funding vehicle for PERA, can make significant contribution to the choices available to Filipino investors and to the growth of the Philippine economy.

# BUILDING A SECURITIES MARKET REGULATOR IN AN EMERGING MARKET



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*Price Waterhouse LLP*



239

5. *Division of Investment Management*

*a. What is the role of the Division of Investment Management?*

Investment funds, their managers and investment advisers occupy special positions of trust. They manage the public's money and participate extensively in the securities markets. A regulator with a small staff and limited budget may be tempted to merge the functions of the Division of Investment Management into the Full Disclosure or other Divisions. Because of the complexity of investment fund operations, the positions of trust that funds, their managers and investment advisers occupy and the broad impact that they have on the market, it is preferable that regulation of funds, their managers and investment advisers be placed in a separate unit.

The Division of Investment Management:

- registers, licenses and inspects investment funds and investment advisers
- proposes rules regarding fund operations and standards of conduct
- oversees offers, sales and redemptions of fund shares.

*b. What special considerations affect the functions of a Division of Investment Management in a transitional economy?*

In a transitional economy, investment funds must focus less on diversification and more on becoming effective shareholders. They must overcome the resistance of company managers and workers and become the instruments of change at enterprises.

To realize the full benefits of share ownership, funds must first ensure that they have effective title to portfolio securities. Second, they must be able to buy and maintain significant blocks of shares of their portfolio companies in order to influence their management and policies.

Lacking liquid markets for the shares they own, funds will require extra guidance in valuing the shares in their portfolios and arriving at meaningful net asset values, which determine the prices at which they sell and redeem their own shares, and which measure their performance and the fees their managers receive.

Although they are essentially vehicles for managing investors' money, funds may be exposed to double taxation of the income and dividends they receive at both the fund and the shareholder levels. It may be necessary for the Division of Investment Management to coordinate with the tax authorities to avoid making investing through funds subject to duplicative and burdensome taxes.

Ultimately, the overriding issue for funds is their economic survival. Fair means must be found to merge small uneconomical funds into larger funds that can take advantage of economies of scale.

*c. What are the specific tasks and priorities necessary to create a Division of Investment Management?*

The Division of Investment Management should study investment funds in other emerging market economies. It should understand how voucher investment funds act as catalysts for change in transitional economies and decide how regulatory policy supports that goal. It should also understand why such funds should not issue redeemable securities until their portfolios are liquid.

It must ensure that:

- the legal and policy framework permits funds to hold meaningful positions so they may influence management of companies in the portfolio

- funds are able to secure full ownership rights
- fund assets are maintained independently
- accounting and valuation guidelines are in place that assist funds, their advisers and managers, investors and the regulator in understanding fund operations and results
- funds buy and sell shares at net asset value
- shareholders have a means of selling their shares at a fair price.

Specific tasks and priorities of the Division include the following:

- Review the laws, rules and forms as they apply to investment funds and their advisers and managers to ensure that they encourage appropriate policy objectives and provide sufficient powers to the regulator
- In consultation with representatives of the fund industry, recommend and draft legislation, to achieve appropriate policy goals
- Draft rules, forms and procedures for licensing funds, their advisers and managers, for registering securities offered for sale by the funds and for examining and licensing employees of funds, investment advisers and investment managers
- In coordination with the entity responsible for accounting standards, design fund accounting standards, valuation guidelines and programs for reconciling them with existing standards, train the funds on their use and ensure that they are implemented
- Coordinate with tax authorities to ensure that the new fund accounting standards are used by them and that they adopt "pass through" tax treatment so that fund income (interest, dividends and net gains on securities transactions) is not subject to "double" taxation, that is, at both the fund and shareholder levels
- Develop model forms for an investment fund prospectus, agreement with investment manager or adviser, fund depository and registrar
- With the Division of Market Regulation and the stock exchange, design a program to list and trade fund shares on an exchange
- Design a survey of funds and their managers which can be used to help them to understand and comply with legal and regulatory requirements and assist the Division in monitoring their activities
- Design and conduct training programs on regulatory requirements for funds
- Inspect several of the largest funds
- With the Office of Chief Counsel, review the laws and regulations applicable to acquisitions of one fund by another and devise fair laws, rules, formulas and procedures related to fund combinations and consolidations

Bangko Sentral ng Pilipinas
MAYNILA, PILIPINAS

SUPERVISION AND EXAMINATION SECTOR

Office of the Deputy Governor

June 09, 1999

**Honorable Joel A. Bañares**
Undersecretary
Department of Finance
M a n i l a

Dear Undersecretary Bañares:

Hereunder are the comments/position of the Bangko Sentral ng Pilipinas (BSP) relative to the issues raised by the Investment Company Association of the Philippines (ICAP) during the May 21, 1999 meeting of the DOF Contractual Savings Task Force (CSTF).

1. On BSP prohibition on the use of personnel and premises of the parent bank and its subsidiaries to sell "mutual funds"

   The BSP consider this as an exception since using the parent bank premises to sell mutual funds gives the impression that the investor is dealing with the parent bank.

   In the examination of one investment house without quasi-banking functions but with trust functions, the BSP required the said investment house to staff its Trust Department with a separate set of officers and employees in accordance with Section 4406N.2 of the Manual of Regulations for Banks and Other Financial Intermediaries, Book IV. This section prohibits a director, officer or employee who are taking part in the management of trust and other fiduciary accounts to perform duties in other departments or the audit committee of the financial institution and vice versa.

2. On the issue that BSP does not allow investment managers to manage other funds. If an investment manager chooses to manage more than one (1) fund, he will be subject to the BSP's trust fund rules.

It is BSP's position that an investment company manager which manages more than one (1) fund will fall within the purview of the rules and regulations on investment management activities and as such is under Bangko Sentral supervision. This position is supported by the following portions of Sections 4403N.c and 4414N of the Manual of Regulations for Banks and Other Financial Intermediaries, Book IV, to wit:

a. Section 4403N.c which defines Investment Management Activity (IMA) as "any activity resulting from a contract or agreement primarily for financial return whereby the bank or an investment house (the investment manager) binds itself to handle or manage investible funds or any investment portfolio in a representative capacity as financial or managing agent, adviser, consultant or administrator of financial or investment management, advisory, consultancy or any similar arrangement which does not create or result in a trusteeship."

b. Section 4414N - Authority to Perform Investment Management

Second Paragraph, which provides that "entities other than banks whose Articles of Incorporation xxx includes the purpose or power to act as managing agent, adviser, consultant or administrator of investment management/advisory/consultancy account shall secure the prior favorable recommendation of the Monetary Board of the Central Bank before the filing of said Articles of Incorporation or amendments thereto, with the Securities and Exchange Commission";

Third paragraph, which also provides that "entities authorized to engage in IMA which are subsequently authorized to engage in trust and other fiduciary business, shall then be subject to the provisions of Part IV "A" and "C" of these regulations"; and

Fourth paragraph, which further provides that if an "entity is found to engage in unauthorized investment management activities whether as its primary, secondary or incidental business, the MB may impose administrative sanctions against such entity or its principal officers and/or majority stockholders or proceed against them in accordance with law."

We hope you understand our position on the matter.

Best regards.

Very truly yours,

ALBERTO V. REYES
Deputy Governor



2-4V

## APPENDIX 9, INDUSTRY PLAYERS

The following is a brief description of each fund and the affiliations of their sponsors and investment advisers:

The First Galleon Family Fund, Inc. was the first fund to be registered under the Rules and Regulations Governing Investment Companies which the SEC promulgated in 1989. It was incorporated on Sept. 27, 1990 as Magellan Income Fund, Inc. but changed its corporate name in 1991. It began commercial operations on February 1, 1991 and was initially a fixed-income fund. In 1994, the SEC granted the fund's request to change its investment policy by allowing it to invest in equity securities. The sponsor of the fund is its investment adviser/manager, The First Galleon Fund Management Corp. (TFGFMC). TFGFMC is a subsidiary of GT Corp., a family owned holding company with business interests in stockbrokerage, customs brokerage, food processing, and travel.

Filipino Fund, Inc. (FFI), the only operating closed-end fund in the country, was incorporated on May 9, 1991 with an authorized capital of ₱50 million. The incorporators of the fund were companies affiliated with the Ayala group of companies like Insular Life and Ayala Life, and the retirement funds of big corporations like Bank of the Philippine Islands (BPI), Ayala Corporation, Pilipinas Shell, Philippine Airlines, Del Monte, Insular Life, and Filipinas Life. On August 26, 1994, the SEC approved the increase in its authorized capital to ₱850 million. The following year, FFI had an IPO and had its shares listed in the Philippine Stock Exchange. Its investment adviser/manager, BPI Investment Management, Inc. (BIMI) is a 100% owned subsidiary of the Bank of the Philippine Islands, the oldest commercial bank in the Philippines.

The Philippine American Life Insurance Co. (Philamlife), the biggest and one of the oldest insurance companies in the Philippines, decided to go into the mutual funds business by entering into a joint venture with the Private Development Corporation of the Philippines (PDCP), the investment adviser/manager of Trinity Shares, Inc. (TSI). TSI was renamed Philam Fund , Inc. and was re-launched in August 1993. In 1995, Philamlife and AIG Management Services bought out PDCP and renamed the management company Philam Fund Management, Inc. It later changed its name to Philam Asset Management, Inc. (PAMI) and launched two more funds - Philam Bond Fund in 1997 and Philam Strategic Growth Fund in 1998.

In 1994, two of the top local stockbrokerage firms, Citisecurities, Inc. and Wealth Securities, Inc. formed their own funds, Citisec Growth & Income Fund, Inc. (CGIF) and Philequity Fund, Inc., respectively. Citisec Management, Inc., the investment adviser/manager of CGIF, is owned by the same individuals who own Citisecurities.

United Fund, Inc. was actually incorporated ahead of Citisec Growth & Income Fund and Philequity Fund (in 1993) but began commercial operations only in 1995. Its incorporators were the United Coconut Planters Life Assurance Corporation (Cocolife) and the retirement funds of affiliated companies. The investment



295

adviser/manager of United Fund is the Trust Banking Division of United Coconut Planters Bank (UCPB), an affiliate of Cocolife.

The Mutual Fund Company of the Philippines, Inc. was the first government-sponsored fund. It's management company, The Mutual Fund Management Company of the Philippines, Inc., (MFMCP) is a joint venture of the Philippine National Bank (then a government-owned bank but is now being privatized), Clemente Fund Management (Asia) Ltd., Daiwa Asset Management, Inc. and National Investment Trust Company of Taiwan. With their clout and political connections, MFMCP was able to convince retirement funds of some of the biggest companies in the Philippines (San Miguel Corporation, MERALCO, PLDT, PNB and AFP RSBS) to put up the seed capital for the fund, which they called Kabuhayan Fund and launched in April 1996.

Abacus Growth Fund, Inc. (AGFI) was incorporated on August 30, 1996 and was launched on November 14, 1997. Its sponsor, First Abacus Financial Holdings, Inc., is a diversified financial holding company listed in the Philippine Stock Exchange. It's subsidiaries are Abacus Securities Corporation (the top local stockbrokerage firm in 1997), Abacus Capital and Investment Corp. (an investment house), First Abacus Investment Management, Inc. (the investment adviser/manager and principal distributor of AGFI), and Vista Holdings Corp (real estate firm).

The GSIS Mutual Fund, Inc. is the other government-sponsored fund and is the fund with the biggest paid-up capital (₱750 million). The Government Security Insurance System is the proponent of the fund. It also linked up with Clemente Asia (Philippines), Inc. to form the management company, The Worldwide Investment Management Company of the Philippines, Inc. (WINVEST). The fund, which they called Kinabukasan Fund was launched in June 1998 and was allowed by the SEC to accept lower initial investment amounts (₱1,000) to GSIS members.

Another fund that began operations in 1998 was the ECC Growth and Income, Inc. Both the fund and the investment adviser/manager (ECC Asset Management, Inc.) are owned by ECC Capital Corporation, a local investment house with links to the Funds for Assistance to Private Education (FAPE).

All Asia Fixed Income Fund, Inc. and All Asia Fund, Inc. began operations in January 1998 and January 1999, respectively. Their sponsor, All Asia Capital and Trust Co., is an investment house and one of the most diversified financial services company in the country with subsidiaries and affiliates in the following industries: stockbrokerage (All Asia Securities) , insurance (All Asia Life), pre-need (All Asia Plans), and asset management (All Asia Asset Management).

The most recent entrant to the industry is Ayala Life Fixed Income Fund, Inc. (ALFM), the second fund of the Ayala group of companies (the other fund is Filipino Fund). The investment adviser of ALFM is the Asset Management and Trust Group of the Bank of the Philippine Islands.

# MEMORANDUM OF AGREEMENT

KNOW ALL MEN BY THESE PRESENTS:

This **Memorandum of Agreement**, executed this 11th day of FEBRUARY, 1999 at Manila, Philippines, by and between:

**BANGKO SENTRAL NG PILIPINAS**, a government corporation duly organized and existing under and by virtue of R. A. No. 7653, the New Central Bank Act, with principal office at Mabini Street, Metro Manila and hereinafter referred to as the "BSP"

and -

**SECURITIES AND EXCHANGE COMMISSION**, a government entity duly organized and existing under and by virtue of Commonwealth Act No. 83 (Securities Act) as amended, with principal office at SEC Building, EDSA, Greenhills, Mandaluyong City, Metro Manila, and hereinafter referred to as the "SEC".

**WITNESSETH:** That

**WHEREAS**, the SEC, under P.D. No. 902-A, as amended, exercises absolute jurisdiction, supervision and control over all corporations, partnerships and associations as well as securities brokers and dealers.

**WHEREAS**, the BSP, under R.A. No. 7653, administers the monetary, banking and credit system of the Philippines and exercises supervisory and regulatory authority over all banks and all financial institutions with quasi-banking functions including their subsidiaries and affiliates engaged in allied activities.

**WHEREAS**, under Section 130 of R.A. No. 7653, it is provided that the BSP shall, within a period of five (5) years from the effectivity of this law (July 3, 1993), phase out its regulatory powers over finance companies without quasi-banking functions (NonBank Financial Institutions) and other institutions performing similar functions as provided in existing laws, the same to be assumed by the SEC.

**WHEREAS**, BSP's regulatory authority over Non-bank Financial Institutions (NBFIs) consists of the following:

1. Regulatory actions as provided under the BSP Manual of Regulations for Banks and Other Financial Intermediaries, Book IV-N
2. Listing of NBFIs for BSP databank
3. Action on SEC endorsements relative to these NBFIs
4. Conduct of special examinations, if circumstances warrant e.g. verification of complaints, borrowings of NBFI from the public



247

5. Collation of data culled from reports

6. Monitoring of borrowing levels of NBFIs as indicators for unauthorized quasi-banking operations

**WHEREAS, BSP** shall continue to regulate and supervise banking institutions and quasi banks including their subsidiaries and affiliates engaged in allied activities and the following institutions:

a. Non-bank financial institutions (NBFIs) authorized to engage in quasi-banking function or in trust or other fiduciary business/investment management operations;

b. Pawnshops;

c. Building and loan associations;

d. Trust companies;

e. Non-stock savings and loan associations; and

f. Other institutions, including government financial institutions and banks/quasi-banks' subsidiaries/affiliates engaged in allied activities, required by law to be under the supervision of **BSP**.

**WHEREAS, SEC** shall also continue to have supervision over investment houses and financing companies regardless of whether these financial institutions have quasi-banking functions or not; Securities related activities to be regulated by the SEC;

**NOW THEREFORE**, for and in consideration of the foregoing premises, the parties agree as follows:

1. That the regulatory powers of **BSP** enumerated in the 4th "Whereas" clause over NBFIs and other institutions performing similar functions as provided by existing laws shall be deemed transferred to **SEC** immediately upon signing of this Memorandum of Agreement and, subject to existing applicable laws, e.g., Section 4 of Republic Act No. 337, as amended, **BSP** shall cease to exercise said powers;

2. That the **BSP** shall inform the NBFIs concerned that the latter shall henceforth submit their reports to **SEC**;

3. That NBFIs suspected to be engaged in banking, quasi-banking, trust and/or investment management functions shall be referred by **SEC** to the **BSP** for examination. The **SEC** shall furnish the **BSP** with the latest financial statements and such other data that may be needed in the examination. The **BSP** shall inform the **SEC** of its examination findings and the Monetary Board action thereon.

On the other hand, BSP shall inform the SEC of violations by banks and other financial institutions still under the jurisdiction of BSP of the Revised Securities Act.

4. That on an annual basis, the SEC shall furnish the BSP with Consolidated Statement of Condition and Income Statement for the individual industries, i.e. Securities Brokers/Dealers, Lending Investors, Financing Companies, Investment Houses, Investment Companies, and Government Non-Bank Financial Institutions.

**IN WITNESS WHEREOF**, the parties have hereunto executed this Agreement on the date and place first above written.

BANGKO SENTRAL NG PILIPINAS

By:

GABRIEL C. SINGSON
Governor

SECURITIES AND EXCHANGE COMMISSION

By:

PERFECTO R. YASAY, JR.
Chairman

SIGNED IN THE PRESENCE OF



249

## ACKNOWLEDGMENT

Republic of the Philippines)
City of Manila ) S.S.

Before Me, a Notary Public, for and in the City of Manila, Philippines, this _____ day of _____, 1998, personally appeared:

| Name | Community Tax Certificate No. | Date/Place of Issuance |
|---|---|---|
| **Gabriel C. Singson**<br>Governor<br>Bangko Sentral ng Pilipinas | _____ | _____ |
| **Perfecto R. Yasay, Jr.**<br>Chairman<br>Securities & Exhange Commission | _____ | _____ |

known to me and to me known to be the same persons who executed the foregoing Memorandum of Agreement and who acknowledged to me that the same is their voluntary act and deed and that of the institutions they respectively represent.

This instrument consists of _____ ( ) pages, including the page on which this acknowledgment is written and signed by the parties and their witnesses on each and every page thereof.

Witness my hand and notarial seal on the date and place abovementioned.

NOTARY PUBLIC

Doc. No. _____
Page No. _____
Book No. _____
Series of _____



250

BEST AVAILABLE COPY

Section 414 of the BSP Memorandum to all Banks and Other Financial Institutions Performing Trust, Other Fiduciary Business and Investment Management Activities, dated 16 October 1990

"Section 414. Authority to Perform Investment Management. Banks may be authorized by the Monetary Board to act as managing agent, adviser, consultant or administrator of investment management/advisory/consultancy account under Section 72 (d) of R.A. No. 337, as amended. However, such authority shall not be construed to include the authority to engage in trust and other fiduciary business under Chapter VII of R.A. No. 337, as amended.

Entities other than banks whose articles of incorporation or any amendments thereto, include the purpose or power to act as managing agent, adviser, consultant or administrator of investment management/advisory/consultancy account shall secure the prior favorable recommendation of the Monetary Board of the Central Bank[1] before the filing of said articles of incorporation or amendments thereto, with the Securities and Exchange Commission.

* * *

If, after due findings, an entity is found to engage in unauthorized investment management activities whether as its primary, secondary or incidental business, the Monetary Board may impose administrative sanctions against such entity or proceed against them in accordance with law.

The Monetary Board may take such action as it may deem proper such as, but may not be limited to, requiring the transfer or turnover of any investment management account to duly

[1] now the Bangko Sentral ng Pilipinas.

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251

incorporated and licensed entities of the choice of the client.

An entity not authorized to engage in investment management activities shall not advertise or represent itself as being engaged in investment management activities or represent itself as investment manager or use words of similar import."[2]

[2] Underscoring supplied.

Sun Life of Canada

111 Paseo de Roxas, Legaspi Village
Makati, Metro Manila

Tel.: 818-6916, 819-5001
Fax: 819-2523

May 17, 1999,

Lew Mendelson, Esq.
Agile
Suite 105, Ground Floor
45 Eisenhower Street, Greenhills
San Juan, Metro Manila

Mr. Mendelson,

Thank you for including me on the distribution list of the draft of your positioning paper relating to the capital markets and the mutual fund Industry in the Philippines. I have read the document with interest, and would like commend you on its judicious contents.

In light of this document, I was wondering if it would be appropriate at this juncture, to raise the issue of mutual funds comprising essentially foreign securities, as the viability of this product, in the Philippines, is severely compromised. This in turn may, and will, negatively impact any attempt made to strengthen the mutual fund industry, and by "ricochet", impact the growth of local capital markets, which will result from a healthy mutual fund industry.

Let me explain. We have found that for a mutual fund operation to be profitable, a basic critical mass of capital under management is required, and this critical mass is in excess of the size of the whole Philippine industry, as it stands today. However if this mass was to be achieved, it simply could not be invested in local securities' markets alone, as these are simply too thin to support such volumes. Therefore, other outlets are required, and hence the creation of foreign funds needs to be aided.

We believe that should this not take place, you will soon realize that potential mutual fund sponsors, whether local or foreign, will not see the Philippine's market, as a viable one for their operations. This will deprive the market from the product legitimization that results from the entrance of important "players" with credible names, well-established images, and large advertising and promotional budgets.

As well, Philippine investors are probably investing their money in offshore funds, managed by well-known foreign mutual fund companies, with offices elsewhere in Asia. In other words, this money is probably leaving your capital markets anyway, therefore it might be desirable to see those assets profit mutual fund operations registered in the Philippines. Such profits will then be taxable here, and hence benefit the economy.

There are several factors which come into play in the Philippines, which severely compromise the viability of such "Foreign" funds, and I will mention four that come to mind.

First, capital gains realized in such funds are taxable in the fund at the rate of 32% (Jan 1, 2000), which is not the case for mutual funds comprising domestic securities. The impact of such tax liabilities, on fund performance, would render the product "unmarketable", unless a "Buy and Hold" strategy was adopted, but this only defers the problem to a later date.

Secondly, as a means to enhance the performance of such funds, and attempt to offset a portion of the tax liability mentioned above, it would be desirable for Asset Management Companies to mandate a sub-advisor with known expertise in foreign markets, to handle the day-to-day portfolio management of these funds. However, the Investment Company Act, with its definition of "Investment Advisor" requires any foreign sub-advisor to register as an investment advisor in the Philippines, and we are told, they may also have to register as "businesses" in this country as well. These requirements do not exist in Canada, or the U.S, and just add to the hindrance of trying to launch such funds. It seems that if the Asset Management Company has to register as the "formal" portfolio manager, it may be a duplication of effort to also require the registration of a "sub-advisor".

A third problem, is that an Asset Management Company in the Philippines, would not launch foreign funds without also launching domestic funds. However it appears that an Asset Management Company in the Philippines can only manage one fund. To manage several funds, the approval of the Monetary Board of the Banko Sentral ng Pilipinas, is required, and this approval needs to be secured before the articles of incorporation and by-laws of the funds, are filed with the Philippine Securities and Exchange Commission.

As yet we are not sure why this duplication of "approval" is required. There does not seem to be any "formal" legal requirement for this, other that an internal opinion which has been issued by the Office of the General Counsel and Legal Services of the BSP, last April 5, addressed to the Department of Thrift Banks and Non-Financial Institutions of the same agency. Nor do we know what will be required to obtain this approval, and what duplication, if any, of reporting and fees will result from this step.

In Canada, the U.S. and the United Kingdom, just to name these countries, Asset Management Companies each manage a multitude of distinct funds, whether close-ended or open-ended, or both. Also such financial instruments come under the jurisdiction of "one" government agency.

A last point is that the playing field in this country needs to be leveled. Common Trust Funds can, and do offer US dollar denominated foreign funds, and the insurance

commission (in it's circular no 9-97) also allowed foreign currency denominated investments, in issues of foreign corporations, and foreign governments. Hence it may be appropriate at this time, to recognize the importance of "Foreign" funds in the Philippine mutual fund equation, going forward.

In parting, I think it might be timely to raise these issues, as simplifying the creation of "Foreign" funds, may mean the difference between your seeing the mutual fund industry remain in it's infancy, as it is, or seeing it grow to thriving levels achieved in other countries or even in other areas of the local financial services industry.

Best regards

Andre-Jacques Belanger
Director, International Investment Products

Bangko Sentral ng Pilipinas

MAYNILA, PILIPINAS

SUPERVISION AND EXAMINATION SECTOR
Supervisory Reports and Studies Office

23 April 1999

Mr. Lewis J. Mendelson
Capital Market Consultant, AGILE
c/o Atty. Eleanor B. Rivera
Suite 105, Ground Floor
Le Gran Condominium
45 Eisenhower St.,
Greenhills, San Juan,
Metro Manila

Dear Mr. Mendelson:

As requested in your letter of 19 March 1999, received by this Office on 12 April 1999, following are our comments on the Circulation Draft Report, "A Strategic Vision: Strengthening Philippine Mutual Funds and Improving the Public's Perception of Them":

1. We support the move to strengthen the Investment Company Association of the Philippine (ICAP) through its adoption of a comprehensive strategic plan.

   We believe that a stronger ICAP could educate the public about what investment companies are and how investors and savers could benefit by investing in mutual funds. We also believe that the success of the mutual fund industry would depend on how well the public can be convinced about its merits and not on how well the demerits of its competing product is brought to the attention of the public.

2. We also suggest the proposal to subject the pre-need industry into stricter regulations for better protection of the investors, particularly the following:

   a. greater transparency into the regulatory structure, including prominent disclosure of actuarial assumptions and lapse experience in an offering document;

   b. reduction of the severity of plan holder losses from lapses;

   c. improvement of procedures for training, testing, licensing and monitoring of salesmen to assure industry-wide professional sales practices.

3. It may be true that pre-need plans and mutual funds are similar and that they may be marketed to the same investors; that both of them are for long-term investors; and that their investment goals are likewise similar, i.e. providing for education and retirement. We would like to point out, however, that investors in pre-need plans differ from the investors of mutual funds, particularly in the cases of health and educational plans. As you have mentioned in the subject Circulation Draft Report, investors in the pre-need plans are not the wealthy or sophisticated clients, but are more likely, the newly-weds, young professionals, teachers and small entrepreneurs and many other first-time investors who normally have very little savings. And we would like to add that they are most probably looking at pre-need plans as a sort of insurance for the future of their dependents at the time they made the decision to invest. Hence, they preferred pre-need plans to mutual funds.

4. Management of common trust funds (CTFs) is a regular business of banks and investment houses authorized to perform trust and other fiduciary activities. They are therefore permitted to directly solicit investments in their CTFs from the public. The Bangko Sentral is not discriminating against mutual funds but merely implementing existing laws by permitting banks and investment houses authorized to perform trust and other fiduciary activities to solicit investments in their CTFs.

5. While it may be true that there are differences in the regulatory environment of mutual funds and banks' CTFs, such differences do not necessarily favor CTFs because existing BSP regulations on CTFs may even be stricter than the SEC's regulations governing mutual funds. Among other regulations designed to protect the investors, it is required that when the trustee is granted discretionary powers in the investment disposition of a trust, the investment of the fund shall be limited to:

   a. Evidences of indebtedness of the Republic of the Philippines and of the Bangko Sentral, and any other evidences of indebtedness or obligations the servicing and repayment of which are fully guaranteed by the Republic of the Philippines or loans against such government securities;

   b. Loans fully guaranteed by the Republic of the Philippines as to the payment of principal and interest;

   c. Loans fully secured by a hold out on, assignment or pledge of deposits maintained either with the bank proper or other banks, or of deposit substitutes of the bank or investment house proper, or mortgage and chattel mortgage bonds issued by the trustee or fiduciary; and

   d. Loans fully secured by real estate or chattels in accordance with Section 78 of R.A. No. 337, as amended, and subject to the requirements of Sections 75, 76 and 77 of R.A. No. 337, as amended.

A trustee or fiduciary is also prohibited from undertaking any of the following transactions for the account of a client under Subsec. X409.3 of the Manual of Regulations, unless prior to its execution, such transaction has been fully disclosed and specifically authorized in writing by the client, beneficiary, other party in interest, court of competent jurisdiction, or other competent authority:

a. Lend, sell, transfer or assign money or property to any of the departments, directors, officers, stockholders, or employees of the trustee or fiduciary, or relatives within the first degree of consanguinity or affinity, or the related interest of such directors, officers and stockholders; or to any corporation where the trustee or fiduciary owns at least fifty percent (50%) of the subscribed capital or voting stock in its own right and not as trustee nor in a representative capacity;

b. Purchase or acquire property or debt instruments from any of the departments, directors, officers, stockholders, or employees of the trustee or fiduciary or relatives within the first degree of consanguinity or affinity, or the related interest of such directors, officers and stockholders; or from any corporation where the trustee or fiduciary owns at least fifty percent (50%) of the subscribed capital or voting stock in its own right and not as trustee nor in a representative capacity;

c. Invest in equities of, or in securities underwritten by, the trustee or fiduciary or a corporation in which the trustee or fiduciary owns at least fifty percent (50%) of the subscribed capital or voting stock in its own right and not as trustee nor in a representative capacity; and

d. Sell, transfer, assign or lend money or property from one trust or fiduciary account to another trust or fiduciary account except where the investment is in any of those enumerated in items "a" to "d" above.

Directors, officers, stockholders or their relatives or related interests (DOSRI) covered by this Subsection shall be those considered as such under existing regulations on loans to DOSRI of banks and investment houses. The procedural and reportorial requirements in said regulations shall also apply.

The disclosure required under this Subsection shall consist of the following minimum information:

1) The transactions to be entered into;
2) Identities of the parties involved in the transactions and their relationships (shall not apply to item "d" of this Subsection);
3) Amount involved; and
4) Collateral security(ies), if any,

which shall be made known to clients in a separate instrument or in the very instrument creating the trust or fiduciary relationship.

6. The solvency and liquidity of individual banks are admittedly the primary concern of the BSP in order to ensure the protection of the depositors and other creditors. However, when it comes to their trust business, BSP's regulations are designed for the protection of the trustors. In addition to the regulations mentioned in item 5 above which are designed for the protection of the trustors, existing BSP regulations also requires the creation of a trust committee and the appointment of a trust officer and subordinate officers of the trust department.

7. We would also like to take exception to the following statements on page 40 of the subject Circulation Draft:

> "Banks had no or inadequate capital to back their CTF operations. They also lacked supervision from regulating agencies. Investment guidelines and restrictions were overlooked. Fee and commission controls were inadequate. Investors were entitled to very few rights and transactions were not fully disclosed to them by their custodian banks. For almost a decade of rapid growth, the industry lacked clear rules on licensing, capitalization and nationality requirements for enterprising companies."

a. The existing BSP Rules and Regulations on Trust, Other Fiduciary Business and Investment Management have adequate provisions regarding licensing of banks applying for authority to engage in trust and fiduciary business.

b. Banks cannot be considered to have no adequate capital to back their CTF operations because substantial amount of capital is required before they can be issued trust license. For thrift banks the minimum capital required is P400 million, while for commercial banks and expanded commercial banks, the capital required is P2.8 billion and P5.4 billion, respectively.

c. The trust operations of banks just like their regular banking operations are subject to examination by the BSP at least once every twelve months.

d. Item 5 above also belies the claim that transactions were not fully disclosed to investors in CTF accounts.

We therefore hold the view that differences in the regulatory environment are not the main cause why the mutual fund industry remains very small as compared to pre-need plans and common trust funds. We believe that the real reason for the industries' very slow development could be attributed to the following:

a. The industry itself failed to make its product acceptable to the public;
b. The small investors' preference to relatively safe investments like CTFs over speculative ones like stocks and mutual funds.

Thank you for giving us the opportunity to express our views on the subject Circulation Draft.

Very truly yours,

R. P. LIRIO
Managing Director, SE II
& Officer-in-Charge, SRSO

cc: The Governor
The Deputy Governor

c:other sulat:mendelson



260

*TABLE 1 - SALES, REDEMPTIONS AND NET ASSETS, ALL MUTUAL FUNDS*

*Rs. in crores*

| | Name of Mutual Fund | New Schemes Launched During the Year | | Existing Schemes | | Total During the Year 1997-98 | | Redemptions / Repurchase During the year | Total Net Assets Under Mgmt as on 31.3.98 |
|---|---|---|---|---|---|---|---|---|---|
| | | No.of Schemes | Sales | No of schemes | Sales | No of Schemes | Sales | | |
| A | Unit Trust of India | 12 | 8,281 | 57 | 5,487 | 69 | 13,748 | 10,050 | 57,554 |
| B | Bank Sponsored (6) | 2 | 114 | 54 | 16 | 56 | 130 | 1,120 | 4,872 |
| C | Institutions (3) | 5 | 81 | 32 | 67 | 37 | 146 | 380 | 2,472 |
| D | Private Sector | | | | | | | | |
| I | Indian (6) | 6 | 2,917 | 16 | 115 | 22 | 3,032 | 2,640 | 1,031 |
| II | Joint Ventures - Predominantly Indian (7) | 13 | 778 | 20 | 534 | 33 | 1,312 | 622 | 1,583 |
| III | Joint ventures - Predominantly Foreign (8) | 5 | 128 | 13 | 203 | 18 | 331 | 182 | 1,472 |
| | Total(I+II+III) | 24 | 3,823 | 49 | 852 | 73 | 4,675 | 3,644 | 4,086 |
| | Grand total (A+B+C+D) | 43 | 12,279 | 192 | 6,422 | 235 | 18,701 | 15,227 | 68,964 |

Note: 1. Net Assets of Unit Trust of India at Book Value. For others at Market Value. 2. Figures in brackets denote number of Mutual Funds

*TABLE 2* - SALES DURING 1997-98 : TYPE AND CATEGORY WISE ANALYSIS - ALL MUTUAL FUNDS.

**2.1 New Schemes Launched**

*Rs. in Crores*

| | Open Ended | | Closed End | | Assured Returns | | Total | |
|---|---|---|---|---|---|---|---|---|
| | No.of schemes | Sales | No.of Schemes | Sales | No.of schemes | Sales | No.of schemes | Sales |
| Income Schemes | 13 | 3,415 | 2 | 81 | 10 | 8,222 | 25 | 11,718 |
| Growth Schemes | 9 | 84 | 4 | 453 | 0 | 0 | 13 | 537 |
| Balanced Schemes | 1 | 0 | 0 | 0 | 0 | 0 | 1 | — |
| ELSS | 0 | 0 | 4 | 24 | 0 | 0 | 4 | 24 |
| Total | 23 | 3,499 | 10 | 558 | 10 | 8,222 | 43 | 12,279 |

**2.2 Existing Schemes**

| | Open Ended | | Closed End | | Assured Returns | | Total | |
|---|---|---|---|---|---|---|---|---|
| | No.of schemes | Sales | No.of Schemes | Sales | No.of schemes | Sales | No.of schemes | Sales |
| Income Schemes | 12 | 1,050 | 12 | 0 | 35 | 11 | 59 | 1,061 |
| Growth Schemes | 19 | 456 | 40 | 194 | 2 | 0 | 61 | 650 |
| Balanced Schemes | 9 | 4,711 | 9 | 0 | 0 | 0 | 18 | 4,711 |
| ELSS | 0 | 0 | 54 | 0 | 0 | 0 | 54 | 0 |
| Total | 40 | 6,217 | 115 | 194 | 37 | 11 | 192 | 6,422 |

**2.3 Total of all Schemes**

| | Open Ended | | Closed End | | Assured Returns | | Total | |
|---|---|---|---|---|---|---|---|---|
| | No.of schemes | Sales | No.of Schemes | Sales | No.of schemes | Sales | No.of schemes | Sales |
| Income Schemes | 25 | 4,465 | 14 | 81 | 45 | 8233 | 84 | 12,779 |
| Growth Schemes | 28 | 540 | 44 | 647 | 2 | 0 | 74 | 1,187 |
| Balanced Schemes | 10 | 4711 | 9 | 0 | 0 | 0 | 19 | 4,711 |
| ELSS | 0 | 0 | 58 | 24 | 0 | 0 | 58 | 24 |
| Total | 63 | 9,716 | 125 | 752 | 47 | 8233 | 235 | 18,701 |

*TABLE 3* - REDEMPTIONS/REPURCHASES DURING THE YEAR.

*Rs. in Crores*

| | Open-end | Closed end | Assured Returns | Total |
|---|---|---|---|---|
| Income Schemes | 3,615 | 5,232 | 493 | 9,340 |
| Growth Schemes | 1,006 | 1,022 | – | 2,028 |
| Balanced Schemes | 3,008 | 140 | – | 3,148 |
| ELSS | — | 711 | — | 711 |
| Total | 7,629 | 7,105 | 493 | 15,227 |



26 |

*TABLE 4 - SALES, REDEMPTIONS AND NET ASSETS.*

*Rs. in Crores*

| | Name of Mutual Fund | No. of Schemes Launched During the Qtr. | Sales of the New Schemes | Sales During the Qtr. from Existing Schemes | Total No. of Schemes as on 30.6.98 | Total Sales for the Qtr | Redemption - Repurchase During the Qtr. | Total Net Assets Under Mgmt. as on 30.6.98 |
|---|---|---|---|---|---|---|---|---|
| A | Unit trust of india | 7 | 1,255 | 906 | 78 | 2,161 | 977 | 58,749 |
| B | Bank sponsered (6) | 1 | 114 | 0 | 57 | 114 | 238 | 4,547 |
| C | Institutions (3) | 1 | 179 | 13 | 38 | 192 | 66 | 2,070 |
| D | Private sector | | | | | | | |
| I | Indian (6) | 1 | 2 | 925 | 23 | 927 | 1039 | 832 |
| II | Joint ventures - Predominantly Indian (7) | 2 | 110 | 413 | 26 | 523 | 361 | 1,758 |
| III | Joint ventures - Predominantly Foreign (8) | 5 | 75 | 83 | 32 | 158 | 68 | 1,843 |
| | Total(I+II+III) | 8 | 187 | 1421 | 81 | 1608 | 1,468 | 4,233 |
| | Grand total (A+B+C+D) | 17 | 1,735 | 2,340 | 252 | 4,075 | 2,749 | 69,569 |

*TABLE 5* - SALES DURING FIRST QUARTER - APRIL - JUNE 1998 : TYPE AND CATEGORY WISE ANALYSIS - ALL MUTUAL FUNDS.

**5.1 New Schemes Launched**

*Rs. in crores*

| | Open Ended | | Closed End | | Assured Returns | | Total | |
|---|---|---|---|---|---|---|---|---|
| | No.of schemes | Sales | No.of Schemes | Sales | No.of schemes | Sales | No.of schemes | Sales |
| Income Schemes | 6 | 77 | 3 | 350 | 1 | 763 | 10 | 1,190 |
| Growth Schemes | 3 | 0 | 3 | 435 | 0 | 0 | 6 | 435 |
| Balanced Schemes | 1 | 110 | 0 | 0 | 0 | 0 | 1 | 110 |
| ELSS | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | 10 | 187 | 5 | 785 | 1 | 763 | 17 | 1,735 |

**5.2 Existing Schemes**

| | Open Ended | | Closed End | | Assured Returns | | Total | |
|---|---|---|---|---|---|---|---|---|
| | No.of schemes | Sales | No.of Schemes | Sales | No.of schemes | Sales | No.of schemes | Sales |
| Income Schemes | 25 | 2,251 | 14 | 0 | 45 | 0 | 84 | 2,251 |
| Growth Schemes | 28 | 75 | 44 | 0 | 2 | 0 | 74 | 75 |
| Balanced Schemes | 10 | 14 | 9 | 0 | 0 | 0 | 19 | 14 |
| ELSS | 0 | 0 | 58 | 0 | 0 | 0 | 58 | 0 |
| Total | 63 | 2,340 | 125 | 0 | 47 | 0 | 235 | 2,340 |

**5.3 Total of all Schemes**

| | Open Ended | | Closed End | | Assured Returns | | Total | |
|---|---|---|---|---|---|---|---|---|
| | No.of schemes | Sales | No.of Schemes | Sales | No.of schemes | Sales | No.of schemes | Sales |
| Income Schemes | 31 | 2,328 | 17 | 350 | 46 | 763 | 94 | 3,441 |
| Growth Schemes | 31 | 75 | 47 | 435 | 2 | 0 | 80 | 510 |
| Balanced Schemes | 11 | 124 | 9 | 0 | 0 | 0 | 20 | 124 |
| ELSS | 0 | 0 | 58 | 0 | 0 | 0 | 58 | 0 |
| Total | 73 | 2,527 | 131 | 785 | 48 | 763 | 252 | 4,075 |

*TABLE 6* - REDEMPTIONS/REPURCHASES FOR QUARTER APRIL - JUNE 1998.

*Rs. in crores*

| | Open-end | Closed end | Assured Returns | Total |
|---|---|---|---|---|
| Income Schemes | 1,883 | 53 | 22 | 1,958 |
| Growth Schemes | 294 | 296 | 0 | 590 |
| Balanced Schemes | 22 | 9 | 0 | 31 |
| ELSS | 0 | 170 | 0 | 170 |
| Total | 2,199 | 528 | 22 | 2,749 |

Number of Schemes redeemed not available.

**Presentation by Mr. Hitoshi Tonomura**

Chairman of Investment Trust Association of Japan

At

ASIA-OCEANIA CONFERENCE

Good morning ladies and gentlemen.

My name is Hitoshi Tonomura and I am the Chairman of The Investment Trust Association, Japan.

First, I would like to highlight the general developments relating to investment trusts in Japan, which are covered in the Country Report already distributed to you.

The total net assets of investment trusts have failed to grow due to the decline of the Japanese stock market over recent years and the extraordinarily low interest rates in Japan. Looking at the past three years, after a sharp decline in 1997, there was a minor recovery in 1998 to 42.739 trillion yen at the year-end. In terms of fund categories, MMF (Money Management Funds) have risen gradually in weight to reach one-third of total assets.

Turning to investments placed in international funds, investments in overseas securities have increased in pursuit of higher returns, as Japanese equities have declined while government bond yields have remained depressed. The weight of foreign currency-denominated assets increased by 6.3 percentage points, from 5.9% at the end of 1996 to 12.2% at the end of 1998. A breakdown of assets as of the end of 1998 gives a figure of 3.8319 trillion yen for government and corporate bonds, 1.0634 trillion for equities and 333.3 billion yen for commercial paper and others. Please refer later to the hand out for the breakdown by country.

Now let me focus on the Financial Reforms that came into effect on December 1, 1998. In particular, I will explain the measures being taken by the Investment Trust Association to meet the challenges of what has been dubbed the "Japanese Big Bang."

I would like to begin by explaining some of the background to the Financial reforms in Japan:

They are intended to make the Japanese Financial system more flexible and fairer, the aim is to promote competition and to establish the necessary conditions for such developments. In other words, the major purpose of these reforms is to provide a more reliable framework, which offers easier access for existing and potential users of the Japanese financial system. The reforms are characterized by the three key concepts of "Global", "Free", and "Fair".

Investment trusts are a priority within this reform program. The intention is to increase the convenience, clarity, and reliability of these products so that everyone in Japan is encouraged to gain an understanding of the importance of savings and investments. This is doubly relevant now, given Japan's demographic environment of a falling birth rate and an aging population. It is also important to foster the recognition that investment trusts are core products within an efficient investment portfolio of personal financial assets.

I will now highlight some of the legal reforms.

First of all, it has recently become possible to increase the variety of investment trust products and to launch corporate-type investment trusts together with privately placed investment trusts.

Secondly, investment trusts can now be marketed through banks and insurance companies; whereas before, securities firms and investment trust management companies were the only authorized outlets. At the end of March this year, the outstanding value of investment trusts sold through the newly authorized financial institutions amounted to 590 billion yen, or 1.4% of the total, and this figure is expected to rise gradually.

Furthermore, the processing of investment trusts (or funds) by the authorities has been changed, from a licensing system to one of registration filing, while disclosure requirements have been enriched and strengthened. Also, funds are now required to have their financial statements audited by certified public accountants, which I expect will result in greater clarity and reliability.

I would now like to outline how the Investment Trust Association is tackling these issues

and how it expects to progress in the future.

The Association aims to promote investment trusts as an essential part of investors' asset management plans, by raising the confidence of individuals in these products. To attain that goal, first we need to implement the new systems smoothly. The Association plans to constantly monitor and carefully assess whether the new systems are truly working in the best interests of the investors and beneficiaries. It will also change any internal rules that need to be updated or improved.

Secondly, we must pave the way for making full use of the reformed system.
One of our Association's most important missions is to promote greater public awareness of investment trusts among individual investors and to properly distribute information about investment trusts. To achieve this, we have to consider the issue of school education. We would like to see our children, who will be investors of the future, gaining a thorough understanding of investment trusts as part of their school education. For the past three years, we have been asking related government offices to introduce the subject of securities investment into junior-high and high school education programs. In addition, we have launched new public relations initiatives, including an Internet homepage to promote basic understanding and statistics concerning investment trusts, and to disclose the funds' performance figures.

The Association is also promoting effective performance evaluation. To enhance the broad recognition of investment trusts amongst investors, we have since April 1997 provided privately managed performance evaluation firms with basic fund data. Using such data they are able to rank the performance of these funds, apply star ratings, and provide information through monthly publications or by electronic distribution. We are encouraging the healthy growth of these performance evaluation firms, so that they may win the confidence of investors and become firmly established.

Furthermore, there has been much discussion about the introduction of defined contribution type pension plans in Japan. If all goes smoothly, the reform bill is expected to go through next year. If the system is introduced in Japan, we have high expectations that investment trusts are sure to become the core investment vehicles.

Meanwhile, it is already decided that the taxation of open type investment trusts will be changed next year. This adjustment will ensure a fairer tax treatment, as investors will be taxed on the basis of actual gains or losses realized through the individual treatment of purchase prices and sales prices.

Finally, I would like to conclude my comments on an encouraging note. While these reforms to the investment trust system will undoubtedly create a more competitive environment, I believe strongly that the market for investment trust products in Japan will grow, to the ultimate benefit of all those involved.

Thank you very much for your attention.

# Country Report(Japan)

## A. Statistical Situation

Total net assets of stock investment trusts, bond investment trusts, and the Money Management Fund (MMF) are listed below.

(in billion)

| Year end | 1996 | 1997 | 1998 |
|---|---|---|---|
| Stock Investment Trusts | ¥12,780 (US$110) | ¥9,986 (US$86) | ¥11,496 (US$99) |
| Bond Investment Trusts | ¥21.669 (US$187) | ¥19,100 (US$165) | ¥16,964 (US$146) |
| MMF | ¥14,219 (US$122) | ¥11,563 (US$99) | ¥14,279 (US$123) |
| Total | ¥48,668 (US$420) | ¥40,649 (US$351) | ¥42,739 (US$369) |

(Note)Exchange Rate:1US$=¥115.70 (98/12)

## B. Trends Concerning International Investment by Investment Funds

Total investments by Japanese investment trusts in foreign currency-denominated assets increased from ¥2,888 billion (US$24.9 billion)at the end of 1996 to ¥5,228 (US$45.1billion) at the end of 1998, an increase of 81.0%. The ratio of foreign currency-denominated assets to total net assets of investment trusts also incereased from 5.9% at the end of 1996 to 12.2% at the end of 1998. Of ¥5,228 billion (US$45.1billion) foreign currency-denominated assets at the end

of 1998, foreign bonds amounted to ¥3,831 billion (US$¥33.1 billion, 73.3%) , foreign stocks ¥1,063 billion (US$9.1 billion, 20.3%) and other asstes such as CP and CD ¥333 billion (US$2.8 billion, 6.4%).

Foreign stocks of 39 different countries and foreign bonds of 23 different countries were held at the end of 1998 by Japanese investment trusts. The top five countries of foreign stocks held by Japanese investment trusts are U.S.A. ¥346 billion (US$2,990 million), U.K.¥132 billion(US$1,140 million), Hong Kong ¥76 billion (US$656 million), Germany ¥69 billion (US$596 million) and France ¥69 billion(US$596 million). On the other hand, top five countries of foreign bonds are U.S.A. ¥2,120 billion (US$18 billion), Germany ¥567 billion (US$4,900 million), U.K. ¥330 billion (US$2,852 million) Denmark ¥114 billion (US$985 million) and France ¥113 billion (US$976 million).

C - Legal Developments

The amended Securities Investment Trust Law and the amended Securities and Exchange Law became effective in December 1998, and following drastic reform of investment trusts were implemented.

1. Introducing the corporate type investment trusts (the securities investment companies) and privately placed investment trusts.

2. Permitting financial institutions such as banks and insurance companies to distribute investment trusts.

3. Permitting investment trust management companies to outsource the management of the investment trusts to the outside companies.

4. Changing the licensing system for investment trust management companies into the authorization system.

5. Chanaging the approval system for the trust deed of investment trusts into the filing system

6. Applying the disclosure requirements under the Securities and Exchange Law to investment trusts.

7. Requiring the financial statement of investment trusts to be audited by public accountants or accounting firms.

D. Future Outlook

1. Implementing the reform of investment trusts smoothly

2. Conditioning circumstances in tune with the reform of investment truts

(1) Promoting the publicity activities for enhancing public awareness on investment trusts and the education on investment trusts in schools

(2) Prevailing the use of performance measurement by investors

(3) Implementing the valuation of unlisted bonds by market prices

(4) Making the preparations related to the introduction of the defined contribution pension plan

(5) Changing the taxation system on investment trusts

## II. Distribution channels of investment funds in each country

### 1.Current situation

Formerly, only securities companies and investment trust management companies (direct marketing) had been permitted to distribute investment trusts in Japan. However, as a part of the financial system reform (the so-called Japanese big bang), the Securities and Exchange Law was amended in June 1998, and this amendment has made it possible for financial institutions such as banks and insurance companies to distribute investment trusts since December 1998.

Referring to the share of each distributing channel in terms of total net assets at the end of February 1999, securities companies occupied 95.0%, direct marketing by investment trust management companies 4.1% and financial institutions such as banks and insurance companies 0.9%. Banks are not accustomed to sell the risk products such as investment trusts yet. So, the sales of investment trusts by banks are unlikely to grow rapidly in the near future.

### 2.Use of internet in the distribution of funds.

In Japan, the growing number of investment trust management companies and securities companies provided already investors with the information on investments on the internet. However, the tradinig of investsment trusts on the internet has just begun in recent years. As many as two investment trust management companies and eighteen securities companies provide investors with the trading service of investment trust on the internet at present. In the future, the trading of investment trusts on the internet is expected to increase rapidly, if the safety of such a trading would be ensured.

Following procedure for trading investment trusts on the internet is an example of one investment trust management company.

A. Preparation

① Opening the account for tradings at the investment trust management company

② Registering the investor's personal information and the secret identity number through the internet

③ Sending the application for the internet trading to the investment trust management company

B. Procedure for purchasing of investment trusts

① Obtaining the porospectus from the investment trust management company by request

② Inputting the purchase amount of the funds on the internet

③ Inputting the payment method (As the payment method, the remittances from banks and post offices, the appropriations by redeeming MMF or Medium-Term Government Securities Fund and so on are acceptable)

④ Confirming the content of input

⑤ Remitting the purchase amount from banks and post office (If the MMF and Medium-Term Government Securities Fund are chosen as the payment method, they are automatically redeemed for appropriating to the purchase of funds.)

3. Problems of investor protection arising from the diversification of distribution channels

As mentioned already, banks have been permitted since December 1998 to distribute investment trusts. In this case, in order to prevent the misunderstanding of investors, banks are required to explain fully the following points:

① Investment trusts are not the bank deposits.

② Invsetment trusts are not covered by the bank deposit insuarance.

③ Principal investments are not guaranteed.

## III. Cross-border cooperation on controls of intermediaries

In a case of obtaining the authorizations of investment trust management companies in Japan, foreign companies are equally treated with domestic companies, and the requirements for their entry into the investment trust business have been substantially relaxed already. For example, the licensing system for investment trust managemnt companies was changed into the authorization system in December 1998. In addition, when foreign companies set up the subsidiary company in Japan in order to enter the investment trust management business, there is no restriction on their capital contribution to that subsidiary company. Further, foreign company can enter the Japanese investment trust mangement business not only in the form of subsidiary company but also in the form of branch. Consequently, among 64 investment trust management companies at the end of March 1999, foreign affiliated investment trust management companies numbered 31 (48%).

In order to make it easy for investment trust management companies to develop their business in overseas markets, foreign countries should be equally treated with domestic companies according to the principle of indiscrimination between domestic and foreign parties. In addition, each country should make efforts to relax the strict requirements for the authorization of investment trust management companies which impede the new entry into the investment trust business.

# IV. Permitted structures and types of investment funds in each country

1. What structures of investment funds are permitted?

Formerly, only the contractual type investment trusts had been permitted in Japan as the structure of investment trusts. However, as a result of the financial system reform, the Securities Investment Trust Law was amended in June 1998, and this amendment made it possible to establish the corporate type investmet trusts (securities investment companies) since December 1998. Both contractual type investment trusts and corporate type investment trusts may choose either the "open end type" or the "closed end type", respectively. Therefore, investment trusts in Japan can take any form of structure. However, the corporate type investment trusts have not been established at the end of March 1999 yet.

2. Are privately placed funds, fund of funds and funds denominated in foreign currency permitted to be established?

As a result of the financial system reform, privately placed investment trusts and domestic investment trusts denominated in foreign currency have been permitted in Japan since December 1998. The privately placed investment trusts are aimed at a small number of investors (between 2 and 49) or the institutional investors, and they can be tailored according to the concrete investment objectives of such investors. There were already three privately placed investment trusts at the end of February 1999 and their total net assets amounted to ¥21.3 billion.

On the contrary, the establishment of a fund of funds is currently not possible, because the self-regulatory rules of the Investment Trusts Association stipulate that the holding of any investment trust managed by other investment trust management companies may not exceed 5% of a fund's total net assets. The Association has been now making the rules necessary for introducing a fund of funds.

3.What roles can play investment fund associations in introducing new structures and types of investment funds?

In order to enable investment trust management companies to establish new structures and types of investment trusts in response to various needs of investors, the Association has actively appealed to the competent authorities for the introduction of new products and has achieved the excellent results so far. For example, the Association played an important role in the recent introduction of the corpotate type investment trusts and the privately placed investment trusts.

## V. Selling and marketing offshore funds

1. What are the rules and regulations in the respective countries on this?

In Japan, offshore funds had been permitted to offer their shares since December 1972, though the Business Guidelines of the Ministry of Finance had imposed followiong restrictions on the domestic sales of offshore funds.

(1) Offshore funds shares must be denominated in a foreign currency, and yen-denominated assets held by an offshore fund must be less than 50% of a fund's total net assets.

(2) More than 50% of the total net assets of an offshore fund must be invested in securities equivalent to securities as defined in the Japanese Securities and Exchange Law.

(3) The offering amount of an offshore fund in overseas markets at the time of its initial public offer must be more than one-sixth of its total offering amount.

However, as part of the financial system reform, these restrictions were abolished in December 1998.
As a result, following minimum rules and regulations are applied to the sales of offshore funds in Japan.

① Like domestic investment trusts, offshore funds are positioned in the Securities Investment Trust Law. So the domestic sales of offshore funds must be subject to these provisions of the Securities Investment Trust Law such as the filing with the regulatory authority and the suspension order of sales.

② Since the shares of offshore funds are defined as "securities" under the Securities and Exchange Law, their sales must fulfill the disclosure requirements set forth by the Securities and Exchange Law.

③The domestic sales of offshore funds and other foreign securities must be made in accordance with the "Regulations Concerning Transactions in Foreign Securities" set forth by the Japan Securities Dealers Associations. Offshore funds are permitted to offer their shares to individual investors, only if they fulfill the requirements for the selection of offshore funds stipulated in the "Regulations Concerning Transactions in Foreign Securities."

2.Statistics (number and assets at the end of 1998)

Offshore funds sold in Japan numbered 185 at the end of 1998, and their total net assets amounted to ¥2,783 billion or US$24 billion (1US$=¥115.70 at the end of 1998).

Those offshore funds were established in the following countries :128 funds in Luxemburg (¥1,880 billion or US$16 billion), 31 funds in Ireland (¥514 billion or US$4,442 million), 16 funds in the U.S.A.(¥343 billion or US$2,964 million), 4 funds in Germany (¥40 billion or US$345 million), 5 funds in France (¥3,986 million or US$ 34 million) and 1 fund in Canada(¥663 million or US$ 5 million).



277

# VI. Roles of investment funds association in the region

1.Role of the respective associations

The Investment Trusts Association functions as both the self-regulatory organization and the national association representing the investment trust industry.

①As the self-regulatory function, the board of directors and the standing committees of the Association make the self-regulatory rules as the agreements of its member companies. These self-regulatory rules regulate the member companies in doing their business. In addition, the Association engages in the settlement of complaints from investors concerning the business of member companies.

②As the national association function, the Association makes the studies and researches on investment trusts as well as the policy recommendations. Further, the Association promotes the knowledge on investment trusts to consumers and urges the Ministry of Education and other parties concerned to advance the education on securities and investment trusts in schools.

2.How each investment fund association is contributing or should contribute to the establishment, management and distribution of investment funds?

One important function of the Association is to create the environment in which member companies can exercise their innovative originality without any restriction in establishing, managing and distributing investment trusts. As a result of the recent financial system reform, corporate type investment trusts (securities investment companies) and privately placed investment trusts were introduced, and financial institutions such as banks and insurance companies were permitted to distribute investment trusts. The Association played the important role in introducing them or diversifying the distribution channel by working hard upon the regulatory authority.

The matters related to the establishment and the management of investment

trusts fall under the sole jurisdiction of our Association, while the matters related to their sales fall under the joint jurisdiction of our Association and the Japan Securities Dealers Association because the Securities and Exchanage Law defines the investment trusts as the securities.

## VII. Impact of the financial crisis on the fund management industry

Japanese stock market, in terms of the Nikkei 225 Stock Average, once rebound to the level of ¥17,264 in March 1998. However, it declined to the level of ¥12,879 in October 1998 due to the adverse effects of the overseas financial crisis such as the Russian crisis in August 1998 in addition to the concerns for the economic recession and financial system in Japan.

Therefore, the Japanese government determined the comprehensive economic measures of ¥16 trillion in April 1998 and the urgent economic measures of ¥27 trillion including the tax cut of ¥9 trillion in November 1998. Further, the government made the scheme of ¥60 trillion for stabilizing the financial sysytem in Japan. Of ¥60 trillion, ¥17 trillion should be used for protecting the bank depositors, ¥18 trillion for reconstructing the failed banks and the remaining ¥25 trillion for injecting the capital into the sound banks. These measures have gradually taken effect on the stock market, and the Nikkei 225 Stock Average recovered to the level of ¥16,378 in March this year thanks to the purchase of Japanese stocks by foreign investors this year.

## VIII. Reciprocity among fund regulatory commissions

In Japan, foreign funds had been permitted to offer their shares since December 1972, though the supervisory authority had imposed certain restrictions on the domestic sales of foreign funds. However, as a part of the financial system reform, these restrictions were abolished in December 1998.

Unlike in Japan where the domestic sales of foreign funds were already liberalized, I suppose that many countries in the Asian region have still prohibited or restricted the domestic sales of foreign funds. Therefore, before discussing the basic regulations or formal standards to permit the marketing of funds in different countries, we should discuss first of all whether the domestic sales of foreign funds are really necessary and useful for investors or not.

I believe that each country should reduce the restrictions on the domestic sales of foreign funds from following reasons, while considering to take the measures necessary for the investor protection.

① If these restrictions are reduced, investors are able to purchase foreign funds more freely. As a result, the investor's convenience would be enhanced. At the same time, this would give the opportunities to investors to purchase foreign funds of their choice.

② The reductions of these restrictions encourage the international competitions between the domestic and the foreign investment trust management companies, and such competitions would lead to improve the fund performance.

③ The investors in the countries such as Japan, in which the control on foreign exchange has been fully liberalized, can receive the profit distributions and the money paid at the redemption in foreign currencies from foreign funds, and can convert the foreign currencies into their own currencies timely by their own judgement on the movement of foreign exchange rate.

# IX. Development of the pension systems

## 1. Statistics

The pension system in Japan consists of public pensions and private pensions. Public pensions include the National Pension, the Employees Pension Insurance and the Mutual Aid Associations. On the other hand, private pensions include corporate pensions and individual pensions.

Total assets of public pensions amounted to ¥171.2 trillion (the National Pension ¥7.8 trillion, the Employees Pension Insurance ¥118.4 trillion, the Mutual Aid Associations ¥45.0 trillion) at the end of March 1997, while those of private pensions amounted to ¥115.0 trillion, (corporate pensions ¥63.5 trillion, individual pensions ¥51.5 trillion). The combined total assets amounted to ¥286.2 trillion.

## 2. Regulatory framework

All pension systems in Japan, regardless of public pensions or private pensions are known as the defined benefit plan. However, the aging population with less children and the low return of the pension asset management due to the maturing of the Japanese economy have made it very difficult for the defined benefit plan to secure financially the retirement life of retirees. So, in addition to the existing defined benefit plan, the introduction of the defined contribution plan has been intensively discussed in Japan. In January 1999, the Ministry of Health and Welfare, the Ministry of Finance, the Ministry of Labor and the Ministry of International Trade and Industry begun jointly to consider concretely how to introduce the defined contribution plan. They aim to reach the conclusion by June 1999 and introduce the bill to the ordinary session of Diet beginning in January 2000. If the defined contribution plan would be introduced, the efficient asset management and record keeping would be required. So, investment trusts which can manage the pension assets most efficiently are expected to become its main player.

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## *REPORT (HONG KONG)*

(1) **Report**

(a) Statistical Situation and Trends

Details on unit trusts and mutual funds authorized by the Securities and Futures Commission ("SFC"):

| Type of funds | Number of funds | Asset size (US$ bn) |
|---|---|---|
| Equity | 905 | 124.84 |
| Bond | 261 | 28.89 |
| Money market | 157 | 12.68 |
| Diversified | 84 | 14.27 |
| UPMF | 40 | 1.03 |
| Warrants | 8 | 0.30 |
| Other specialized* | 20 | 1.08 |
| **Total** | **1,475** | **183.09** |
| Umbrella structures | 133 | |
| **Total number, incl. umbrella structure** | **1,608** | |

* includes: futures and options funds; guaranteed funds and leveraged funds.

Note: Source: Securities and Futures Commission - The number of funds referred to data as at the end of March 1999, whereas asset size was as at the end of December 1998.

(b) Trends concerning international investment funds

- Most authorised unit trusts and mutual funds in Hong Kong are domiciled in offshore jurisdictions and are invested in foreign stocks, bonds or other foreign currency-denominated assets. Authorised funds that are invested solely in Hong Kong equity or solely in Hong Kong money market instruments account for about less than 2% of the industry total, both in terms of asset size and number of funds.

- In 1998, we saw more investors moving into international/balanced funds, bond funds and European funds; and in aggregate they took up 45% of the industry's gross sales. Investor interest in Asian sectors was lacklustre - the various Asian sectors only accounted for 22% of the industry's total sales.

This was just the reverse of 1997 when Asian sectors in aggregate took up over 55% of the industry's gross total, whereas international/balanced funds, bond funds and European funds accounted for about 25% of the industry's total.

(c) Legal developments

- SFC: Securities (Disclosure of Interests) Ordinance

In 1998, the SFC conducted a public consultation on its proposals to revise the disclosure regime of Hong Kong.

*Objectives of its proposal:*

- to bring Hong Kong's disclosure regime in line with international standards, to increase market transparency and to enhance Hong Kong's competitive position as an international financial centre.

*Some of the proposed key changes:*

- Disclosure threshold:
  * reduce the initial substantial shareholding disclosure threshold from 10% to 5%.

- Notification period:
  * shorten the disclosure notification period from 5 days to 3 business days.

- Investment managers and trust companies:
  * remove the exemption currently made available to Hong Kong registered investment managers and trust companies under the Securities (Disclosure of Interests) (Exclusions) Regulations. However, the SFC recognises that substantial shareholders such as professional investment managers, custodians and trustees, should be treated differently from shareholders who exercise control over interests in shares. Accordingly, the SFC proposes that where the organisational structure of a corporate group is such that the voting and investment powers over interests in shares held by such professionals are exercised independently, then aggregation of interests held by any

such persons with those held by its holding or related entities is not required. The SFC suggests that the Ordinance be amended to allow "disaggregation" of group interests in these situations.

- SFC: Client Identity Rule Policy

After much consultation, the SFC published a policy for administering the Client Identity Rule, which came into effect in November 1998.

*Objectives of the Rule:*

- the Rule aims to enhance the market surveillance capabilities of the exchanges, as frontline regulators of trading on their markets and the SFC.

*Key requirement of the Rule:*

- the Rule requires a registered person, before executing a transaction, to obtain and record details of the ultimate beneficiary of the transaction and the person who originates instructions in relation to that transaction.

*Highlights of the Policy:*

- information will not be requested about subscriptions to, redemptions from or switches between collective investment schemes;

- except in unusual market conditions, client identity information need only be made available within two business days of a request from the regulators;

- the SFC will not specify any particular ways for a registered person to comply with the Rule, as long as the registrant is satisfied on reasonable grounds before a transaction that the client identity information will be made available within two business days of a request.

(d) Other comments and outlook

It is expected that the fund management industry in Hong Kong will undergo rapid development in the next few years because:

- the Asian financial crisis has led more investors to become aware of the need for and importance in developing a diversified portfolio. Many have started to appreciate that unit trusts/mutual funds - which offer access to international markets - can have a role to play in their financial planning programs.

- more and more banks, especially the retail banks, are committed to distributing funds. This will greatly boost the popularity of fund investment because of the large distribution network of banks and the fact that the local population has a lot of trust and confidence in banks.

- on a longer term, the implementation of Mandatory Provident Fund Scheme ("MPF") will be positive to the industry because when MPF begins implementation next year, all Hong Kong employees will be investing in some form of pooled investment vehicles. This will increase their understanding of, and comfort level, with unitised funds and can only be positive for the growth of the unit trust industry in Hong Kong.

## (2) Distribution channels of authorised funds in Hong Kong

(a) Distribution channels:

In Hong Kong, authorised unit trusts and mutual funds are distributed through various distribution channels, namely:

- **Direct**: fund houses - their investment centres;

- **Intermediaries**: private and retail banks, independent investment advisers; and

- **Others**: accounting firms and insurance companies.

(b) Trends:

Banks, especially retail banks, have assumed an increasingly important roles in the last few years. This is probably because of the following reasons:

- traditionally, there is a high level of trust and confidence among the local population in banks;

- banks are increasingly looking to add more financial products to their product range so as to provide a more complete financial package to customer;

- more depositors are looking for value-added services other than pure deposit services; and

- banks are also increasingly looking to develop more sources of fee-based-income.

(c) Relative importance of the various channels:

Below is a breakdown showing the relative importance of the various channels in the distribution of funds:

| **Channels** | **% share (based on $ value of gross sales)** | | | |
|---|---|---|---|---|
| | | ***1998*** | | ***1997*** |
| ***Direct*** | | 19% | | 28% |
| ***Intermediaries:*** | | | | |
| Banks: (retail + private) | 48% | | 41% | |
| Investment Advisors (IAs) | 13% | | 19% | |
| Breakdown not available (Banks + IAs) | 7% | | 5% | |
| ***Subtotal*** | | 68% | | 65% |
| ***Others*** | | 13% | | 7% |
| ***Grand Total*** | | ***100%*** | | ***100%*** |

(d) Use of Internet in the distribution of funds:

- At present, there are no fund management companies in Hong Kong that accept subscriptions and redemptions on the Internet, though some are exploring the feasibility of doing so. For some fund houses, switching can be done on the Net. However, for the vast majority of fund houses which have their own sites, the key objective is to provide information.

- the SFC published a Guidance Note on Internet Regulation on March 31, 1999, to clarify its regulatory approach on various Internet activities under the existing legislation.

  As a general principle, the SFC does not seek to regulate Internet activities that originate outside Hong Kong, provided that such activities are not detrimental to the interests of the investing public in Hong Kong. In addition to compliance with the registration requirements and applicable SFC codes and guidelines, the SFC expects registered persons to put in place additional operational measures for conducting businesses over the Internet.

  The issue of advertisements or documents on securities, investment arrangements and advisory services is subject to SFC regulation irrespective of the medium used. The SFC, however, will not seek to apply the regulatory requirements to activities that are not targeted at people residing in Hong Kong.

## (3) Permitted structures and types of investment funds in HK

- Structures of investment funds permitted:

In Hong Kong, what is being offered to the general public include open-ended unit trusts and mutual funds. Among the open-ended authorized funds, probably about half are mutual funds, while the rest are unit trusts.

These funds can be in umbrella structure, fund of fund structure as well as other structures that are permitted under the SFC Code on Unit Trusts and Mutual Funds. There are no restrictions on the denomination of funds, and in fact the vast majority of funds are denominated in US$, yen, pound or Euro.

Closed-end funds are also available for sale in Hong Kong. However, they are primarily catered for institutional investors only and are mainly listed. Privately-placed investment funds are also allowed in Hong Kong.

It is not within HKIFA's brief to introduce any new structures or types of investment funds. However, HKIFA monitors closely the market trend and if there are certain new developments within

the industry which require guidance or clearance from the regulators, the HKIFA will take a lead role to help relay the industry's views.

(4) **Selling and marketing offshore funds**

According to the SFC Code on Unit Trusts and Mutual Funds:

- offshore funds can be marketed in Hong Kong as long as they receive SFC's authorisation;

- for schemes that are domiciled in recognised jurisdictions, they can be approved on "fast track". Jurisdictions are recognized on the SFC's understanding that the types of scheme referred to are governed by laws and regulations which are comparable to the Code or offer equivalent investor protection;

- applications for recognized jurisdiction schemes will generally be reviewed on the basis that the scheme's structural and operational requirements and core investment restrictions (except where noted) already comply in substance with the Code; and

- the SFC expects recognised jurisdiction schemes to comply in all material respects with this Code and reserves the right to require such compliance as a condition of authorization.

- Domicile Mix:

  At the end of March 1999, Hong Kong-domiciled funds accounted for 1.2% of the total assets of authorised funds.

  The rest are overseas-domiciled funds, with Luxembourg assuming a leading role, taking up 44% of the total assets. It was followed by Ireland and UK, which accounted for 11% of the total assets respectively.

  It is expected that over a longer term, with the implementation of MPF, there would be more Hong Kong-domiciled funds being set up. The reason is because under MPF, all approved investment funds should be set up under Hong Kong law.

## (5) Roles of HKIFA

The HKIFA is not a self-regulatory organisation. It is a trade body that represents the investment management industry in Hong Kong and it has two major roles:

- Consultation:
  - * the HKIFA acts as the representative and consulting body for its members in the investment fund industry in all dealings concerning the Government and the regulation of unit trusts, mutual funds, retirement funds and other funds of a similar nature.
  - * the HKIFA has been working closely with the SFC to provide members' inputs on draft codes and guidelines that have an impact on the fund management industry.
  - * also, the HKIFA has been working closely with the Mandatory Provident Fund Schemes Authority to relay the industry's views on Mandatory Provident Fund Scheme Ordinance, and the related Guidelines and Codes.
- Promotion/education:
  - * to promote Hong Kong managed investment products and to educate the public about the benefits and value of using units trusts and mutual funds through organising educational events targeted at the general public; and
  - * to organize training courses for industry participants (both in Hong Kong and the Mainland), which aim to provide industry participants with a comprehensive overview of the industry so as to boost the professionalism of the industry and the quality of services provided.

Through these two briefs, the HKIFA helps to foster the establishment, management, and distribution of funds in Hong Kong.

## (6) Impact of the financial crisis on the fund management industry

- investors have increasingly become aware of the importance of developing a diversified portfolio.

- investors have increasingly turned to bond funds and shunned Asian funds in the last 12-18 months:

  Gross sales of bond funds rose significantly, from US$498.35 million (7.8% of the total) in 1997 to US$686.62 million (18.8%) in 1998. Net sales of this sector rose from US$270.58 million (Industry's total net inflows was US$1,522.06 million in 1997) to US$343.86 million (Industry's total net inflows was US$134.24 million in 1998).

  Gross sales of the six Asian fund sectors shrunk, from US$3,550.44 million (55.5% of the total) in 1997 to US$808.14 million (22.1%) in 1998. Net sales of US$816.48 million in 1997 turned to net redemptions of US$431.2 million in 1998.

## (7) Reciprocity among fund regulatory commissions

Please refer to Appendix 1a & 1b.

## (8) Development of the pension systems

- Pension fund industry in Hong Kong

  The Occupational Retirement Schemes Ordinance ("ORSO"), which has been in operation since 1993, established the legal framework for the regulation of private occupational retirement schemes in Hong Kong.

  The ORSO has wide coverage. Apart from schemes contained in or established by any other Ordinances and schemes set up by the government of any country or one of its non-profit-making agencies, the ORSO applies to all private occupational retirement schemes covering persons gainfully employed under contracts of service with any employer, irrespective of whether such schemes are operated in or from Hong Kong. This includes not only schemes whose governing law is Hong Kong but also offshore schemes.

The following statistics are compiled on the basis of the 18,259 retirement schemes registered or exempted under the ORSO as at December 31, 1997, having excluded 1,923 schemes which were terminated or wound up voluntarily since the commencement of ORSO.

**Benefit Types:**

| No.of schemes | Defined Contribution Schemes | Defined Benefit Schemes | Total |
|---|---|---|---|
| Registered | 15,780 | 544 | 16,324 |
| Exempted | 1,041 | 894 | 1,935 |
| **Total** | **16,821** | **1,438** | **18,259** |

The number of registered schemes reached 16,933 as at the end of June 1998, of which 16,400 are defined contribution schemes and 533 are defined benefit schemes. Total asset size amounted to about US$18-20 billion.

- Mandatory Provident Fund System

The Mandatory Provident Fund ("MPF") System is an employment-related contributory system whereby contributions are made by persons in the workforce during their working lives (5% from employees and 5% from employers). Contributions will start in December 2000.

Upon retirement, scheme members will be able to receive benefits that commensurate with the contributions they have previously made and the investment returns arising from such contributions.

The MPF System is a privately-managed system in that scheme assets will be managed solely by the private sector, and trustees will be responsible for safeguarding scheme members' interests.

The Mandatory Provident Fund Schemes Authority is the regulatory authority which will monitor the management and operation of MPF schemes so as to ensure compliance with the MPF requirements. SFC will also assume a regulatory role under MPF - it will authorise pooled investment funds, focusing on the disclosure of information as well as approve the investment managers. (End)
(Prepared: April 1999)

ASIA PACIFIC

17. China Securities Regulatory Commission, PRC
    - MORC (19 June 1993), Shanghai Securities Exchange and Shenzhen Stock Exchange are also signatories (see 12 & 13 below)
    - MORC concerning futures (4 July 1995), parties being International Division of SFC and Department of Futures of CSRC

18. Shanghai Securities Exchange, PRC
    - MORC (19 June 1993), CSRC and Shenzhen Stock Exchange are also signatories (see 11 above and 13 below)

19. Shenzhen Stock Exchange, PRC
    - MORC (19 June 1993), CSRC and Shanghai Securities Exchange are also signatories (see 11 and 12 above)

20. Australian Securities and Investments Commission, Australia (previously known as Australian Securities Commission)
    - MOU (29 September 1993)

21. Securities and Exchange Commission, Thailand
    - MOU (2 November 1993)

22. Securities Commission, Malaysia
    - MOU (22 February 1994)

23. Capital Market Supervisory Agency, Indonesia
    - MOU (31 October 1994)

24. Securities and Futures Commission, Taipei
    - MOU (7 February 1996)

25. Securities Commission, New Zealand
    - MOU (17 September 1996)

26. The State Administration of Foreign Exchange, PRC
    - MORC (11 December 1996), parties being Intermediaries Division of SFC and The Administration and Supervision Department of SAFE

27. Monetary Authority of Singapore
    - MOU (16 January 1997)

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favorable uses of the Internet, particularly in regard to secondary market securities and derivatives transactions. Regulatory implications and other problems emerging from its use are also part of Working Party 2's mandate and are being closely examined.

5.11 A second major initiative involves the Year 2000 computer problem, which presents a serious challenge to the world's financial markets. The Technical Committee of IOSCO has issued a statement that all IOSCO members and market participants should take all necessary and appropriate action to address the problem. Working Party 2 conducted a survey of its members to ascertain what actions are being taken within member jurisdictions. Follow-up surveys will be carried out approximately every six months until 2000 to monitor the progress of remedial action and testing.

5.12 Third, Working Party 2 completed a survey of the methods and scope of Working Party 2 members' supervision of regulated markets and clearing houses. The survey was directed expressly at identifying the practical measures IOSCO members use to ensure the integrity and appropriate infrastructure of secondary markets. The results of the survey also identified some common areas of difficulty which would benefit from further discussion and collaboration by members. It is believed that the results of the survey can be used to develop some practical guidance for benchmarking regulators' supervision techniques.

5.13 Amongst its other initiatives, a joint working group has been formed with the G-10 Central Bank Committee on Payment and Settlement Systems (CPSS) to study the worldwide development of securities lending and its implications for securities regulators and central banks, in particular its implications for securities clearance and settlement systems. Towards that end, a survey of securities lending activity will be conducted of firms active in each major segment of the global securities market.

## Supervision of Market Intermediaries

### Disclosure about Trading and Derivatives Activities of Banks and Securities Firms 1996

5.14 The 1996 annual survey of Disclosure about Trading and Derivatives Activities of Banks and Securities Firms by the Basle Committee Information sub-group and Working Party 3 of the IOSCO Technical Committee has been completed and was published on 3 November 1997.

5.15 The results of this survey show enhanced disclosure of value-at-risk data and assumptions underlying value-at-risk models. In addition, institutions expanded their discussion of operating and legal risks and provided more information about the valuation techniques for trading and derivatives activities and the accounting treatment for derivatives credit losses.

### Client Asset Protection Self-Evaluation Questionnaire

5.16 In conjunction with the published report on Client Asset Protection, a self-evaluation questionnaire has been compiled to assess where all IOSCO members stand in the use of the standards and practices described in the report. The questionnaire was distributed to all IOSCO members in December 1997 and is intended to encourage and assist authorities to assess the extent to which the regimes they administer for the protection of client assets held by investment firms conform to the recommendations in the report.

### Joint Forum Papers in consultation

5.17 The following Joint Forum papers were issued for consultation to the industry and the supervisory community in each sector: Capital Adequacy Principles; Fit and Proper Principles; Framework for Supervisory Information Sharing; and Principles for Supervisory Information Sharing.

5.18 As the Working Party responsible for intermediaries, Working Party 3 reviewed the report and offered comments and suggestions to the IOSCO Technical Committee for feedback to the Joint Forum.

### Revising the joint 1995 Basle Committee/IOSCO Supervisory Information Framework for Derivatives

5.19 As part of the continuing effort by the Basle Committee and by IOSCO to monitor the trading and derivatives activities of banks and securities firms, Working Party 3 together with the IOSCO Information sub-group have been actively revising the draft in order to enhance the supervisory information framework. Work is continuing in this area.

### Risk Management and Control Guidance for Securities Firms and their Supervisors

5.20 The Technical Committee has approved for publication a Working Party 3 report on "Risk Management and Control Guidance for Securities Firms and their Supervisors" in March 1998.

5.21 The purpose of the report is to provide guidance to and encourage discussion among supervisors concerning risk management policies and internal control systems for regulated and unregulated securities intermediaries and end-users in order to develop a strong domestic and international risk management structure.



294

## Enforcement and Exchange of Information

5.22 Pursuant to the 1994 IOSCO resolution on "Commitment to Basic IOSCO Principles of High Regulatory Standards and Mutual Cooperation and Assistance", Working Party 4 commenced a self-evaluation exercise covering IOSCO members' capabilities in respect of international cooperation. During the year, the SFC was actively involved in this self-evaluation exercise and in the assessment of responses submitted by members from the Asia Pacific region.

5.23 The self-evaluation exercise resulted in a November 1997 "Resolution on Principles in the Area of Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation with a View to Improving the Enforcement of Securities and Futures Laws by the Technical Committee" and the publication of a report on the self-evaluation exercise itself. This report, based on responses received from 79 out of 87 member jurisdictions, provides a useful reference document for IOSCO members on matters relating to international cooperation and exchange of information.

5.24 During the year the Internet Task Force of Working Party 4 completed work on its mandate on "Issues raised by the increasing use of public electronic networks in the securities and futures field". Its report on enforcement issues in this area has been adopted by the Technical Committee.

5.25 There is also a growing relationship between Working Party 4 and the Emerging Markets Committee Working Group 4. In May 1997, the results from a survey on price manipulation of shares prices on securities markets conducted by Working Group 4 was discussed in a joint meeting of both groups. It was recognized that the sanctions available to combat price manipulation vary from jurisdiction to jurisdiction and that there is a need for international cooperation to counter such activities. At the same meeting, the SFC recommended devising a regional enforcement training program. This recommendation has since been developed into a wider securities regulators training program with the World Bank, Asian Development Bank and the APEC Securities Regulators Training Consultative Group also participating. It is hoped that the first program will be conducted in the forthcoming year.

## Investment Management

### First Globally Co-ordinated Inspection

5.26 The international co-operation arrangements on supervision of cross-border investment management activity have facilitated and resulted in the first global co-ordinated inspection, jointly organised with the Investment Management Regulatory Organisation (IMRO) in the UK and the US Securities and Exchange Commission (US SEC). Intended as a pilot scheme, the review focused on global supervisory functions and cross-border activities of an international fund management group with world-wide operations, areas which might not have been examined during routine local inspections carried out in the respective jurisdictions.

5.27 Given the increasingly globalised nature of investment management businesses, the success of the co-ordinated inspection demonstrates the importance of co-operation amongst international regulators in enhancing the supervision of cross-border investment management activities. It is envisaged that such co-ordinated efforts will persist in the coming year and cross-border supervision will continue to evolve to ensure effective monitoring of global investment management activities.

## IOSCO Working Party No 5 on Investment Management

5.28 Hong Kong continues to be an active member of Working Party 5 on Investment Management. In 1996, Working Party 5 took on a new mandate to review issues relating to the supervision of fund managers. A discussion paper on "Principles for the Supervision of Operators of Collective Investment Schemes" was finalised during the year. The paper aims to assist IOSCO members in reaching a common approach in effective supervision of operators of collective investment schemes. It is also anticipated that the Principles will better enhance co-operation among IOSCO members in supervision of the increasingly global investment management industry.

5.29 Working Party 5 also undertook to review issues in relation to the supervision of offers of collective investments on the Internet. With rapid advancements in technology, this is a typical area for which international co-operation amongst different regulators and the setting of common standards is much desired. Various Internet issues are being discussed with a view to preparing a report to the IOSCO Internet Task Force (ITF) which incorporates Working Party 5's views on these issues. The objective of the ITF is to facilitate industry developments



295

Extract from SFC Annual Report 97/98

by only developing principles at a very broad general level, thereby leaving the industry a greater degree of flexibility to use new technologies within broader parameters set by regulators.

The IOSCO Asia Pacific Region Committee

5.30 In addition to the SFC's participation in the work of the IOSCO Technical Committee, it is also an active member of the IOSCO Asia Pacific Region Committee (APRC). The APRC has to date 17 members from the region. APRC members and their enforcement heads meet regularly to discuss policy and operational issues.

5.31 At the APRC meeting held in Mumbai, India between 11-13 February 1998, members and their enforcement heads discussed a wide range of topics arising from the turbulent market conditions seen in the Asia Pacific since mid 1997. In view of the greater need for cooperation amongst regulators, a resolution was passed at that meeting calling upon members to use their best endeavours to provide mutual assistance to each other in order to achieve more effective regulation of market intermediaries.

Ongoing Regulatory Cooperation

5.32 During the year, the SFC received and processed 42 enforcement-related requests for information of which 17 were for non-public information. The SFC also received 199 licensing-related requests for non-public information from overseas regulatory bodies. The SFC itself made 996 requests to overseas regulatory bodies for non-public licensing-related information and 8 requests for enforcement-related information.

5.33 In addition, the SFC received 11 requests from overseas regulatory authorities for investigatory assistance and itself made 15 requests to overseas regulatory authorities for investigatory assistance. The SFC exercised its powers under section 59A of the Securities and Futures Commission Ordinance and section 63A of the Leveraged Foreign Exchange Trading Ordinance in response to a request from Australian Securities Commission (ASC) and one from US Commodity Futures Trading Commission (US CFTC) respectively. The assistance provided in these cases included obtaining affidavits, witness' statements, non-public records and documents to assist overseas regulators, in accordance with the MOUs with these commissions. The SFC also provided assistance to the US CFTC in serving notices of hearing before an administrative judge to two Chinese males in Hong Kong.

5.34 Between 1996 and 1997, the SFC provided investigatory assistance to the US SEC in an insider dealing case whereby the alleged tipper and tippee resided in Hong Kong. With the assistance of the SFC, the US SEC was able to authorise an emergency lawsuit charging the tippee with illegal insider trading, resulting in the cancellation of the trades. Subsequently, the US SEC filed an insider dealing lawsuit in Federal District Court against the tippee on 26 June 1997. The tippee later consented, without admitting or denying the allegations, to be enjoined from violating the antifraud provisions of the Federal securities laws and to pay US$2 million in civil penalties.

5.35 Since 1996, the SFC has also been providing investigatory assistance to assist the US SEC in a market manipulation case which involved the transfer of trading profits to nominee bank accounts in Hong Kong. The US SEC's investigation resulted in the commencement of legal proceedings against two businessmen in February 1998, seeking to compel them to pay back their trading profits and to have them banned from holding company directorships in the US in the future.

5.36 Another case arising out of international regulatory cooperation is the case of Nomura (as mentioned in paragraphs 3.58 to 3.60, the conduct subject of the SFC disciplinary proceedings and ASC litigation took place in 1996). This case raises serious issues regarding the difficulties and problems regulators encounter in regulating entities that operate in multiple jurisdictions, and the need for coordination for effective enforcement of securities and futures laws.

5.37 During the year, the SFC obtained assistance from the China Securities Regulatory Commission, Australian Stock Exchange, US SEC, Commission des Operations de Bourse of France and Swiss Federal Banking Commission in obtaining non-public records and documents for its investigations.



296

# COUNTRY REPORT

REPUBLIC OF KOREA
KOREA INVESTMENT TRUST COMPANIES ASSOCIATION(KITCA)
THE 4TH ASIA · OCEANIA REGIONAL MEETING

## A. Current Developments & Statistics

- The assets held in investment trusts at the end of 1998 totalled 196 trillion won, an increase of 118.2% over the end of 1997.

  - Assets in equity funds decreased by 23.8%, while assets in money market funds (MMFs) and bond funds soared by 278.2% and 74.5% respectively in the same period.

- In US dollar terms, the total assets managed by investment trust companies recorded USD 162.6 billion as of the end of 1998, up by 155.7% from USD 63.6 billion as of the end of the previous year.

- The huge increase in assets in investment trusts is due to their characteristic of providing high, short-term returns compared with other financial products.

  - Specifically, the investment trust companies provided higher yielding products than other financial institutions through the establishment of bond funds, which invested in the bonds with high credit ratings and high yields that were issued during the first half of 1998.

- After the financial crisis which began in December 1997, two regional investment trust companies and five investment trust management companies were shut down in the midst of the industry restructuring process.

  - As a result of these closures, there are currently four investment trust companies and 20 investment trust management companies in business.

- As of the end of 1998, 47.3% of total assets under management in the investment trust companies is composed of MMFs.

- This is a reflection of investors' uncertainty about the future direction of interest rates.

Assets under Management (in US$ billion)

| End of Year | Equity-type | | Bond-type | | MMF | | Total | |
|---|---|---|---|---|---|---|---|---|
| | Net Assets | %change | Net Assets | %change | Net Assets | %change | Net Assets | %change |
| 1995 | 15.9 | △7.0 | 57.8 | 20.4 | 6.5 | 12.1 | 80.2 | 13.1 |
| 1996 | 14.9 | △6.2 | 57.4 | △0.7 | 11.3 | 73.8 | 83.7 | 4.3 |
| 1997 | 7.7 | △48.4 | 38.5 | △32.9 | 17.4 | 53.2 | 63.6 | △24.0 |
| 1998 | 6.9 | △10.7 | 78.8 | 104.4 | 77.0 | 343.1 | 162.6 | 155.7 |

* % change denotes increase/decrease over the previous year.

** In 1997, the decrease of the total assets in US dollar terms, was due to the rapid depreciation of the Korean won(67.6%).

Assets under Management (in Won billion)

| End of Year | Equity-type | | Bond-type | | MMF | | Total | |
|---|---|---|---|---|---|---|---|---|
| | Net Assets | %change | Net Assets | %change | Net Assets | %change | Net Assets | %change |
| 1995 | 12,334 | △8.7 | 44,759 | 18.3 | 5,056 | 10.1 | 62,149 | 11.1 |
| 1996 | 12,611 | 2.2 | 48,450 | 8.2 | 9,573 | 89.3 | 70,634 | 13.7 |
| 1997 | 10,917 | △13.4 | 54,519 | 12.5 | 24,584 | 156.8 | 90,020 | 27.4 |
| 1998 | 8,316 | △23.8 | 95,126 | 74.5 | 92,976 | 278.2 | 196,418 | 118.2 |

## B. International Investment Funds

- International investment funds are divided into two types of investment vehicle. First, there are funds that are set up in Korea for domestic investors that invest their assets mainly in overseas securities, which are called Overseas Investment Funds. Second there are Foreign-domiciled Funds (these are funds registered outside Korea) that are sold in the domestic market.

### (1) Overseas Investment Funds

- No funds were newly established in 1998 and the existing funds experienced a steady stream of redemptions. As of the end of 1998, net assets stood at USD 848 million, a decrease of USD 222 million during the year.

(2) Foreign-domiciled Funds

- As of the end of 1997, seven funds from six foreign fund management companies had recorded sales of USD 22 million, but as of the end of 1998, sales had decreased to USD 18 million for six funds from five fund management companies.

- However, as the foreign exchange situation and domestic economic conditions have improved, there are signs that local investors are regaining an appetite for overseas financial products.

C. Legal Developments

a. Changes in Legislation of Fund Management Business

- First Revision of the Securities Investment Trust Business Act (September 1998)

  - The distributing agents for investment trusts were expanded from securities houses to banks.

  - Fund management companies were permitted to exercise the voting rights of equity stock held in trusted assets.

  - Criteria for registering fund managers were introduced and a fund management company must have at least seven such qualified fund managers on its staff.

  - Funds established after 16 November 1998 that include bonds in the portfolio should apply the mark to market valuation practice in the calculation of net asset value (in contrast to the amortised cost method).

  - The privately placed fund was introduced. For these funds, the restrictions that over 10% of total assets cannot be invested in a single company and a fund cannot invest in more than 20% of the total outstanding shares of any invested company may be waived.

- Second Revision of the Securities Investment Trust Business Act (Modified at the end of 1998 and effective from 1 February 1999)

  - Investment trusts may invest in futures (both domestic and foreign products).

  - KITCA must disclose the performance and unit prices of funds.

  - The minimum capital required for the establishment of an investment trust company was lowered to 10 billion won from 30 billion won (to be effective soon).

- Enactment and Promulgation of the Securities Investment Company Act (September 1998)

  - In addition to the previous unit trust type funds, corporate type funds may be established. Currently, only closed-end funds are allowed and open-end funds will be allowed within five years as set by the Presidential Decree.

  - As of the end of 1998, five corporate type equity funds had been set up with the total amount of their assets recording USD 241 million.

  - As the Korean stock market has rebounded from the end of 1998, investors are taking a growing interest in these new funds as the transparent management of the corporate type funds has been highlighted compared with unit trusts.

b. Foreigners' Participation in Domestic Fund Industry

- On 1 December 1996 foreign direct investment of up to 30% in local fund management companies was permitted, and on 1 December 1997 the direct investment ceiling for foreign investors was removed.

  From 1 December 1998, when permission was given for foreign fund management companies to set up independent subsidiaries, the fund management business was completely opened to foreign companies.



300

c. Changes in Taxation

- For investment funds that have over 50% of bonds in their portfolios, the tax rate (including income tax and resident tax, which is 10% of income tax) was increased from 22% to 24.2%

  - This was to alleviate the government's concern over falling tax revenues resulting from the sluggish economy, and also to place a greater tax burden on those investors who were realizing hefty gains on their financial assets during the period for the purpose of fair taxation.

D. New Products : None

E. Cross-border Sales of Investment Funds

- There are three kinds of international investment funds.

  First, offshore mutual funds that satisfy the relevant laws and regulations were allowed to be sold domestically from 1 January 1997.
  (See Foreign-domiciled Fund above)

  Second, there are the investment funds for sale exclusively to foreign investors that were set up by the domestic investment trust companies.

  - As the financial market is now almost completely open to foreign investors, the future of these funds is uncertain.

  - As of the end of 1998, total assets of these funds stood at USD 1,607 million, down by 22.7% from USD 2,080 million at the end of 1997.

  Third, there are domestic investment funds, which were opened to foreign investors from January 1997 although actual sales only began in 1998.

  - As of the end of 1998, the amount of these funds sold to foreign investors was only USD 7.74 million, and compared with the funds exclusively for foreign investors the size is minimal.

## F. Future Prospects

- As the entry barriers into the fund management business have now been almost removed, foreign investors can now receive virtually national treatment. As a result, numerous new players are expected to appear in the market, which will lead to greater competition.

- Asset inflows into the fund management industry are expected to be sustained because of the low interest rate along with the increased financial assets of individuals.

- Assets in bond funds, which currently occupy 95% of the total assets in the investment trust industry, will be gradually switched into equity funds owing to the economic rebound, prevailing low interest rates and recent bullish bourse.

- When the mark to market valuation system is introduced for all funds in July 2000, the domestic fund management industry will be one step closer to global standards and transparency in the management of funds will also be improved.

- Foreign investment into Korea along with overseas investment by domestic investors will increase, and there will be brisk movement of assets into and out of Korea as the domestic fund management industry is completely open to foreign investors and the current economic recovery is sustainable.



302

# Mutual Funds Offer Value In Jumping Korean Market

The Seoul

5/28-29 P.13

By HAE WON CHOI
*Staff Reporter*

In South Korea's hot stock market, it's getting harder to find cheap shares. But investors now have a vehicle for buying Korean stocks at a discount: the country's infant mutual-fund industry.

The government lifted a prohibition on mutual funds in December. Since then, low interest rates coupled with a robust stock market have prompted a flood of investors to shovel their money into the new funds. Mutual funds now hold two trillion won ($1.68 billion) in assets, according to the Financial Supervisory Service, the country's financial watchdog.

By law, South Korea's mutual funds are all closed-end funds — they have a fixed number of shares that trade on either the Korea Stock Exchange or the over-the-counter Kosdaq market. The funds buy only stocks and bonds issued in South Korea, and there are no restrictions on foreigners investing in the funds. In addition, the law calls for the funds to expire just one year after they are listed, though they can be extended for another year. When they expire, as with all closed-end funds, they will be liquidated, and investors will receive the net value of the shares.

### Discount to Asset Values

As is often the case with closed-end funds, some of the biggest of these new South Korean funds are trading at a discount to their net asset value. That means investors can buy a block of South Korean stocks at a bargain price.

"We are just starting to understand the industry, but we believe many foreign investors will be very interested in investing in the funds," says Nick Paris, head of the country-funds team at Credit Lyonnais Securities Asia in London.

The funds certainly carry several risks. For one, they are only a few months old and so don't have much of a track record. In addition, the market for the funds' shares isn't very liquid, which partly explains the discount. If the discount persists, investors selling their shares before the funds are liquidated wouldn't receive the shares' net asset value. "Illiquidity of the shares right now is a drawback to investors," says Paik Woon, a financial analyst at Samsung Securities in Seoul.

A more serious risk is that the stock market could falter. Low interest rates compelled investors to put money into stocks, but as the economy improves, interest rates might rise. Companies that dramatically cut production and investment in the past 18 months are expected to resume borrowing from banks. If that boosts interest rates, investors might pull their money out of stocks.

### Blue-Chip Focus

But for investors optimistic that Korean stocks will keep rising, there are several interesting funds. The Platinum 1 Fund, which listed on the exchange in March, has amassed a portfolio comprising 88% stocks and 12% bonds. Its net asset value has jumped more than 50% since it started trading, a good 20 percentage points more than the rise in Korea Composite Stock Price Index over the same period. The fund's manager, Seoul Investment Trust Management, says it achieved that high return by putting more than 50% of its investment into blue-chip stocks, which have led the stock market's rally. The fund's largest holdings are Samsung Securities, Housing and Commercial Bank and cellular-phone service provider SK Telecom.

Despite its huge gains, the Platinum 1 Fund still is a bargain. Since they were listed, the fund's shares have risen more than 17% to 6,490 won, as of Wednesday. But that still means they are trading at a 14% discount to the net asset value of 7,556.92 won a share, also as of Wednesday.

Closed-end funds managed by Mirae Asset Investment Management are also attracting attention. In an unorthodox marketing move, the company names some of its funds after its president and chief executive officer, Park Hyeon Joo.

The Mirae Asset Park Hyeon Joo 3 Fund was the first closed-end fund listed. As of Wednesday, its net asset value had soared more than 42% since its listing in December, beating the Kospi by more than 14 percentage points. But during the same period, the funds' share price fell almost 15%, closing Wednesday at 6,050 won. The Mirae Asset Park Hyeon Joo 3 Fund holds 90% of its assets in stocks and 10% in bonds.

Mr. Park says he favors sticking to blue-chip stocks because most of the shareholders are conservative investors. The fund's major holdings are SK Telecom, Samsung Electronics and Kookmin Bank. As of Wednesday, the fund's shares traded at a discount of nearly 15% to their net asset value of 7,107.76 won.

For even more conservative investors, Mr. Park runs a fund that holds mostly fixed-income investments. The Mirae Asset Albatross 1 Fund consists of 80% bonds and 20% stocks. As of Wednesday, its net asset value had risen more than 13% since it was listed. "It beats putting the money into savings accounts," says Mr. Park. The fund's shares trade at an 8.2% discount to their net asset value of 5,668.43 won.

One advantage of these new closed-end

*Please Turn to Page 19, Column 3*

**Considering Funds?**

**South Korea's mutual funds have assets of $1.68 billion under management and are outperforming the Kospi despite their short history**

***Mutual funds listed in South Korea:***

Korea Stock Exchange

Over-the-counter KOSDAQ 16

| | Net asset value per share* (won) | Increase since listing |
|---|---|---|
| Platinum 1 Fund | 7,556.92 | 51.4% |
| Mirae Asset Park Hyeon Joo 3 Fund | 7,107.76 | 42.15% |
| Mirae Asset Albatross 1 Fund | 5,668.43 | 13.37% |

*Based on May 26 closing prices

*Source: Korea Stock Exchange, KOSDAQ, Financial Supervisory Service, the companies*

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303

# Korean Mutual Funds Offer Unusual Value

*Continued From Page 13*

funds is that the Financial Supervisory Service closely monitors them and enforces stricter disclosure requirements than with other investment-trust products in South Korea. Under the current regulations, investors must receive a prospectus that explains the fund, its investment strategy and the risks involved. Furthermore, investment firms must send a "performance report" to fund shareholders every month.

Soon the closed-end funds may have company: The government plans to allow open-ended mutual funds as early as next year.

FEDERATION OF MALAYSIAN UNIT TRUST MANAGERS
(Company No. 272577-P)

# COUNTRY REPORT-MALAYSIA
# 4TH ASIA OCEANIA REGIONAL MEETING
# 28th - 30th April 1999

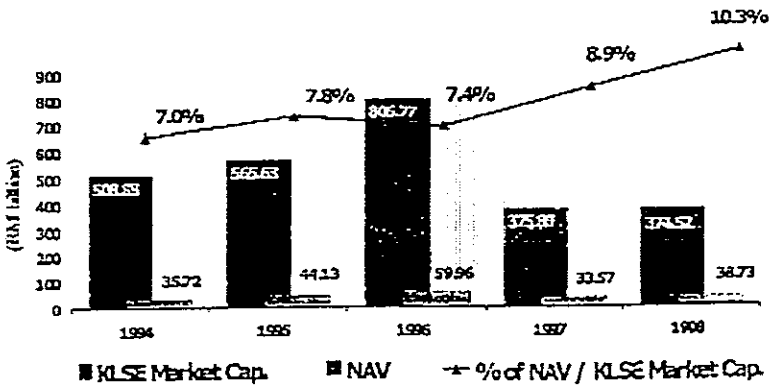
## A. STATISTICS

### INDUSTRY ASSETS

Total Net Asset Value (NAV) of the funds in the industry expanded from RM35.72 billion in 1994 to RM59.96 billion in 1996. With the onset of financial crisis in July 1997, the NAV contracted 44% to RM33.57 billion in 1997 and recovered by 15% to RM38.73 billion by end of 1998.

Nonetheless, the percentage of NAV against the KLSE Market Capitalisation, has increased from 7.0% in 1994 to 10.3% as at end of 1998. Figure 1 depicts the unit trust industry in Malaysia for the five year period from 1994 to 1998.

Figure 1
**Total Net Asset Value of Funds vs KLSE Market Cap. (As at 31 December)**




Source : Securities Commission

CB PLAZA, 12TH FLOOR, EAST WING, SUITE 1203 - 1204, NO.6 JALAN KAMPAR, 50400 KUALA LUMPUR. TEL: (603) 444 1600 FAX: (603) 444 1700
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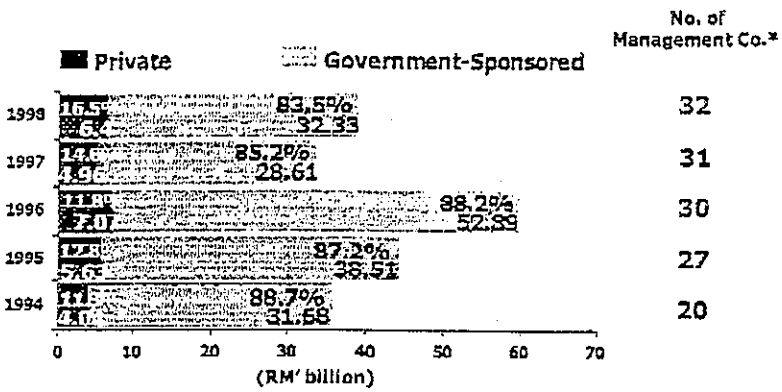
305

Across the span of five years, the unit trust industry in Malaysia is dominated by government-sponsored funds. As at end of 1998, government-sponsored funds accounted for 83.5% of the total size of the industry, whilst private sector funds contributed 16.5%, up from 14.8% as at end of 1997 (Figure 2).

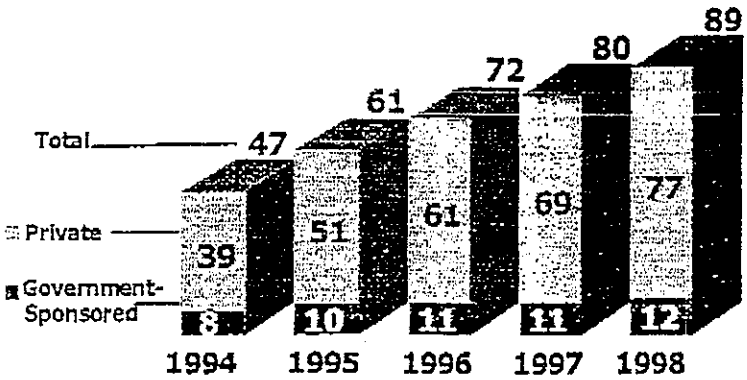
Total number of funds stood at 89 in 1998; almost doubled from 47 funds registered in 1994. Number of private sector funds outnumbered government-sponsored funds with 77 against 12 funds (Figure 3).

Figure 2
**Total Net Asset Value of Funds As at 31 December**




Source: Securities Commission
* Includes management companies approved but not yet launched any fund

Figure 3
**Total Number of Funds As at 31 December**

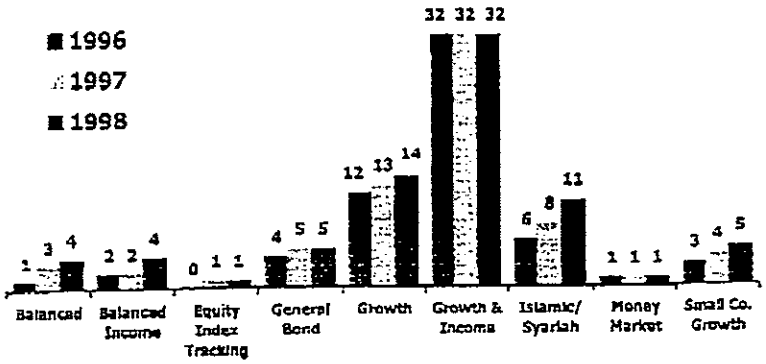



Source: Lipper Asia Ltd. and FMUTM

## TYPES OF FUNDS

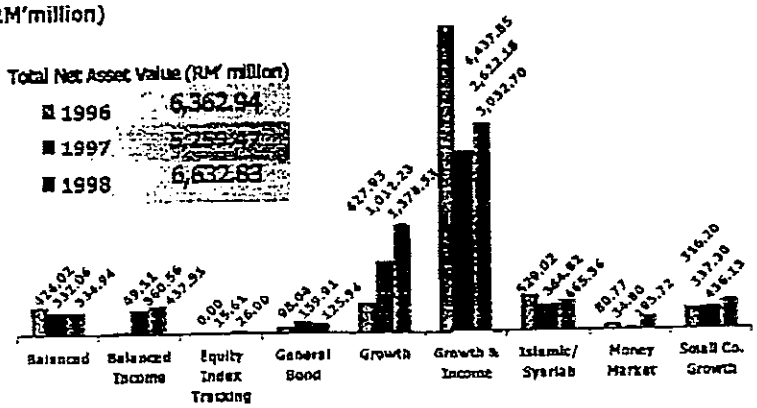
For the past three years ended 1998, the number of funds that invested mainly in the stock market far outstripped other types of funds such as General Bond Funds and Money Market Funds. Based on Lipper Asia Ltd.'s fund classification, he total number of Growth & Income Funds top the list and stood at 32 or 36% of total number of private sector funds in the industry (Figure 4). In 1998 alone, eight new private sector funds were launched with three new Islamic/ Syariah funds, two Balanced Income funds and one of Balanced, Growth and Small Company Growth Fund each.

Figure 4
**Total Number of Private Sector Funds As at 31 December 1996 - 1998**




Source: Lipper Asia Ltd.

Figure 5
**Total Net Asset Value of Private Funds As at 31 December 1996 – 1998 (RM'million)**




Source: Lipper Asia Ltd.
Based on more than 70% of the total number of private funds in the industry

In terms of NAV, Growth & Income Funds account for a larger fund size relative to other funds for the past three years. Growth & Income Funds occupied 69.7%, 49.9% and 45.7% of NAV of the total private sector funds for year 1996, 1997 and 1998 respectively (Figure 5).

The NAV of Growth Funds has consistently increased since 1996 and is account for 23.8% of private sector funds as at end of 1998, up from 19.3% in 1997.

## B. Trends Concerning International Investment Funds

All unit trust funds authorised and launched in Malaysia are allowed to invest in foreign securities; subject to the specific approval of Bank Negara Malaysia (BNM) and other relevant authorities. The proposed investment must also be approved by the Securities Commission (SC). Whilst there is no data available for the international funds by unit trust schemes, it is believed that most of the funds are largely invested in domestic securities.

## C. Legal Developments

The unit trust industry in Malaysia is primarily regulated by the SC, principally via the Securities Commission (Unit Trust Scheme) Regulations 1996 and the Guidelines on Unit Trust Funds(revised 1997).

In 1998, several Practice Notes were issued. These include:

- Basis of computation of Annual Management Fee and Annual Trustee Fee;
- Eligibility of a management company;
- Participation of unit trust scheme in futures contracts; and
- Revised submission of monthly statistical and compliance returns.

On a broader regulatory front, policy strategy to revive and sustain economic growth as well as efforts broadly intended to restore confidence in Malaysia capital market and to facilitate capital raising have been initiated by the SC and BNM. Amongst others, the following main initiatives were taken:

- SC stepped up enforcement efforts by amending The Securities Commission Act 1993 (SCA) to include, inter alia, a new section 39C on the compounding of offences under the SCA to broaden the Commission's compoundable powers.
- Releasing of Corporate Governance Report on 25 March 1999 by the Finance Committee on Corporate Governance. The report provides a comprehensive action plan that covers the following three broad areas:
  1. Develop Malaysian Code on Corporate Governance which sets out a set of principles and best practices for good governance;
  2. Formulate effective enforcement mechanisms that involve reforming of laws, regulations and rules to strengthen the regulatory framework for public listed companies including enforcement of good corporate conduct; and
  3. Training and education to expand the pool of persons suitable for appointment as company directors.
- Reviewing the appointment of chief executive officers in financial institutions every two years.
- Proposed separation of non-banking units from banking units under a different holding company to mitigate the overdependence on the banking sector for strategic development of the financial system.

These measures form part of government's keen efforts to get Malaysia back to the mainstream by ensuring corporate credibility to improve market confidence.

## D. Other Comments and Outlook

High standard of due diligence, disclosure and corporate governance practices accompanied by other regulatory efforts are evidences of Malaysia's collective efforts to continue developing an efficient, innovative and competitive financial system. The unit trust and fund management industry would serve to promote savings and mobilise financing needs of the real economy. Given the pivotal role of the capital market as the funding source of growth in the real economy, the promotion of the unit trust and fund management industry which plays an integral part in the market will continue to be supported by the government.

The FMUTM envisions to develop the unit trust scheme as the preferred vehicle for savings and retirement. The FMUTM also endeavors to reach the industry's goal of 40% market capitalisation by year 2020.

In view of the above, FMUTM will continue to seek opportunities to further improve the benefits to investors and unit trust management companies under the Employees Provident Fund (EPF) Members Investment Withdrawal Scheme that was introduced in November 1996. The scheme permits eligible EPF contributors below 55 years of age with more than RM50,000 under Account 1 (i.e. 60 percent of total contributions) to invest 20% of the excess amount in Account 1 in approved unit trust schemes and asset management companies. As at October 1998, there were 34 approved asset management companies.

Further tax incentives for retirement savings schemes will continue to be proposed to the Ministry of Finance. These include:

- Tax relief for individual investors;
- To increase employers' contribution towards employees' retirement benefits and directly channel the additional contributions to unit trust funds managed by approved asset management companies; and
- Tax exemption on income received by the investments of the specially designed employees' unit trust retirement schemes.

As announced in the 1999 Budget, interest income from specified securities and deposits with licensed financial institutions is exempted from income tax. This exemption came into effect from 1 January 1998.

## E. Distribution of Unit Trusts

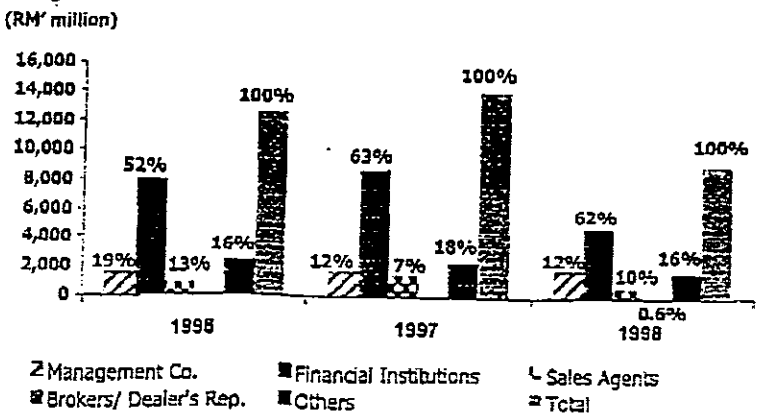
The marketing and distribution of unit trusts are generally conducted through the following channels:

- Unit Trust Management Company
- Financial Institutions
- Sales Agents
- Brokers / Dealer's representatives

While financial institutions are the most frequently used channel industry wide, most of the sales for private sector funds are believed to be brought in by sales agents. Sales agents are individuals who are tied to unit trust management company and are only allowed to market and distribute the management company's unit trust schemes.

Percentage of sales volume registered by sales agents dropped nearly by half from 13% in 1996 to 7% in 1997 and increase to 10% in 1998 (Figure 6).

Figure 6
**Total Industry Gross Sales by Distribution Channels (1996 – 1998)**




Source: Securities Commission

BNM has recently permitted financial institutions to distribute third party unit trusts. The Federation is currently formulating Guidelines to assist and facilitate the orderly development of this channel. Upon implementation of these Guidelines, financial institutions will be allowed to market and distribute multi unit trust schemes. Meanwhile, use of Internet for marketing and distribution unit trust funds is prohibited.

## F. Permitted Structures and Types of Investment Funds

a. In Malaysia, both open-ended funds and closed-ended funds are permitted. As at 31 December 1998, there are 89 open-ended funds and five closed-ended funds. The categorisation of open-ended funds is illustrated in Part A, type of funds. Four closed-ended funds consist of listed property trusts and one equity fund which was launched on 17 February 1997.

b. Privately-placed investment funds are permitted to be established. Meanwhile, fund of funds and domestic funds denominated in foreign currency are currently not permitted to be established.

c. FMUTM continues to propose to the SC for greater freedom and rights to unit trusts in defining the identity and products. Efforts such as encouraging geographical diversification of products and product benefits as well as further regulations regarding specialised funds e.g. futures funds, warrant funds and hedge funds, for local and foreign domicile funds and investments, can be pursued in response to market developments in the world.

## G. Selling and Marketing of Offshore Funds

Selling and marketing of offshore funds are currently not permitted.

## H. Roles of Self-Regulatory Organisations (SRO)

a. FMUTM envisions to be an SRO. As an SRO, FMUTM will take a lead role in:
   - Undertaking public awareness campaign through various investor education programmes;
   - Initiating and developing career path and professional education needs for those dealing in unit trusts;
   - Regulating and licensing the various distribution channels in the marketing and distribution of unit trusts;
   - Implementing compliance and disciplinary procedures;
   - Serving as a strong and resourceful lobby group for the industry; and
   - Make available to the members and the investing public the most complete and updated resource centre for the industry.

b. FMUTM continues to pursue its primary objectives to enhance professional standards and image of the unit trust industry, with emphasis in the following four components:
   - To improve the regulatory, fiscal and legal environment for unit trusts;
   - To formulate sound and ethical business practices to promote the interest in unit trust industry;
   - To provide information, assistance and other services to members; and
   - To promote public awareness of the benefits and risks of investing in unit trusts.

## I. Impact of the Financial Crisis

The Asian financial crisis fully impacted the Malaysian economy in 1998. The uncertain economic environment together with the battered stock market made it extremely difficult to attract people to invest their money in unit trust funds. Values and prices of most funds were at their lows but investor confidence was even lower.

Despite the fact that sales was slow and redemption high for the whole industry, medium to long term outlook for unit trust funds remained encouraging. The future prospects for unit trust funds in Malaysia are tremendous as the industry is at the growth stage.

4th Asia Oceania Regional Meeting, Hong Kong
28th - 30th April 1999

# Unit Trust Industry in Malaysia

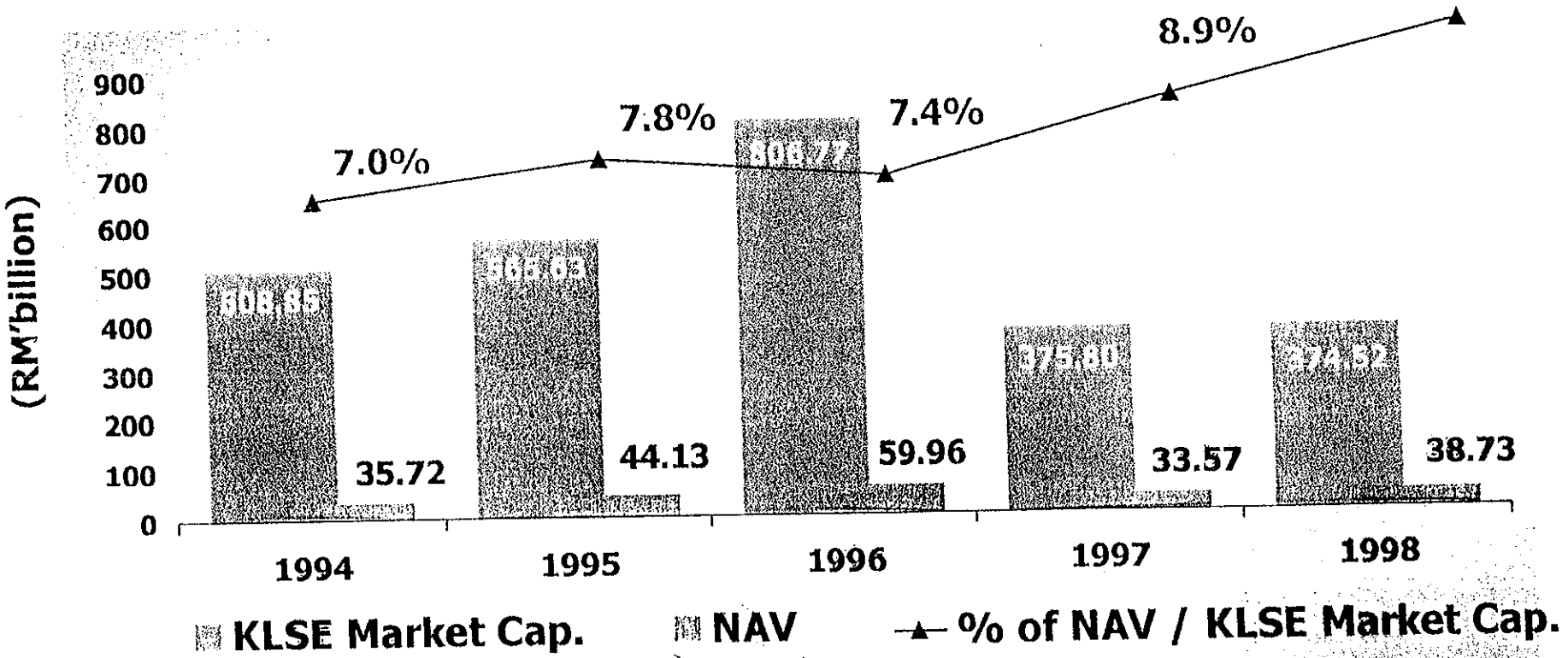
By Mr. Ching Lai Huat
Chairman of the International Affairs Committee
Federation of Malaysian Unit Trust Managers



314

# Malaysian Unit Trust Industry

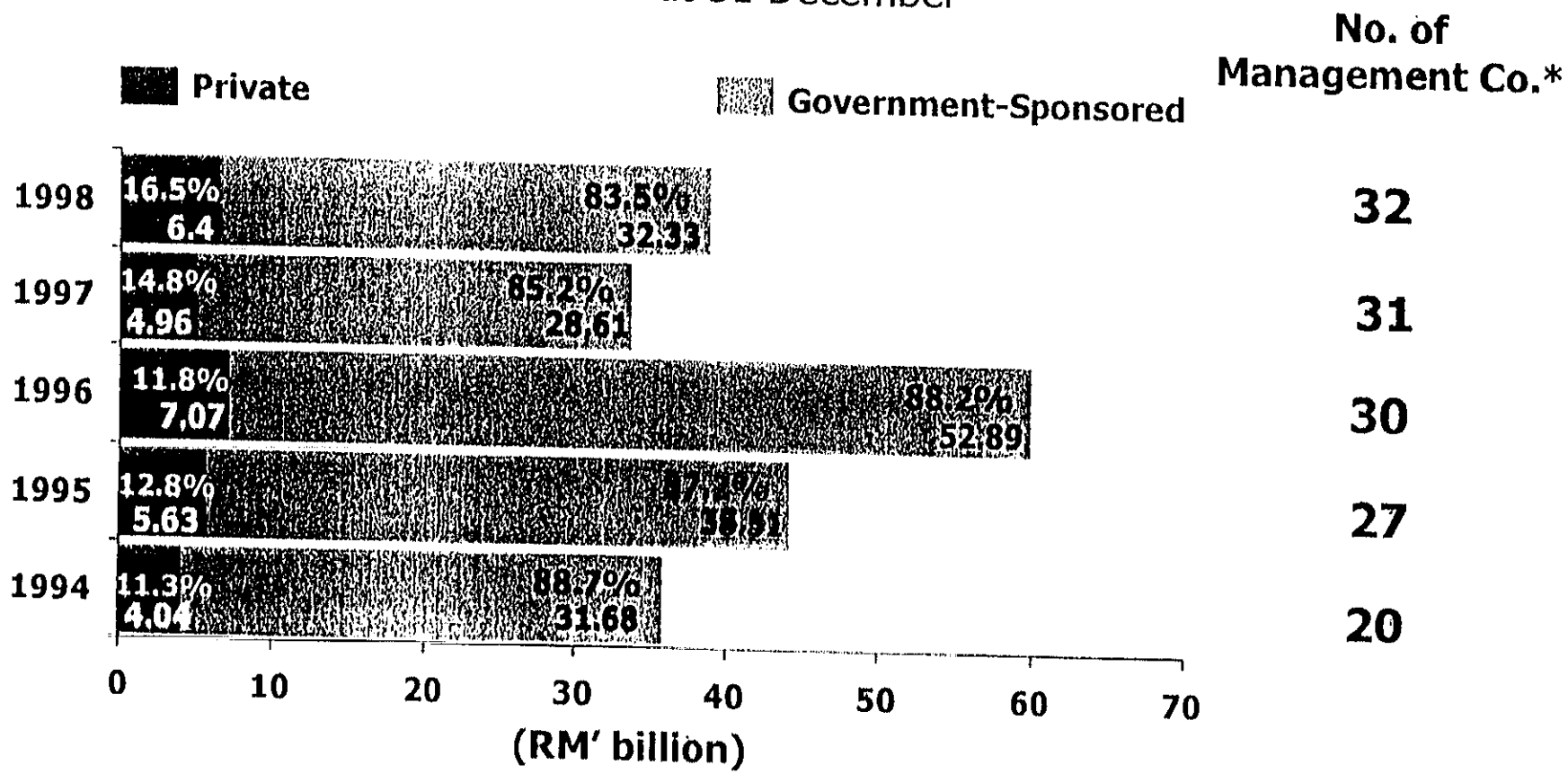
Total Net Asset Value of Funds vs KLSE Market Cap.
As at 31 December




Source : Securities Commission

# Malaysian Unit Trust Industry - Private vs Government-Sponsored Funds

Total Net Asset Value of Funds
As at 31 December

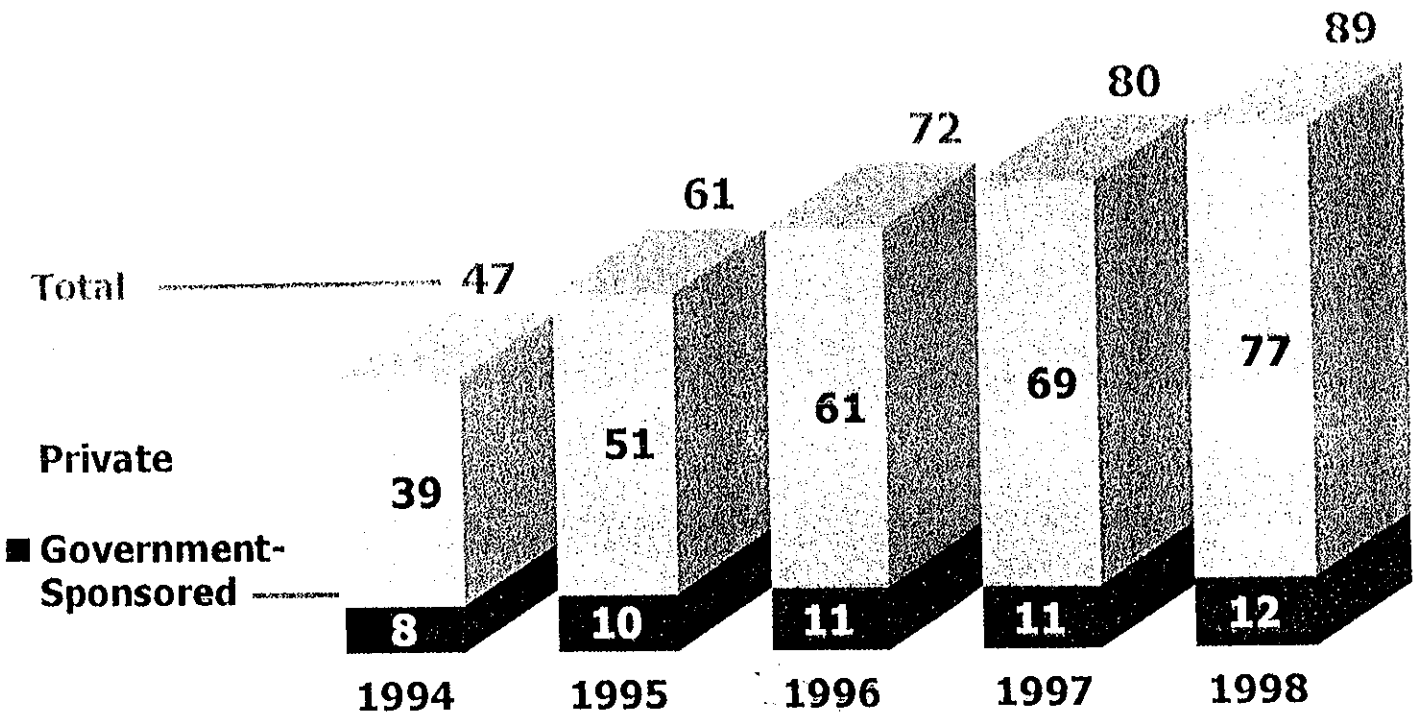



Source : Securities Commission

* Includes management companies approved but not yet launched any fund

# Malaysian Unit Trust Industry - Private vs Government-Sponsored Funds (Contd...)

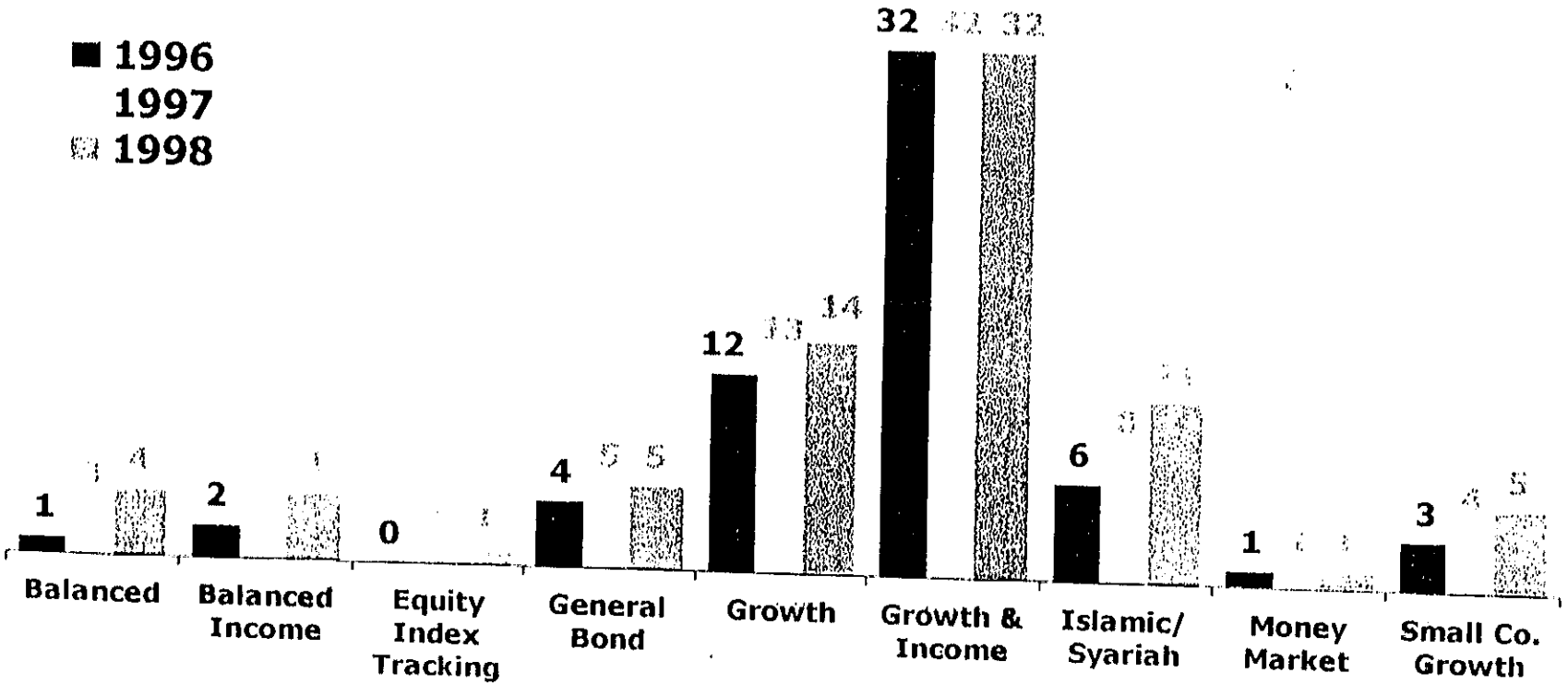
Total Number of Funds
As at 31 December




Source : Lipper Asia Ltd. and FMUTM

# Industry Statistics - Private Funds

Total Number of Private Funds
As at 31 December 1996 - 1998




Source : Lipper Asia Ltd.

FEDERATION OF MALAYSIAN UNIT TRUST MANAGERS

FMUTM

# Other Developments

- Standardised accounting and financial reporting of unit trusts
  - A Draft Statement of Principles entitled "Accounting and Reporting by Unit Trusts" was issued by Malaysian Accounting Standard Board.
- Interest income exempted from tax
  - Interest income from specified securities and deposits with licensed financial institutions is exempted from income tax. Effective from 1 January 1998.
- Introduction of Employees Provident Fund (EPF) Members' Investment Withdrawal Scheme in November 1996.
- Third party distribution by Financial Institutions.

# Legal Developments-Update

- Practice Notes -Guidelines on Unit Trust Funds were issued in 1998:
  - **Practice Note 1:** Basis of computation of Annual Management Fee and Annual Trustee Fee.
  - **Practice Note 2:** Eligibility of a management company.
  - **Practice Note 3:** Participation of unit trust scheme in futures contracts.
  - **Practice Note 4:** Submission of monthly statistical and compliance returns (Revisions).

# Legal Developments-Update (Contd...)

- Guidelines for application for licences for futures fund managers, futures fund manager representatives and registration of compliance officers under the Futures Industry Act, 1993.

# Legal Developments-Background

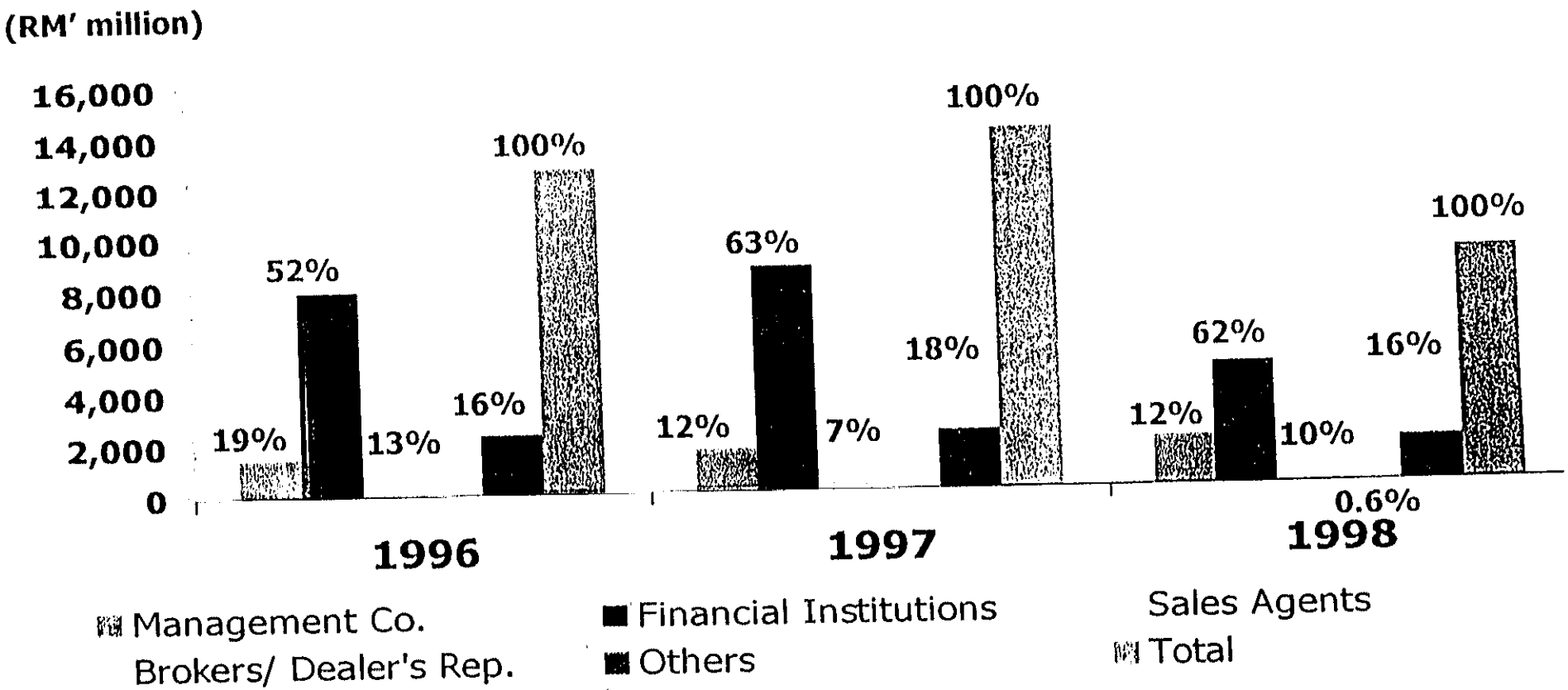
- SC regulates all matters relating to unit trust schemes.
- SC has issued the Securities Commission (Unit Trust Scheme) Regulations 1996.
  - Approval of Management company and trustee
  - Prospectus
  - Trust Deed
  - Advertisements and Promotional Materials

# Legal Developments-Background (Contd...)

- SC also administers the Guidelines on Unit Trust Funds (revised 1997)
  - Submissions to the SC
  - Management company
  - Trustee
  - Investment Committee and Syariah Committee
  - Compliance and internal audit
  - Fees and expenses
  - Objectives and size of scheme
  - Investment powers and restrictions
  - Pricing and dealing
  - Reporting and audit
  - Other operational matters

# Distribution of Unit Trusts in Malaysia

Total Industry Gross Sales by Distribution Channels
(1996 - 1998)




Source : Securities Commission

# Distribution of Unit Trusts in Malaysia (Contd...)

- Selling and marketing of offshore funds are not permitted currently.
- Use of Internet for marketing and distribution unit trust funds is prohibited.

# Roles of FMUTM as SRO

- As a SRO, FMUTM will take the lead role in:
  - Undertaking public awareness campaigns through various investor education programmes.
  - Initiating and developing career path and professional education needs for those dealing in unit trusts.
  - Regulating and licensing the various distribution channels in the marketing and distribution of unit trusts.
  - Implementing compliance and disciplinary procedures.
  - Being a strong and resourceful lobby group for the industry.
  - Offering itself as the most complete and updated resource centre for the industry.

# Evolving Into SRO...

- FMUTM will build an independent, strong and effective self-regulated organization.
- FMUTM to be fully staffed with skilled, knowledgeable personnel and technologically equipped Secretariat.
- FMUTM to be a value-led organization.

# SINGAPORE'S SECURITIES INDUSTRY REPORT

(EXCERPT)

## Unit Trusts and Funds

Unit trusts and funds are similar to mutual funds in the United States. Their importance has grown over the last decade as their increasing variety has attracted a growing number of local investors, particularly risk-averse small investors. Unit trusts and funds are regulated under the Singapore Companies Act by the Ministry of Finance's Registry of Companies and Businesses. Trustees are screened and approved by the Minister under the Companies Act.

As of the end of 1997, there were 161 local and foreign financial institutions in Singapore offering 101 unit trusts and managing a total of S$125 billion in local and foreign funds, nearly double the value in 1994. Fifty of the unit trusts were managed by foreign firms. This strong growth was attributable primarily to fund management companies transferring funds invested in Asian markets previously managed by their offices in the region to Singapore for management. Over 90 percent of the funds managed from Singapore were sourced to foreign investors, including about 50 percent from Europe and the United States. Nearly 70 percent of these funds were invested in equities, with about 10 percent of the total invested in Singapore. In 1998, as part of its broad financial sector liberalization efforts, the government announced that it will allocate S$35 billion (up from S$10 billion) in public sector funds to Singapore-based private fund managers over the next three years.

U.S.-based mutual fund companies may market their funds to Singapore residents, provided the necessary prospectuses are registered with the Singapore Registrar of Companies. There are also no barriers to foreign-owned financial institutions offering Singapore-based unit trusts and funds.

There are currently nine U.S. asset management companies operating in Singapore.

# INVESTMENT MANAGEMENT ASSOCIATION OF SINGAPORE

MISSION STATEMENT

As a representative body of investment managers, to spearhead the development and growth of the industry in Singapore by fostering high standards of professionalism amongst practitioners and creating public awareness of, and interest in, the industry.

## HISTORY

The Investment Management Association of Singapore("IMAS") was registered as a society in Singapore on 22 September 1997. The idea of an investment body was first mooted in November 1995 by Finance Minister Richard Hu.

The founder members of IMAS were The Development Bank of Singapore Ltd, Keppel Bank of Singapore Ltd, Nomura Asset Management Singapore Ltd, Oversea-Chinese Banking Corporation Ltd, Overseas Union Bank Ltd, Prudential Portfolio Managers Singapore Ltd, Tat Lee Bank Ltd, United Overseas Bank Ltd, Stock Exchange of Singapore, Singapore Society of Financial Analysts ("SSFA").

IMAS plans to address issues such as establishment of a code of best practice and standards for the industry and training programmes. Longer term, IMAS could become a forum for members to discuss issues of common interest, and for the association to represent the industry to the government as well as to the external environment.

## OBJECTIVES

The main objectives of IMAS are as follows:

i. To promote professionalism and exemplary practice among members in their conduct of the investment management business.
ii. To provide a forum for members to discuss issues or matters relating to the investment management industry.
iii. To represent members collectively in discussions with, or assist any member to make any representation or recommendation to, any government, government representative, supervisory authority , whether local or foreign, which are concerned with the investment management industry.
iv. To promote the education of the investing public on investments generally and the investment management industry.
v. To improve professionalism and standards of research and fund management expertise in Singapore.
vi. To promote the investment and fund management industry.

## MANAGEMENT

**Chairman**
Elizabeth Sam
Oversea-Chinese Banking Corporation Ltd

**Deputy Chairman**
Ronnie Teo
DBS Asset Management Ltd

**Committee Members**
Gon Mui Hong
OUB Asset Management Ltd

Alan Lim
Prudential Portfolio Managers Singapore Ltd

**Ex-Officio members**
Lim Choo Peng
Stock Exchange of Singapore

**Treasurer**
Dennis Lim
Templeton Asset Management Ltd

**Secretary**
Matthew Dobbs
Schroder Investment Management(Singapore) Ltd

Lee Tiong Seng
BT Funds Management (S) Ltd

Joseph Bohrer
JP Morgan Investment Management Ltd

George Teo
Singapore Society of Financial Analysts

# MEMBERSHIP REQUIREMENTS

There are 2 classes of membership :

**Regular Members**
Persons who are eligible to be Regular Members are :-

- Any company whether incorporated in Singapore or not which holds a dealer's licence under the Securities Industry Act
- Any company incorporated in Singapore which holds a licence issued by the Monetary Authority of Singapore under the Banking Act
- Any merchant bank that is approved as a financial institution under Section 28 of the Monetary Authority of Singapore Act
- Any investment and/or fund management company whether incorporated in Singapore or not which holds an investment adviser's licence under the Securities Industry Act
- Any investment and/or fund management company resident in Singapore which falls within Regulation 41 (1)(e) of the Securities Industry Regulations
- Any investment and/or fund management company whether incorporated in Singapore or not which is approved under Section 43A of the Income Tax Act, Chapter 134 of Singapore as an Approved Fund Manager
- Regular Members are eligible for representation on the Committee and may receive notices of, attend, vote and participate in discussions at General Meetings.

**Affiliate Members**
Persons who are eligible to be Affiliate Members are:-

- Members of Singapore Society of Financial Analysts ("SSFA")
- Persons who are at least 21 years of age, of whom the Committee has no reason to believe is not of good character or reputation or is engaged in any business or occupation which, in the opinion of the Committee, derogates from the integrity of the investment and fund management industry and IMAS, and who is either gainfully employed in the investment and fund management industry or who holds a dealers' licence under the Securities Industry Act.

Affiliate Members may receive notices of and attend General Meetings.

## MEMBERS

Regular

1. ABN AMRO Asset Mangement (S) Ltd
2. AGF Asset Management Asia Ltd
3. AIB Govett (Asia) Ltd
4. AIDEC Management Company Pte Ltd
5. Aberdeen Asset Management
6. Alliance Capital Management (S) Ltd
7. Amercian Express Asset Management Ltd
8. BBL Asset Management (S) Pte Ltd
9. BNP Prime Peregrine (Singapore) Ltd
10. BT Funds Management (S) Ltd
11. Barclays Private Bank Asia Ltd
12. Capital International Research & Management Inc
13. Citicorp Investment Bank (S) Ltd
14. Clariden Asset Management (S) Pte Ltd
15. Commerical Union Investment Management (S) Ltd
16. Commerzbank Asset Management Asia Ltd
17. Copthorne International Investment Ltd
18. Daiwa International Capital Management (S) Ltd
19. Daiwa Asset Management (S)Ltd
20. DB Fund Management Ltd
21. DBS Asset Management Ltd
22. Development Bank of Singapore Ltd
23. Dresdner Asset Management Ltd
24. First Capital Fund Management Pte Ltd

25. Fischer Francis Trees & Watts (S) Pte Ltd

26. GK Goh Research Pte Ltd

27. Goldman Sachs (S) Pte

28. Grand Pacific Capital Management Pte Ltd

29. Henderson Investors Singapore Ltd

30. HSBC Asset Management Singapore Ltd

31. Indocam Singapore Ltd

32. Indosuez W.I. Carr Securities (S) Pte Ltd

33. Jardine Fleming Investment Management(S)Ltd

34. JP Morgan Investment Management

35. Keppel Bank of Singapore Ltd

36. Keppel Investment Management Ltd

37. Lehman Brothers Inc.

38. Lloyds Merchant Bank Asia Ltd

39. Mercury Asset Management Pte Ltd

40. Merrill Lynch International Bank Ltd

41. Morgan Grenfell (Asia) Pte Ltd

42. Morgan Stanley Dean Witter Investment Management

43. Murray Johnstone (Asia) Pte Ltd

44. Newton Management (Asia) Pte Ltd

45. Next Century Capital Pte Ltd

46. Nicholas-Applegate Capital Management Asia

47. Nikko Global Asset Management (S) Ltd

48. Nomura Asset Management Singapore Limited

49. OCBC Asset Management Ltd

50. Oversea-Chinese Banking Corporation Ltd

51. Overseas Union Bank Limited

52. OUB Asset Management Ltd

53. Paribas Asset Management Asia Ltd

54. Pheim Asset Management(Asia) Pte Ltd

55. Phillip Securities Research Pte Ltd

56. Pictet Asia Pte Ltd

57. PointWorth Management Pte Ltd

58. Prudential-Portfolio Managers Singapore Ltd

59. Prudential-Bache Securities Asia Pacific Ltd

60. Rabobank Asia Limited

61. Rashid Hussain-Cathay Research Pte Ltd

62. Rosenberg Nomura Asset Management Asia Ltd

63. Rothschild Asset Management (S) Ltd

64. Samsung Asset Management (S)Pte Ltd

65. Schroder Investment Management (Singapore) Ltd

66. SGY Asset Management (S) Limited

67. Singapore Consortium Investment Management Ltd

68. Singapore Society of Financial Analysts c/o JM Sassoon & Co (Pte) Ltd

69. Singapore Unit Trusts Ltd

70. Societe Generate Asset Management (Asia) Pte Ltd

71. SPH Asset Management Ltd

72. Standard Chartered Bank

73. Stock Exchange of Singapore Ltd

74. Sumitomo Life Investment Singapore Ltd

75. Tat Lee Bank Limited

76. Tat Lee Asset Management Ltd

77. TDF Management Pte Ltd

78. Templeton Asset Management Ltd

79. Tokyo-Mitsubishi International (S) Ltd

80. United Overseas Bank Ltd

81. UOB Asset Management Limited

82. Vertex Management (II) Pte Ltd

83. Vickers Ballas Investment Research Pte Ltd

84. Wellington International Management Co Pte Ltd

## STANDARDS & PRACTICE

Upon approval by the Main Committee, the Sub-Committee shall draft guidelines relating to the following:

1) Code of Ethics

2) Standards of Professional Conduct which would include the following: Definition of Investment Managers

Conduct of Business

- Professional Standards
- Integrity
- Disciplinary Proceedings
- Promotion and Representation
- Financial Resources

Client Relations

- General
- Performance Measurement and Reporting

Third Party Relations

- Relationship with relevant bodies e.g regulators, trustee companies etc.

Conduct of Investment

- Dealing with Third Parties
- Gearing
- Dealing Guidelines
- Derivatives Dealing

Compliance

- Relevant Legislation
- Agreements and Mandates
- Personal Trading
- Insider Trading
- Segregation of Business Activities
- Compliance Issues and Monitoring

3) Draft additional guidelines as required for the furtherance of the investment management industry in Singapore

## Fortnightly Column

THERE are about 116 unit trusts available in Singapore and the number is growing.

With further financial liberalisation, more funds are expected to be launched in the months ahead.

As it stands, 23 of the 116 funds available here are global equity funds, 42 are regional funds and 34 are single country funds.

There are also 12 bond funds, three balanced funds and two gold funds.

# COUNTRY REPORT
# TAIWAN, ROC

December 31, 1998

Securities investment Trust & Consulting Association R.O.C.

## 1. Statistical situation and trends

### A. Overall:

Total net assets of investment funds (Divided to the different type of funds):
(US million - as at the end of)

| Taiwan-issued Mutual funds | Dec-93 | Dec-94 | Dec-95 | Dec-96 | Dec-97 | Dec-98 |
|---|---|---|---|---|---|---|
| Close-end equity | $4,013 | $4,718 | $2,915 | $4,368 | $3,227 | $1,901 |
| Open-end equity | $355 | $1,761 | $1,675 | $1,775 | $4,378 | $5,148 |
| Offshore Country | $1,552 | $2,154 | $1,929 | $2,719 | $1,494 | $937 |
| International-equity | $37 | $36 | $294 | $395 | $926 | $1,272 |
| Open-end Balance | $634 | $163 | $113 | $100 | $154 | $138 |
| Open-end Bond | $438 | $683 | $2,184 | $8,568 | $6,817 | $13,685 |
| International-bond | $0 | $0 | $14 | $3 | $69 | $19 |
| Total | $7,029 | $9,515 | $9,124 | $17,928 | $17,065 | $23,100 |

In 1998, the total number of funds had increased to 44, and the fund size increased over sixty hundred million US dollars as well.



336

Compared to 1997, the total asset value on December 1998 increased about 35.36%.

B. Sector analysis

a. Stock funds

Closed-end equity

According to the Regulation of the Securities Investment Trust, the fund has to open and accept the customer's redemption when the market price diminished than ninety percent of its actual price for the closed-end equity. Therefore, the closed-end equity has the pressure of redemption from their customers, and the fund size will be diminished.

In 1998, the number of closed-end equity funds has decreased from 21 to 17, and the fund size decreased 41.09% at the same time.

Open-end equity

This type of fund had a 17.59% growth in 1998. In despite of the transfer of closed-end equity to the open-end equity, there are 32 new funds that have participated in this market.

b. Offshore country fund

The size of offshore country funds invested in the Taiwan market has decreased 26.24%. The whole Asia pessimistic economic situation caused the QFII to lose confidence and draw out their money from Taiwan.

c. Bond fund

Open bond

The asset size of open bond funds had a double growth this year.

Because of the stock market was not appearing well in this year; the return rate of the stock market was lower than the bond fund market. Therefore, the bond fund attracted the money follow and had wonderful score.

International bond

The asset of international bond fund had a 72.46% decline in this year. The crucial reason of the decline was the performance. Due to the good performance of the domestic open bond fund, the capital flow into the domestic open bond fund or other investing products instead of the international bond fund.

d. Balance fund

The balance fund has dropped 10.39% for the past year.

## 2. distribution channels

SITCA has thirty-two SITE members, which have been approved by SFC to do the fund management business. As we know, some banks and security companies will cooperate to establish the investment trust company. We are glad to see that the fund industry has developed prosperously and successfully.

Generally, all funds are sold primarily through the fund management companies. Up to now, most of the transactions had traded in the banks or their branches, which play major roles in the sale of domestic funds. In these years, it is more important for using the channel of bank to distribute funds because some of investment trust companies have initiated positive project to carry out the saving plan. This project is to transfer fixed money through personal account monthly.

## 3. Trends concerning international investment funds

The funds, which launch within the country in order to invest international, had been developed to be a segment of the market.

There were four new funds on the market in 1998, which made the total number of funds to 21. The asset size of the international-equity fund had an increasing rate of 37.37%. Although the asset still can not compare with that of the domestic stock funds, this data shows a steady growth in every year.

Due to the impact by the Asia economic crisis, the investors prefer to hold foreign currencies instead of Taiwan currency for minimizing the pressure of the currency depreciation. In addition to above reason, the international step of the fund management companies in Taiwan is in process, so we could see the international fund would be issued more and more in the future.

## 4. Legislative and Regulatory Development

The securities and funds industry in Taiwan has been strong administrated by SFC under the Law of Securities Transaction and the Regulation of Securities Investment Trust. Following regulations and law were under legislative reformation and amendment.

B. Although, the SFC already removed the ceiling of the annual turnover rate on stock-type funds, but the top three high turnover funds still be required to disclose the reasons for the sake of investor's protection recently.

C. Under the amendment, the Law of Securities Transaction will request all securities investment trust companies to be the members of their association (now is the SITCA).

D. The most important thing that will strongly influence the investment trust management industry and the securities investment market in Taiwan is the legalizing of the discretionary investment business.

E. The SITCA will be authorized by the SFC under the amended Regulation of Securities Investment Trust to review the initiate

application for the discretionary investment business.

## 5. Tax regulations

The Tax integration system of Taiwan has been enforced on January 1, 1998. This new regulation combines the personal income tax and the business income tax in order to the fair-taxed. To fulfill the requirement, the company has to set up an independent account for assigning the dividend. The investors will not be double taxed under this new regulation.

## 6. Other comments and outlook

A. SITCA, the association of whole country has been established on October 8, 1998 instead of SITTA, the association of Taipei City, in order to accept the management which is authorized by the SFC and to carry the self-regulatory affairs in this industry.

B. In recent years, the investment funds become more acceptable by investors in Taiwan, which was showed the sixth place of the most popular products by a famous magazine.

C. The discretionary investment business will be authorized to securities investment trust and advisory industry only, therefore, the domestic bank is preparing to establish securities investment trust or advisory company in order to devote into this market. There are five new investment trust companies and many advisory companies have been set up last year. It is foreseeable that the securities investment trusts market in Taiwan will develop more prosperously in the near future.

# The 4th Oceania Regional Meeting
April 28-30, 1999

# AGENDA TOPICS

## I. Distribution channels of investment funds in Taiwan

a. What channels are permitted for distributing investment funds?

There is no specific regulation about distributing channel for investment funds; mutual fund companies regularly adopt the following channels:

1. Securities company: The securities market investors take almost 25% of the population in Taiwan, and they also treat mutual fund as the important investment instrument, therefore, securities companies are permitted for distributing investment funds.
2. Bank: Investors may purchase funds through the bank counters by themselves or by the assistance of the investment consultants.
3. Direct marketing: Funds are sold through the mail, by telephone, or at office locations of fund companies. Sometimes, fund companies offer to investors with lower sales charge or no charge.

b. What channel(s) are most frequently used?

Generally, all funds are sold primarily through the fund management companies. The most of the transactions had traded in the banks or their branches, which play major roles in the sale of domestic funds.

c. Recent trend (which distribution channels have assumed an increasing share; or any new distribution channels)

In these years, it is more important for using the channel of bank to distribute funds because some of investment trust companies have initiated positive project to carry out the saving plan. This project is to transfer fixed money through personal account monthly.

d. Use of Internet in the distribution of funds

SFC accepts Internet as one of the distribution channels for mutual funds. However, it requires the approval for individual company by SFC to use Internet as a distribution channel.

e. Problems of investor protection arising from the diversification of distribution channels

Pursuant to the "Computer Processed Personal Data Protection Law" in 1995, all of the companies have the duty to prevent their customer's data or privacy from divulging to unrelated persons in order to avoid claims. According to the law, the companies related to securities are required to propose a plan concerning the protection of customer's personal data. We can find that investment fund companies take more cautious steps to keep personal data while distributing mutual funds as the result.

## II. Cross-border co-operation on controls of intermediaries

At present, Taiwan funds are sold primarily through the fund management companies. The situation of cross-border co-operation on controls of intermediaries was seldom happened in Taiwan.

## III. Permitted structures and types of investment funds

a. What structures of investment funds are permitted?

1. Close-end equity
2. Open-end equity
3. Offshore Country
4. International-equity
5. Open-end Balance
6. Open-end Bond
7. International-bond

b. Are privately-placed investment funds, fund of funds and domestic funds denominated in foreign currency permitted to be established?

Those funds are still not permitted in Taiwan yet.

c. What roles do/can investment fund associations play in introducing new structures and types of investment funds?

SITCA will gather, study and analyze pertinent laws and regulations at home and abroad related to new type of investment fund first, than negotiate with SFC in order to get the realization and permission to establish this new fund.

## IV. Selling and marketing offshore funds

a. What are the rules and regulations in the respective countries on this?

In accordance with the Rules for Administration of Securities Investment Trust and Consulting Enterprise promulgated by SFC in Taiwan:

1. Offshore funds (foreign funds) are not permitted to offer publicly their shares in Taiwan.
2. Offshore funds also can not be marketed and sold in Taiwan through SITE or SICE.
3. It is very clear and strong policy that the offshore funds will not be marketed and sold in Taiwan, and there are no signs that the SFC will change this situation in the near future.
4. Offshore funds can only be consulted by SITE as long as they receive SFC's approval.

However, if investor would like to invest offshore funds directly, they can buy it through the "non-discretionary trust account" of bank within the amount of 5 million US Dollars according to the regulation of the Central Bank of China.

b. Statistics: number and assets of offshore funds
(As at the end of 1998)

Because offshore funds can not be marketed and sold in Taiwan through SITE or SICE, it is impossible to figure out the total assets of offshore fund through the "non-discretionary trust account" of bank. In other side, SFC has approved 438 offshore funds that SICE can render services of consulting and advise.

## V. Roles of investment funds associations in the Region

SITCA has been formed instead of SITTA in October 8, 1998. The members are made up by officially licensed government and private organizations, which are engaging in securities trust and consulting business from the whole country. As of April in 1999, our current membership includes 33 securities investment trust and 144 securities investment consulting firms.

a. Role of the respective associations – SRO vs. non-SRO, etc.

SRO — SITCA is a self-regulatory organization, the most important function is to enhance the notion of self-regulation among member firms, to take the initiative to set up a sound internal control system for the purpose of earning the trust of the investor and acquire broader business development. We believe its implementation will boost the positive image of the industry and better protect the investor interest.

b. How each investment fund association is contributing or should contribute to the establishment, management, and distribution of investment funds.

SITCA plays the following roles to reach the common interest goal:

1. Role of the respective associations – SRO.

The real momentum to establishing a good image for the entire industry lies in "self-regulation". Therefore, the association and our SITE members have a spontaneous awareness of the importance and positive impact of self-regulation that prompts them to take the initiative to set up a sound internal control and internal auditing system. Only by winning the trust of the investors can we acquire broader room for development.

2. Role of the show window of the entire industries

Our current member includes two industries: securities investment trust and securities investment consulting firms. All information from our SITE members will be gathered in the Association. Therefore, the Association is the show window of the entire industries. During the window, you can have a fully understanding about the both industries in Taiwan.

3. Role of the bridge between government, society and our members.

"Facilitating economic progress, assisting members to overcome operating difficulties and enhancing members' common interests" are our setting purposes. Therefore, how to coordinate with government's policies and provide more information and inquiry services to the members and the general public has become an important role to Association.

4. Role of the promoter to push the progressing of the industries.

We always focus our business on breaking down information and technical barriers, strengthening international exchange, bringing in professional know-how, assisting members in business development and breaking new ground that keeps in line with the market trend. The Association, playing the role of the promoter to push the progressing of the industries, is undoubted.

5. Role of provider to offer the professional training to the industries.

We also hold more training classes and seminars to help the businesses cultivate more professionals. Only by professional training can we win the trust of the investors and acquire broader room for development.

SITCA provides the following services to assist the establishment, management and distribution of investment funds:

1. Carrying out survey, statistics collection, research and development on members' business activities.



344

2. Breaking down information and technical barriers, strengthening international exchange, bring in professional know-how in order to assist members in business development.
3. Carrying out research and providing recommendations to the government regarding economic policies, securities related laws and commercial laws and assisting in the implementation of such laws.
4. Helping to mediate disputes among members.
5. Providing training and seminars to the industry.
6. Acting on behalf of members to apply for alteration and renewal of registration.
7. Protecting and securing members' legal rights and interests.

## VI. Impact of the financial crisis on the fund management industry

The Asia economic crisis did not to hurt the Taiwan fund industry seriously; the total assets still grew in 1998. The government tried their best to stabilize the financial market during the crisis. SFC also took the policy to speed up the approval of new securities investment trust enterprises (SITEs) and new funds in order to attract more money into securities market and minimize the impact. Up to the present, Taiwan's currency (New Taiwan dollar) to US dollars has slightly appreciated 1.06% and stock index has dropped 14.11%, however, the asset size of open bond funds had double growth last year.

Due to the impact by the Asia economic crisis, the investors prefer to hold foreign currencies instead of Taiwan currency for minimizing the pressure of the currency depreciation.

The Asia economic crisis seems to have effected Taiwan within limits. The government and people are very cautious toward the crisis and related matters.

## VII. Reciprocity among fund regulatory commissions

【See the attachment paper】

## VIII. Development of the pension systems

The pension system just starts to discuss in Taiwan.

There are two retirements funds existed in Taiwan up to now. One is the Worker's Retirement Fund, which is set up according to the requirement of Labor Standards Law. The Labor Standards Law compels the employers to deduct a certain sum of money every month and to deposit the same in a special account as the reserve fund of retirement payment for workers. The retirement fund of workers shall be controlled and operated under a financial



345

agency designated by the central competent authority and the Ministry of Finance. A worker who is in any one of the following situations may retire and apply for his own retirement payment:

1. When the worker attains the age of 55 and has worked for one and the same business entity for 15 years.
2. When the worker has worked for one and the same business entity for more than 25 years.
3. When the worker attains 60 years of age.

The other one is the Public Service Pension Fund. This Fund is established by the requirement of the pension system that is offered to the public servants of whole country. In accordance with the law, both the government and the public servants, including the military, educators and civil servants, contribute to the Fund. The government takes the responsibility for pension payments to take care of the welfare of both retirees and personnel in service. Two authorities, the management board and the supervisory board of the Fund, were set up by the government to assume responsibility for the management, supervision and related affairs.



346

## LIST OF MOUs SIGNED BY THE SFC AND OTHER MEMBERS OF IOSCO

| | Member | Signatory | Nature | Date of Signature |
|---|---|---|---|---|
| 1 | U.S.A.(CFTC) | AIT & CCNAA | Exchange of Information | January 11, 1993 |
| 2 | Singapore | Monetary Authority of Singapore | Exchange of Information | February 8, 1993 |
| 3 | U.K. | Securities and Investment Board | Exchange of Information | June 16, 1993 |
| 4 | France | Commission des Operations de Bourse | Mutual Assistance Administrative Arrangement | June 20, 1994 |
| 5 | Japan | Interchange association Japan & Association of Easter Asian Reintions | Exchange of Information | April 24, 1995 |
| 6 | Argentina | Comision Nacional de Valores of Argentina | Exchange of Information | November 2, 1995 |
| 7 | Australia | Australian Securities Commission | Exchange of Information | November 2, 1995 * (By Exchange of Letters) |
| 8 | Hong Kong | Hong Kong Securities and Futures Commission | Exchange of Information | February 7, 1996 |
| 9 | South Africa | Financial Services Board of the RSA | Exchange of Information | April 1, 1996 |
| 10 | Thailand | Securities and Futures Commission | Exchange of Information | June 19, 1996 |
| 11 | Kenya | Capital Markets Authority | Exchange of Information | September 17, 1996 |
| 12 | New Zealand | Securities Commission | Exchange of Information | December 9, 1996 |
| 13 | Italy | Commission Nazional per le Societa e la Borsa | Exchange of Information | November 5, 1997 |
| 14 | Germany | Bundesaufsichtsamt fur den Wertpapierhandel | Exchange of Information | November 7, 1997 |
| 15 | Malaysia | Securities Commission | Exchange of Information | November 7, 1997 |
| 16 | Spain | Comision Nacional del Mercado de Valores | Exchange of Information | November 7, 1997 |
| 17 | Brazil | Comissao de Valores Mobiliarios | Exchange of Information | November 7, 1997 |
| 18 | Sweden | Finansinspektionen | Exchange of Information | November 7, 1997 |
| 19 | Chile | Superintendencia de Valores y Seguros | Exchange of Information | May 26, 1998 |