SEC Issues Rules on Corporate Debt Vehicles

October 6, 2020

The Securities and Exchange Commission (SEC) has issued *Memorandum Circular No. 23, Series of 2020* (CDV Circular), dated August 18, 2020, which provides a regulatory framework for the creation and operation of Corporate Debt Vehicles (CDV). The circular aims to alleviate the adverse economic effects of the COVID-19 pandemic on large corporations and medium-sized enterprises by giving them another mode of raising capital through the intermediation of a mutual fund.

1. Setting up a CDV

A CDV is a closed-end investment company or mutual fund organized under the Investment Company Act,[1] the shares or units of participation of which are offered to any number of qualified buyers,[2] or to non-qualified buyers not exceeding 19 persons in the Philippines during any 12-month period. It must be created for the purpose of investing in the corporate debts (secured or unsecured) of (a) large corporations and medium-sized enterprises, or (b) any company the debts of which are guaranteed by (i) a large or medium-sized domestic corporation, (ii) the Philippine government or any of its agencies, or (iii) multilateral agencies involving exempt securities under Rule 9.1.2.3[3] of the *Implementing Rules and Regulations of the Securities Regulation Code*.

Large corporations are corporations with total assets of more than Php350 million or total liabilities of more than Php250 million, while medium-sized enterprises are corporations with more than Php100 million to Php350 million in total assets or more than Php100 million to Php250 million in total liabilities.

[1] Republic Act No. 2629, as amended.

[2] The term "qualified buyers" include (i) banks, (ii) registered investment houses, (iii) insurance companies, (iv) pension or retirement funds maintained by the Philippine government or managed by a licensed trust entity, (v) investment companies, and (vi) such other natural or juridical persons as the SEC may determine as qualified buyers on the basis of such factors as financial sophistication, net worth, knowledge and experience in financial and business matters, or amount of assets under management.

[3] Rule 9.1.2.3 exempts securities from the registration requirement of the Securities Regulation Code if they are guaranteed by multilateral financial entities established through a treaty or any other binding agreement to which the Philippines is a party or subsequently becomes a member.

A CDV must also have a minimum subscribed and paid-up capital of Php50 million, but this amount may be lowered to Php1 million if it is part of a group of investment companies to be created or already in existence and managed by the same fund manager with a track record of at least five years. All of the company's directors must be Philippine citizens.

2. Offering of securities

The CDV Circular seeks to expedite a CDV's offering of its securities by providing for the submission of a simplified prospectus and product highlight sheet when it registers such securities with the SEC. A CDV may offer several shares or unit classes managed as separate asset pools with the same investment objectives. Since a CDV is a closed-end fund, subscription to its securities are done only on initial offering and investors cannot redeem their shares or units at any time. However, a CDV may make periodic distribution of income to investors, provided it is made only from cash received from interest income earned after deducting applicable taxes and expenses.

A CDV may offer its securities in one or more tranches. The first tranche must be offered within six months from the SEC's approval of the securities, while subsequent tranches must be offered within three months from submission to the SEC of the company's current report and updated simplified prospectus.

3. Investment limits

The value of a CDV's investments in corporate debt must not exceed (a) 25% of its net asset value if the debt is issued by a single enterprise, and (b) 50% of its net asset value for investments in single group entities. However, the single issuer limit may be increased to 30% if a local or global rating agency gives the corporate debt or the issuer the highest credit rating. The limit may also be waived if the CDV has a capital protection feature in which the return of the investor's capital is guaranteed at a predetermined date in the future, with some returns, if any.

A CDV is prohibited from investing in the securities it is issuing and in corporate debts of corporations in which any of its directors or officers or any of the directors or officers of its investment advisor, fund manager, or distributors is a stockholder or member.

Under the CDV Circular, a fund's total operating expenses must not exceed 10% of its average investment fund or net worth. It may borrow but only for the purpose of meeting redemptions and meeting corporate requirements, provided the tenor of the borrowing does not exceed one month and the aggregate borrowing does not exceed 10% of the company's net assets.

4. Disclosures

A CDV is required to comply with several reporting and recording requirements, in addition to the disclosures that public companies are required to make. These include the submission of the following: (a) a monthly report showing the net assets of the CDV, (b) details of corporate debts acquired for the month, (c) the outstanding balance of the investments held in the portfolio and the total number of individual and institutional account holders or investors as of the reporting period; and (d) annual audited financial statements and interim financial statements showing a combined statement of net assets and including a detailed breakdown of the financial statement for each class of shares or units.

5. Need for guidance from other regulators

The CDV Circular is a welcome development, as it provides additional funding options to large and medium enterprises during these difficult times. For instance, qualified corporations may now raise debt in a private placement exceeding Php150 million without SEC approval if done within the framework of the CDV Circular. Otherwise, companies without quasi-banking license need to get SEC approval for each debt issuance in a private placement exceeding that amount.[4]

It would help, however, if other key regulators aligned their rules with the CDV Circular to encourage more investments. Universal banks are required to get approval from the Bangko Sentral ng Pilipinas (BSP, the Philippine Central Bank) before investing in a mutual fund, which is a non-allied undertaking.[5] The BSP should issue guidelines on the CDV investments of universal banks that would facilitate these transactions and make the approval requirement unnecessary. BSP can also clarify how these investments should be treated for purposes of the single-borrower and other prudential limits on lending. The Insurance Commission should set the conditions under which investments will qualify as admitted assets of insurance companies.

SyCipLaw's Banking, Finance and Securities Department

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[4] SRC Rule 10.1.2.3.
[5] BSP Manual of Regulations for Banks, sec. 376-A. Other categories of banks are not allowed by law to invest in the equity of non-allied enterprises.

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