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INVESTOR PROTECTION: SEGREGATION OF ASSETS

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ABSTRACT

The article is devoted to the contemporary problems of the ownership rights on intermediated securities and investor protection. Authors provide brief introduction to the major aspects of the Latvian securities law, then they study peculiarities of US approach to the ownership rights on intermediated securities as well US techniques of investor protection in the context of segregation and separation of assets of investors as well as briefly review the insolvency regimes and return of the financial assets to the investors, customers of insolvent US regulated firms. In conclusion authors provide brief comparative summarizing of Latvian and US approaches.

Objectives: *The study aims at continuing development of the securities law theory, while its task is to characterise the problematic of investor protection especially in insolvency proceedings on example of US as well as to discuss some peculiarities ownership rights on intermediated securities from the point of view of US law and practice.*

Methods/Approach *Scientific research methods – both comparative and analytical – is used in the process of drawing up of this article.*

Results: *Authors come to conclusion that US investor protection system is more complex than Latvian, it uses the separation and segregation approaches, while Latvian system only segregation approach. Both systems do not excluding situations of shortfall in customer assets. Both systems recognize the pro-rata distribution of damages, but US system recognises various pro-rata approaches to the distribution of damages (from the defined amount of assets; from all the assets; from all the assets belonging to a specific category of customers), while Latvian law stays silent regarding this topic. Authors believe that modernisation of the law is required for the better protection of the customers in case of insolvency of investment service providers and obtaining of the greater certainty of the legal outcomes. Author suggest should to determine the prohibition to meet the claims of one class of assets at the expense of another class of assets during insolvency proceedings of investment service providers in case of shortfall in assets.*

Keywords: securities, ownership, intermediaries, segregation, USA, Latvia, investors

JEL classification: *K11, K15, K22*

Paper type: Research article

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INTRODUCTION

Latvia belongs to the groups of the Baltic countries, which has emerging capital markets. Successful development of the capital markets and legal research in the relevant areas, leads to achieve strategical aim to be modern financial canter with well-developed infrastructure and absence of uncertainties in protection of the investor's rights (securities holders).

"Financial Instrument Market Law" (Finanšu instrument tirgus likums, 2003) (thereinafter – FIML) is the main law regulating the circulation of securities in the Republic of Latvia. The FIML also lays down the foundations for the functioning of the financial instruments market in Latvia, but various other laws amend the architecture of the market or are aimed on the protection of interests of the customers (investors). Among them following acts should be mentioned: "Investor Protection Law" (Ieguldītāju Aizsardzības likums, 2001), which sets up the system of repayment of compensation for the pending investments service or irrevocable lost of financial instruments in amount not exceeding 20000 EUR per investor, "Investment Brokerage Companies Law" (Ieguldījumu broker sabiedrību likums, 2022), "Law on Recovery of Activities and Resolution of Credit Institutions and Investment Brokerage Companies", (Kredītiestāžu un ieguldījumu brokeru sabiedrību darbības atjaunošanas un noregulējuma likums, 2015) "Insolvency law" (Maksātnespējas likums, 2010). The Insolvency Law applies subject to the special provisions of Section I of the FIML[1].

Investment service provider makes relevant entries in the accounts of the investors and certifies ownership rights of investors on securities. Latvia belongs to the countries in which individual ownership model is used (Jukna &Grasis, 2022), while USA belongs to the countries where securities entitlement model is used (Mooney, 2019).

FIML sets up requirements for investment service providers (investment brokerage companies (ieguldījumu brokeru sabiedrības) and credit institutions) regarding segregated holding of the assets. Segregation' refers to the process of physically separating assets, e.g. holding assets separately, i.e. holding assets in separate higher-tier accounts, to prevent commingling of assets and the including of assets belonging to investors in the property of the investment service provider in the event of insolvency of the last and to reduce the possibility of using assets belonging to clients for investment services to satisfy (secure) the obligations of the provider towards third parties (Jukna, 2019).

In 2022 a new law 'On Investment Brokerage Companies' was adopted in Latvia. The law contains a section relating to insolvency cases of investment brokerage companies. Although the new law contains special provisions complementing the Insolvency Law and the Investor Protection Law. Law 'On Investment Brokerage Companies' contains only general provisions concerning return of assets to investors, namely, return of assets held by investment brokerage firm, and sets strict deadlines for submission of applications and possibility to calm assets (upon expiry of 10 years unclaimed assets become the property of the state). The law, while stating that assets in custody to be transferred to investors or setting up the order of claims repayment to creditors of investment brokerage company, including those who received compensation of €20,000 for failure to provide investment services, remains a silent about cases where assets in custody are only partially available and does not answer the question: how distribution (return of the remaining deeds) will take place in such cases? In other words, the law operates only in ideal categories and does not provide for any regulation in case of partial availability of assets.

As per data on 26 April 2022 from Insolvency Register (Maksātnespējas reģistrs) maintained by Register of Enterprises of Republic of Latvia there is no one entry regarding insolvency proceedings of investment

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[1] *For the purposes of the article only investment brokerage companies will be studied.*

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brokerage companies in the register, it means that regulation implemented into the FIML regarding return of the segregated assets in case of the insolvency are not tested in the practise. The preliminary review of it shows practical shortcoming in it. Thus, it is important to be prepared for new and evolving challenges by continuously improving of the Latvian system and ensuring of a greater level of protection of the customer securities.

METHODOLOGY

Methods and materials: methods used to achieve the aims of the study are comparative and analytical methods of scientific research. Materials of the studies consists of analysis of law texts, scientific articles and publications, as well practical experience gained in the topic of the research.

DISCUSSION AND RESULTS

Individual concepts of the US legal system in frame of intermediated holding: Financial assets and securities entitlements

The US legal system has 2 holding regimes – direct holding and indirect or intermediated holding. For the purposes of the article only intermediated holding with be review as the holding being in the scope of the scientific interests of the authors, because Latvian intermediaries has access to the US market only via intermediaries[2].

The intermediated holding system is mainly governed by provisions of Part 5 of Article 8[3] and Article 9 of Uniform commercial code (UCC, 2009) (thereinafter – UCC). It should be noted that UCC itself does not govern asset holding and separation requirements or duties of intermediaries, but lays the foundation for the legal system, which is detailed in federal laws and regulations in relation of securities, activities of intermediaries, as well as laws governing insolvency proceedings. Review of provision of UCC is required for better understanding of the definitions and their meanings in US system, because this is the basis for the understanding of the whole system, the system which utilizes the concept of the "securities entitlement".

Financial asset is a concept which includes both securities and other property or property entitlement, which are held in a securities account and on which it has been agreed that this property forms a financial asset (UCC §8-102 (9)). Financial assets are held in securities accounts by securities intermediaries. Investors and customers of intermediaries own entitlement rather than a financial asset. This statement also applied to securities – respectively, the investor or the security entitlement holder owns security entitlement

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[2] *An intermediary for the purpose of the article is the provider of the investment service, who ensures holding of the assets, securities and funds. In accordance with UCC §8-102 (14) securities Intermediary means (a) clearing corporations (b) persons, including a bank or broker, that in ordinary course of business maintains securities accounts. It should be noted that US securities accounts may be held not only by banks and brokers, but also by other commercial companies. Under Article 8 of UCC a broker is a person registered as a Broker-Dealer under the US federal securities laws.*

[3] *Article 8 of UCC is related to investment securities. Part 1 contains important definitions and concepts such as control, choice of law, securities intermediaries. Other parts of Article 8 specify the matters related to the issue and the issuer (Part 2), transfer of certificated and uncertificated securities (Part 3) and registration of transfer. Part 5 contains regulations of the intermediated holding system.*

rather than the security itself. (Chun, 2012) This is critical difference between individual ownership model and securities entitlement model: in the first investor owns securities, in the last investor owns – securities entitlement.

It should be noted that "security entitlement" means not only security entitlement, but also interest with respect to the financial assets in the securities account. "A security entitlement is a package of rights less then ownership on underlying financial asset". Chun (2012) emphasises that the concept of "security entitlement" is formed by rights and property interest. So, the concept of "security entitlement" is "*sui generis*" interest representing both personal and property rights in the underlying pool of assets". (Johansson, 2010).

Proprietary aspects of the concept of "Securities entitlement"

Pro rata property interest

A security entitlement has the nature of a proprietary rights, but the proprietary nature is reshaped, and limited till a proportional participation, without a direct right to a specific financial asset. (Chun, 2012). Section UCC 8-503(b) specifies that a security entitlement is a *pro rata* property interest in all interests in that financial asset held in a securities account by an intermediary, irrespective of the sequence or the relevant intermediary's acquisition (reception) time of that financial asset in the account. This *pro rata* property interest is similar to the institution of co-ownership rights known in the Latvian law.[4]

On the ownership of pro rata property interests and satisfaction of creditors' claims from financial assets

To satisfy pro rata property interests of investors, UCC § 8-503 (a) specifies the legal regime for the financial assets held in securities accounts:

(a) first, the intermediary holds financial assets on behalf of the investor;

(b) second, financial assets are not property of the intermediary;

(c) third, no part of financial assets can be subject to claims of creditors of the intermediary, except as otherwise provided in UCC § 8-511.

UCC § 8-511 lays down the sequence of satisfaction of claims in case of default of a specific financial asset, providing for priority in satisfying claims of investors in a financial asset (a), except when the creditor has a security interest in that financial asset and the creditor has control over the financial asset (c), as well as providing that if clearing corporations do not have sufficient assets the creditors who have a security interest in that financial asset have priority over the investor.

It should be noted that Part 8 of UCC does not presume that an intermediary ensures holding of financial instruments (securities) using other intermediaries. UCC § 8-503 does not provide for the obligation to

[4] *There exist, however, known differences, co-owner's rights are protected against all third persons and all co-owners, while pro rata property interest applies only to the assets held by a specific intermediary and does not limits "co-owners" in any other ways in concluding transactions (disposal of the financial asset if the intermediary does this in the ordinary course of its business).*
Latvia does not have a detailed legal model for holding financial instruments and assets: the basic concept is included into FIML, but the major uncertainty constitutes the rights of the investors in case of the insolvency of intermediary and loss sharing. While legal concept from the beginning is based on pro-rata interests and it forms the ground for the future loss sharing in case of securities shortfall. Whether loss sharing occurs among investors of one certain financial instrument, or all financial instruments held with certain depository institution or all financial instruments being in the holding of insolvent investment brokerage company?

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ensure separation of financial assets in upper tiers of accounts[5], i.e. to hold financial assets separately from own property. In fact, separation of financial assets is ensured at the level of accounts of the intermediary, i.e. in intermediary's internal records. Financial instruments are usually held in upper tiers in the omnibus account, i.e. assets of customers and assets of the intermediary are held together. The above-mentioned means that other intermediaries may use assets owned by their customers to repay debts of the intermediary and other intermediary's customers.

The financial assets holding regime provided for in UCC § 8-503 differs from the segregation requirements in force in the Republic of Latvia. Chun (2012) specifies that the model selected by the United States is not formed to ensure separation of investor's securities from intermediary's securities. Thus, for instance, an opinion is provided in comments to UCC § 8-503 that due to the fact that intermediaries usually do not ensure separation in such a way so as to be able to determine the securities held for the benefit of the customer at any time, in result the statement "that customers' assets cannot be the object of claims of intermediary's creditors" does not reflect reality. (Chun, 2012)

However, the above-mentioned statement does not mean that the United States do not use other methods and techniques of investor protection, although they do not ensure complete security of investors' financial assets in case of intermediary's insolvency and return of financial assets, in particular taking into account the pro rata interest in the amount of financial assets in the intermediary's accounts.

In conclusion of that part, it is possible to say that the US regulatory framework:

a) formally recognises separation of property of the intermediary (provider of investment services) and the investor;

b) however, in individual cases investor's assets can be the object of claim of creditors of the intermediary and may thus be used to satisfy creditor's claims against the intermediary.

The concept of investor's asset means pro rata interest in financial property rather than the specific security or amount of money.

Ttechniques for the protection of financial assets in the United States

Overall, the US customer protection system used 2 different approaches to the protection of assets, Securities Exchange Commission (thereafter – SEC) approach under SEA rule 15c3-3 and Commodities and Futures Trading Commission (thereafter – CFTC) approach under CEA rules 1.20 and 30.7. Brief comparison of regulations is reflected in the Table 1: CFTC and SEC methods of investors protection.

Table 1: CFTC and SEC methods of investors protection.

SEA	**CEA**
SEA Rule 15c3-3 provides for 2 main customer protection methods:	The purpose of CFTC (CEA) Rules 1.20 and 30.7 is to ensure the protection of customer by requesting

[5] *Brokers-Dealers are obliged to ensure separation of their customers' securities only at the level of the investors' intermediary in accordance with rule 15c3-3 of the Securities Exchange Act (1934).*

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(1) possession and control over securities; (2) reserve formula. The purpose of the regulation is to specify the guidelines for separation of customers' assets, the method of separation and preventing the broker from excessive usage of customers' assets in its transactions, incl. to cover shortfall in the assets or short selling of customers' assets.	constant segregation of customers' assets. 2 statements are used to control the amount of segregated assets: (1) segregation statement; (2) secured amount statement. The purpose of calculating segregated and secured assets is to determine the amount of assets necessary to cover obligations towards customers.

"Segregation" will further mean the holding regime, in accordance with which assets are always held in segregation for the benefit of customers.[6] Meanwhile, "separation" will further mean the holding regime, in accordance with which assets are considered customers' assets, however, in individual moments, when the assets have not been paid in full, they are not necessarily held only for the benefit of customers.

Investor protection rules under SEA (1934)

All the largest US intermediaries are registered as Brokers-Dealers in SEC in accordance with SEA (1934)[7], and they should observe SEA rule 15c3-3 (thereinafter - Investment protection rules).

Investor protection rules contain requirements:

(i) to take over the physical possession or control of fully-paid securities[8] and excess margin securities. The above-mention, in fact, means that the Broker-Dealer is obliged to separate the above-mentioned securities in its accounting system and registers;

(ii) to hold securities in a separate reserve account for the exclusive benefit of customers, the amount of which has been calculated using a special formula and depends on the amount of customers' claims towards the intermediary.

The investor protection rules prohibit the Broker-Dealer to pledge fully paid securities or use them otherwise within proprietary business, as well as restricts the scope, to which the intermediary may pledge securities to third parties to secure margin loans[9].

However, the Broker-Dealer is entitled to use customers' assets (fully paid and partially paid) if the customer has separately agreed with this. As a result of such a consent the assets are no longer considered customer's assets, and customer's claims become claims of unsecured creditors.[10]

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[6] *The same meaning is used to describe method of investors assets protection under Latvian Law.*
[7] *SEA is the federal law and it is applicable throughout the United States.*
[8] *If control is not taken over, then situations are possible, when the assets held by the intermediary are initially used by a creditor of the Broker-Dealer to satisfy its claims and only then by investors.*
[9] *Security loans, as well as cash loans for securities trading.*
[10] *FIML allow usage of the customer assets if the customer agreed with it. As it was mentioned above the question is whether assets used by the Intermediary themselves or other customer or intermediary of the intermediary, thus the consequences of the usage of the assets under Latvian law not so clear, but we presume that the customers who allowed using of the assets without title transfer (title transfer is limited by provisions of the FIML: prohibited for the private customers, limited for professional and eligible counterparties), should belong to the specific group of the creditors, because his assets still are in the holding, thus if they are not used for the proprietary trading of the intermediary or are owed to him at the certain moment should not change the status of the*

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Overall, the purpose of the Investment Protection Rules is to determine the amount of financial assets, which should be separated and which the Broker-Dealer is not entitled to use in proprietary trading, as well as the method of separation and practice of separation for the purpose of preventing the use of fully paid customers' assets by the Broker-Dealer for financing of its own transactions, in particular in case of short selling.

The basic principles of operation of separated accounts can be formulated as follows:

(1) the balance sheet of customers' financial assets is separated from the balance sheet of the Broker-Dealer;
(2) The assets should not be used in the Broker's-Dealer's own transactions and for payment of debts of the Broker-Dealer, unless the customer has expressly agreed with this;
(3) in case of insolvency of a Broker-Dealer, the financial assets owned by customers should be clearly identifiable and shall be transferred to customers in accordance with the applicable insolvency regime;
(4) separated financial assets are returned in the order of priority, following the pro rata principle.

Remarks on the Investor Protection Rules (SEA)

Despite the requirements of the regulations to ensure separation of assets, cases shortfall in assets are observed in practice pretty often. The reasons of shortfalls are usually related to insufficient control over the amount of separated assets, to the use of assets contrary to the regulations or to fraud.

Such cases are quite often in the United States, e.g., in 2016, SEC concluded an agreement and imposed a penalty of 7.5 USD for violations of SEA 15c3-3, i.e., for improper management and separation of customers' assets (Merrill Lync, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corp. *v.* SEC, 2016). In another case involving Melrryl Linch SEC found that the company executed complex transactions to artificially reduce the required deposit of customer funds in the reserve account (Eversheds Suterhards, 2018). In yet another case (Tirrel, 2017), customers' funds were not deposited in a secure account and were used for speculative transactions. There are cases in practice, when the assets, which should be well-separated, are not held properly, or orders for division of assets are not fulfilled: J.P. Morgan Clearing Corp and J.P. Morgan Securities, 2016, fine of 2.8 million USD (Sherry, 2017), reason shortfall of Italian securities, in amount of 146 million USD). Other cases can also be mentioned here, when fines were imposed for asset holding violations resulting in shortfall of assets: Wedbush Securities Inc, 2018, fine of 2.8 million (Lofchie, 2018), Nomura Securities International, Inc., 2018, fine of 875,000 USD (Cadwalader, Wickersham & Taft LLP, 2018), etc.[11]

priority of the investor on receiving of the assets, especially if assets are fully paid. But law of Latvia states nothing about priority of the investors on receiving of the assets being in the holding of the intermediary, in case of insolvency of the last especially when assets are used or are not fully paid.

[11] *It should be noted, that a new SEC supervision initiative on a simplified procedure of examination of violations of section 15c3-3 was introduced in 2016, namely, all Brokers-Dealers had to notify about violations and undertake to make improvements to their operational compliance programme, as well as cooperate in violation investigation cases, pay fines and repay unjustly (illegally) received.*

In case of shortfall of assets loss sharing rules apply.

Loss sharing rules are based on the investors' *pro rata* asset interest. Only the approach to the distribution of damage differs in the regulations:

- *Pro rata* from the defined amount of assets;
- *Pro rata* from all the assets;
- *Pro rata* from all the assets belonging to a specific category of customers.

For example, within the Securities Investment Protection Act (1970) (thereinafter – SIPA) proceedings, the insufficient amount of assets is proportionally distributed among all the investors, and this amount is calculated not for the specific security, which is in default, but for all the assets in default together.

The above-mentioned means that despite the fact that assets have been paid in full, they were not used or pledged, there is a risk that the assets are lost due to the fault of the intermediary (Broker-Dealer or FCM broker).

CFTC and Investor protection rules

The questions of the protection of investors' assets were raised in US after insolvencies of MF Global Inc. and Peregrine Financial Group Inc. (Goldsmith, 2013), thus, for instance, only 89% of the amount of segregated assets was transferred to customers within the insolvency of MF Global Holdings (Heitkamp, 2013), and as a result significant amendments to the regulation were made in 2014.

Taking into account the existing regulation, all customers of FCM brokers[12] may be categorised as:

- customers trading futures (future contracts) and options listed on US futures exchanges ("US futures customers");
- customers trading futures and options listed on foreign exchanges ("Foreign futures customers");
- customers trading swaps, where clearing takes place in CFTC-registered clearing corporations ("Cleared Swaps Customers").

The segregation requirements applied to the segregation of assets of each category of customers vary. (CEA § 1.20(a); NFA Financial Requirements § 16(a); § 30.7(a); § 22(b))

The funds of US futures customers deposited as a security are segregated in a separate account held for the benefit of US futures customers. Funds of several US futures customers are usually held in a segregated account. The funds are separated from assets of the FCM broker. (CEA, § 1.20)

The funds of foreign futures customers deposited as a security in accordance with the requirements of the applicable foreign regulation are segregated in separate accounts. The assets may be held also abroad, i.e. outside the United States. The regulation sets restrictions for holding of assets outside the United States. Assets of several customers are usually held in segregated accounts. Segregated assets of Foreign futures customers cannot be held together with assets of US futures customers, because US futures customers assume additional risks. It is specified in the legal literature (Charles, 2014) that the main risk undertaken by Foreign futures customers is the risk that the asset does not get the same level of protection as assets of US

[12] *broker registered as Future Commission merchant.*

futures customers, because in the cases, when a FCM broker is liquidated, foreign regulations may apply in its liquidation.

When characterising segregation of assets of Cleared Swaps Customers, special attention should be paid to the segregation of US swap class assets, where the "LSOC" (legally segregated operationally commingled) technical model is functioning. The purpose of use of the model is to prevent that assets of one customer are used for the satisfaction of claims towards other customers, e.g., in case of a margin call. The purpose of introducing the new concept is to ensure full segregation and return of customers' assets and to avoid *pro rata* distribution of losses. (Cooper, 2013).

In conclusion of that part, it is possible to say that:

(1) Customers' Assets are segregated from assets of the FCM broker;

(2) the assets segregation requirements differ from the class of segregated assets, and in cases of insolvency the amount of assets intended to be returned is calculated within each class of assets (17 CFR Appendix B to Part 190 -Special Bankruptcy distribution);

(3) the assets included in one class cannot be used to satisfy claims of customers, which are related to the assets included in another class

Brief insight into US insolvency regimes

Insolvency of any person established or domiciled in the United States is subject to the Bankruptcy Code (1978), however, there are exceptions, when insolvency proceedings are supervised by the Orderly Liquidation Authority[13] (hereinafter referred to as OLA) or when the proceedings take place within the SIPA (1970) procedure.

The Bankruptcy Code includes several procedures, in accordance with which insolvency proceedings can be organised. For example, insolvency can also happen in accordance with Chapter 11 (Reorganization) or Chapter 7 (Liquidation) of Bankruptcy Code.

Liquidation of a stockbroker as well as liquidation of the Broker-Dealer takes place in accordance with Chapter 7, Subchapter III (Stockbroker Liquidation), liquidation of commodity brokers (FCM brokers) in accordance with Chapter 7, Subchapter IV (Commodity Broker Liquidation), while liquidation itself is codified in as *"Part 190 of Title 17 of the Code of Federal Regulations*" (Gotlieb, 2017), (Hensler, 2012).

In practice, there have been attempts to perform liquidation under Chapter 11 (Reorganization)[14], however, it is specified in the legal literature (Gotlieb, 2017) that liquidation of a stockbroker and liquidation of a commodity broker should take place in accordance with Chapter 7.

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[13] The OLA authorisations are specified in the Dodd-Frank Act (2010). Orderly liquidation proceedings are applied in the cases, when a systemically important financial institution is in difficulty and the institution is too big to fail. The purpose of the proceedings is to liquidate quickly and effectively the big institution close to failing. Provisions of 12 U.S.C. § 5383 (Dodd-Frank Act (2010) § 203) apply to determine the systemic nature of the institution. In accordance with § 5383 (a)(1)(B), a Broker-Dealer is considered a systemic financial institution.

[14] In case of Refco insolvency, there was an attempt to perform reorganisation in accordance with provision of Chapter 11. Thanks to SIPC, Refco was obliged to conclude an agreement with creditors or pay for assets, and, only when these conditions were fulfilled, the court confirmed the possibility to perform liquidation of Refco in accordance with Chapter 11. (GlobalCustodian, 2006) However, also in this case the proceedings took place under supervision of Securities Investors Protection Corporation (SIPC).

Liquidation of stockbrokers, if they are members of SIPC, is subject to the SIPA liquidation procedure. SIPC designates a special SIPA trustee. Within the SIPA procedure, claims of customers of an insolvent broker are granted priority in receiving assets compared to other unsecured creditors.

It is specified in the legal literature that the proceedings that do not happen within SIPA, are fundamentally different from the SIPA proceedings. If liquidation does not take place in accordance with SIPA rules, then the purpose is not maximum return of assets, but maximum quick satisfaction of creditors' claims, as a result assets are sold, and creditors (customers) receive amounts in proportion to their claims instead of securities.

A SIPA trustee is vested with the authorisations defined under the law to satisfy net equity claims[15] in securities 15 U.S.C. § 78fff-2(d)) / SIPA, it is obliged to return customer name securities[16] (15 U.S.C. § 78fff-2(c)(2)) / SIPA), return based on the *pro rata* principle securities, which are held in "street name" as customer property[17], as well as to repay remaining customer's claims from SIPC funds (SIPA §§ 78fff-2(b) and 3(a)), if the funds are not sufficient.

The trustee operating under the Bankruptcy Code does not have the authorisation of a SIPA trustee, because the Bankruptcy Code ensures protection of the value of customers' assets liquidating all the securities not held in "customer name" (i.e. held in "street name"), and within the proceedings the customer receives monetary compensation rather than securities.

SIPA recognises that a broker can be dually registered, i.e. in SEC and CFTC, and, taking into account that two separate insolvency proceedings cannot take place at the same time within one insolvency proceedings, the SIPA trustees has been vested with specific authorisations to act in accordance with Chapter 7, Subchapter IV (FCM Broker Liquidation).

So, if a broker is dually registered, the SIPA trustee shall separate customer property and apply 2 different proceedings: with regard to customer property protected in accordance with SIPA rules (i.e. when the insolvent person (person to be liquidated) operates as a SEC-registered Broker-Dealer), and with regard to customer property held in accordance with CFTC rules (segregation) (i.e. when the insolvent person (person to be liquidated) provided services to the customer as a FCM broker).

Insolvency proceedings of dually registered brokers usually take place in accordance with the procedures set by SIPA. It should be noted that SIPA was applied to the insolvent *Bernard L. Madoff Investment*

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[15] A customer's "net equity claim" equals the dollar amount of all cash in the customer's account at the broker-dealer for the purpose of purchasing securities plus the value of securities held in the customer's account minus any amount owed by the customer to the broker-dealer. A net equity claim represented by securities owned by a customer will to the extent possible be paid in kind by a distribution of securities of the same class. If the broker-dealer does not own enough securities to cover the claim, SIPC will attempt to purchase the needed securities in the marketplace. (See 15 USC Section 78fff-2(d).) (Broker-Dealer & Investment Management Regulation Group, 2008).

[16] "Customer name securities" are securities registered in the name of the customer and are not transferable in the hands of the failed broker-dealer. They do not include securities registered in the name of the customer which, by endorsement or otherwise, were in negotiable form. The stock transfer certificate must be completely unavailable to the broker-dealer so that it would be impossible for the broker-dealer to transfer the security to a new name. (Broker-Dealer and Investment management regulation group, 2008)

[17] "Customer property" is "cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted. (15 U.S.C Section 78lll (4) / SIPA).

Securities LLC (SEC vs Madoff, 2008), *Lehman Brothers Inc.* (SIPC v. Lehman Brothers Inc, 2008) and *MF Global Inc*.

It should be noted that SIPA proceedings and liquidation in accordance with Chapter 7, Subchapter IV are different, because under Chapter 7, Subchapter IV fully segregated positions are usually transferred to another registered service provider[18], while in case of liquidation under SIPA rules[19] assets are distributed based on the *pro rata* principle.[20]

It can be concluded from the aforementioned that assets segregated in the status of a FCM broker within insolvency proceedings are usually transferred to another broker[21], the assets protected in accordance with SIPA rules shall be returned to the maximum possible degree, the assets not protected in accordance with SIPA rules, but declared customer property are not returned, but compensation is paid instead, while the claims with regard to property, which is not declared customer property, are satisfied in cash after all the customers' claims are satisfied.

CONCLUSION

US law introduces a more complex investor protection system than Latvian law. Whereas US law implements different approaches for different types of assets, namely asset segregation and asset separation, where the asset separation approach is used for securities, Latvian law uses the asset segregation approach only. Despite the introduction of asset protection measures, shortfalls in asset are not rare in the US. Insufficiency of assets (financial instruments) in insolvency proceedings raises issues relating to the priority of return of assets held by the insolvent entity and the loss sharing among investors.

US law uses the concept of a security entitlement, which is a *pro rata* property interest in all interests in that financial asset held in a securities account by an intermediary as well as subsequent pro-rata loss sharing among investors. The law recognizes various types of pro-rata loss sharing (a) from the defined amount of assets; (b) from all the assets; (c) from all the assets belonging to a specific category of customers. In turn, the approach of Latvian law to loss sharing with regard to various pools of customers' assets (financial instruments), in case of their insufficiency, is not regulated[22]. Since in practice there may be situations where the securities of one type are fully sufficient to be returned to investors, while securities of another type are not, which raises questions as to how securities that are insufficient should be shared between all investors? In addition, the principle of return of assets to the maximum extent possible is also not

[18] *However, also in these cases closing of positions and distribution of assets based on the pro rata cannot be excluded if default of a specific asset within a class is stated. It should be noted that regulations contain exceptions, when positions are not transferred, for example, when a customer has negative balance (17 CFR § 190.06).*

[19] *Authors believe that the use of the "segregation" concept in this case would not be correct, it would be more correct to designate the process concerned as "separation of assets" (paid/unpaid). Attention should be paid that in the legal literature individual authors call the holding regime ensured by Brokers-Dealers (SEC) "segregation", thus leading to inconsistent use of terminology.*

[20] *When preparing this papers, the authors faced cases, when disputes occur within distribution of assets, because it is believed that the CFTC segregation regime is safer than SEC separation of assets in terms of preservation of assets, and there are attempts to use it as safe harbor.*

[21] *The authors cannot exclude that in the cases, when assets are in accounts of foreign intermediaries, default of funds (assets) may occur, and the pro rata transfer of positions and return of assets will most likely happen as a result of that.*

[22] *But it should be mentioned, that Latvian Insolvency law in general recognizes the pro-rata loss sharing.*

defined. This creates legal uncertainty, which has also not been resolved with the adoption of the Investment Brokerage Companies Law in 2022.

In our opinion, the regulation of the Republic of Latvia should determine the prohibition to meet the claims of one class of assets at the expense of another class of assets. Besides, we believe that assets should be returned to investors taking into account the place of their holding - the particular depositary institution and if similar assets have been held in a financial institution and are irrevocably lost or missing there, assets should be grouped not only between different asset classes, but also within the class between the institutions in which assets were held and only after that taking into account contracts - rights of asset use.

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Conflict of interests

The authors declare no conflict of interest.

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