

# A Complement to the Technological Change in the Exchange: Distressed Securities Market Participants and Investor Protection

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## I. INTRODUCTION

Advancements in information technology have altered business transactions. The recent years have witnessed how the Internet made paper unnecessary

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in the conduct of several business activities.<sup>1</sup> What used to be paper-based transactions are now being performed in electronic form.<sup>2</sup>

One of the trades significantly affected by this shift to electronic transactions is the securities market.<sup>3</sup> Due to advances in information technology, the securities market has experienced an unprecedented level of efficiency.<sup>4</sup> Transaction costs of trading lowered and price determination became more efficient through new electronic and virtual platforms.<sup>5</sup> These platforms also made cross-border transactions and inter-market trading possible.<sup>6</sup>

The paradigm shift in the securities market brought by technological advancements seems to be well-received by investors. For instance, it has been estimated that around 40 million people in the United States utilize computers in trading stocks and other financial instruments because of their

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1. 2 JAMES W. CORTADA, *THE DIGITAL HAND: HOW COMPUTERS CHANGED THE WORK OF AMERICAN FINANCIAL, TELECOMMUNICATIONS, MEDIA, AND ENTERTAINMENT INDUSTRIES* 107 (2005).

2. *Id.*

3. See Background to the UNIDROIT Convention on Substantive Rules for Intermediated Securities, *available at* <http://www.unidroit.org/english/conventions/2009intermediatedsecurities/overview.htm> (last accessed Feb. 28, 2013). It has been noted that

[o]ver the past [50] years, the practice of holding and disposition of investment securities has changed considerably. Departing from the traditional concept of custody or deposit of physical certificates, a system of holding through intermediaries has been developed for reasons of efficiency, operational certainty and speed. In this system, the greater part of securities is immobilised with a central securities depository. The investor holds securities through a chain of intermediaries that are ultimately connected to the central securities depository. The transfer of securities and the creation of security and other limited interests therein are in practice commonly effected by way of book entries to the accounts concerned. The securities themselves are no longer physically moved.

*Id.*

4. Chief Anthony I. Idigbe & Okorie Kalu, *The Nigerian Insolvency Law and the Rights of Creditors and Account Holders of Intermediated Securities vis-à-vis the Insolvent Intermediary*, Remarks at SEC on UNIDROIT Workshop on Intermediated Securities in Nigeria (May 2009) (transcript *available at* <http://www.punuka.com/uploads/THE-NIGERIAN-INSOLVENCY-LAW-AND-THE-RIGHTS-OF-CREDITORS-AND-ACCOUNT-HOLDERS-OF-INTERMEDIATED-SECURITIES.pdf> (last accessed Feb. 28, 2013)).

5. LAJOS BOKROS, ET AL., *FINANCIAL TRANSITIONS IN EUROPE AND CENTRAL ASIA* 224 (2001).

6. *Id.*

efficiency.<sup>7</sup> Another country that illustrates the warm investor reception for the use of the Internet for stock trading is Korea — majority of the stock traders there are already using the Internet for their transactions.<sup>8</sup>

Here in the Philippines, the use of the Internet to conduct securities market transactions is still in its early stages. As of August 2012, only a small minority (10–15 out of 133) of active brokerage houses in the Philippine securities market have online trading platforms.<sup>9</sup> Phone calls and physical interactions with intermediaries — i.e., stockbrokers and agents — are still inevitable to majority of investors.<sup>10</sup>

This, however, may change in the near future as the Philippine Stock Exchange (PSE) recently announced the scheduled launch of its Online Service Bureau (OSB) this year.<sup>11</sup>

Envisioned to “take advantage of the Internet and the continuous growth of online transactions,”<sup>12</sup> the OSB, on the one hand, will allow stock brokers to provide an online trading platform for investors at a cost significantly lower than developing their own online platforms.<sup>13</sup> On the other hand, it will also allow securities investors to transact their securities market activities through their own computers and mobile phones.<sup>14</sup>

With the OSB, the PSE anticipates that 20% of the securities market transactions in the next three years “will be facilitated by brokerage firms that offer investors [ ] online retail account[s].”<sup>15</sup>

In addition to the OSB, the PSE is also upgrading information technology “engines for its clearinghouse, issuers, and traders.”<sup>16</sup> As

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7. R. KELLY RAINER & CASEY G. CEGIELSKI, INTRODUCTION TO INFORMATION SYSTEMS: ENABLING AND TRANSFORMING BUSINESS 210 (2010).

8. *Id.*

9. Doris C. Dumlao, *Philippine bourse sets online trading platform*, PHIL. DAILY INQ., Aug. 20, 2012, available at <http://business.inquirer.net/77886/philippine-bourse-sets-online-trading-platform> (last accessed Feb. 28, 2013) & *PSE set to launch online trading facility this month*, BUS. MIRROR, Jan. 2, 2013, available at <http://businessmirror.com.ph/index.php/business/companies/6979-pse-set-to-launch-online-trading-facility-this-month> (last accessed Feb. 28, 2013).

10. *Id.*

11. Neil Jerome C. Morales, *PSE, SEC set to launch new products*, PHIL. STAR, Jan. 21, 2013, available at <http://www.philstar.com/business/2013/01/21/899207/pse-sec-launch-new-products> (last accessed Feb. 28, 2013).

12. Dumlao, *supra* note 9.

13. *Id.*

14. *PSE set to launch online trading facility this month*, *supra* note 9.

15. Morales, *supra* note 11.

enunciated by PSE President Hans J. Sicat, the PSE envisions itself to be “an exchange [that is] very much 21st century in terms of the [information technology] foundations.”<sup>17</sup>

This Essay seeks to complement the PSE’s laudable efforts in making the Philippine securities market contemporary with the recent advancements in information technology. As a supplement to these opportune upgrades in the region’s oldest bourse,<sup>18</sup> the Essay examines whether the country’s current laws provide enough investor protection from an inevitable aspect of any business endeavor — insolvency.<sup>19</sup> While recognizing that the planned technological changes in the PSE will certainly give a boost to the rise of the country’s securities market, the Essay also considers the fact that the virtual platform’s unprecedented efficiency and speed may invite thieves and embezzlers to develop more efficient means of running away with other people’s hard-earned money.<sup>20</sup>

Thus, the Essay discusses the investor protection measures granted by Philippine laws — particularly the Financial Rehabilitation and Insolvency Act<sup>21</sup> (FRIA) and the Securities Regulation Code<sup>22</sup> (SRC) — to minimize the insolvency risks that investors must assume in the country’s securities market. It is hoped that this discourse on the Philippine legal system’s investment protection measures complement the upcoming technological change in the country’s sole stock exchange.

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16. *PSE set to launch online trading facility this month*, *supra* note 9.

17. *Id.*

18. Rouchelle R. Dinglasan, *Investing in Philippine stocks: A quick guide*, available at <http://www.gmanetwork.com/news/story/253974/economy/finance/investing-in-philippine-stocks-a-quick-guide> (last accessed Feb. 28, 2013). The Philippines became acquainted with investment instruments as early as the late 1920s — when the Manila Stock Exchange and the Makati Stock Exchange opened. *Id.*

19. See CHAN HO LOOK, *CROSS-BORDER INSOLVENCY: A COMMENTARY ON THE UNCITRAL MODEL LAW 7* (2007).

20. See Idigbe & Kalu, *supra* note 4.

21. An Act Providing for the Rehabilitation or Liquidation of Financially Distressed Enterprises and Individuals [Financial Rehabilitation and Insolvency Act (FRIA) of 2010], Republic Act No. 10142 (2010).

22. Securities Regulation Code [SECURITIES REGULATION CODE], Republic Act No. 8799 (2000).

## II. INSOLVENCY RISK — AN INVESTOR’S PRIMARY CONCERN

The fall of a securities market participant is not unknown to the Philippine securities market.<sup>23</sup> Even before the proliferation of electronic and virtual trading platforms, instances of brokers becoming insolvent have been reported.

Several years ago, local stock brokerage firm HK Securities Inc. collapsed allegedly because of the fraudulent activities of its owner.<sup>24</sup> It has been reported that the local stockbroker’s misuse amounted to more than ₱106 million.<sup>25</sup> The PSE eventually padlocked the firm’s offices, and took over the assets of HK Securities Inc.<sup>26</sup> It also started the liquidation of HK Securities Inc.’s trade-related assets.<sup>27</sup> Complaints of syndicated estafa have also been filed against the officers of HK Securities who are alleged to have committed the fraudulent transactions.<sup>28</sup>

From the investor’s point of view, however, the collapse of HK Securities Inc. further fortified one thing: even stock brokers are not immune to financial collapse. It proved that all investments in the securities market are subject to insolvency risk — even those invested in a firm owned by a former president of a local chamber of commerce.<sup>29</sup>

## III. SECURITIES MARKET PARTICIPANTS UNDER THE FRIA

The FRIA provides several measures that minimize the abovementioned insolvency<sup>30</sup> risk. Unlike the Insolvency Law,<sup>31</sup> the FRIA is cognizant of the

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23. Doris Dumlao, *Insurance fund for stocks, bonds proposed*, PHIL. DAILY. INQ., May 5, 2009, available at <http://business.inquirer.net/money/breakingnews/view/20090504-203020/Insurance-fund-for-stocks-bonds-proposed> (last accessed Feb. 28, 2013).

24. *Id.*

25. *Id.*

26. Doris Dumlao, *SEC junks HK Securities’ appeal*, PHIL. DAILY. INQ., Aug. 7, 2011, available at <http://business.inquirer.net/11159/sec-junks-hk-securities%E2%80%99-appeal> (last accessed Feb. 28, 2013).

27. *Id.*

28. HK Securities execs jailed, available at <http://www.abs-cbnnews.com/business/02/17/11/hk-securities-execs-jailed> (last accessed Feb. 28, 2013).

29. Dumlao, *supra* note 23.

30. Under the FRIA, the term “insolvent” refers “to the financial condition of a debtor that is generally unable to pay its or his liabilities as they fall due in the ordinary course of business or has liabilities that are greater than its or his assets.” Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 4 (p). This definition provides for two tests in determining one’s insolvency: (1) the balance sheet test and (2) the equity test. See HECTOR S. DE LEON, COMMENTS AND CASES ON CREDIT TRANSACTIONS 532-33 (10th ed. 2006).

special relationship between the investor and the securities intermediary or the broker. Section 4 (mm) of the FRIA specifically provides that the term “securities market participant” refers to a “broker dealer, underwriter, transfer agent[,] or other juridical persons transacting securities in the capital market.”<sup>32</sup> Under the FRIA, investors of financially distressed security market participants are entitled to the following protective measures: (1) exception from the Stay Order; (2) priority in choice of rehabilitation receiver; and (3) absolute priority in liquidation proceedings.

#### A. Exception from Stay Order

One of the client-investor rights guaranteed under the FRIA finds relevance in cases of court-supervised rehabilitations. In these rehabilitations, included in the court order declaring its commencement is a Stay Order.<sup>33</sup> A Stay Order has the following effects:

- (1) [It] suspend[s] all actions or proceedings, in court or otherwise, for the enforcement of claims against the debtor;
- (2) [It] suspend[s] all actions to enforce any judgment, attachment or other provisional remedies against the debtor;
- (3) [It] prohibit[s] the debtor from selling, encumbering, transferring or disposing in any manner any of its properties except in the ordinary course of business; and

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On the one hand, the balance sheet test calls for the comparison of one’s assets and liabilities. *Id.* One is insolvent when all his assets, even if made immediately available, are not sufficient to pay for his debts. *Id.*

On the other hand, the equity test determines one’s insolvency based on his inability “to pay his debts as they become due in the ordinary course of business[.]” *Id.* Thus, “a person may be insolvent although he may be able to pay his debts at some future time on a settlement and winding up of his affairs.” *Id.*

31. An Act Providing for the Suspension of Payments, the Relief of Insolvent Debtors, the Protection of Creditors, and the Punishment of Fraudulent Debtors [Insolvency Law], Act No. 1956, as Amended, (1909). The Insolvency Law contains no provision regarding the liquidation or rehabilitation of a securities market participant. This absence can be traced to the fact that the Insolvency Law was enacted in early 1900s. Back then, the notion of intermediated securities is not very common. As mentioned earlier, the earliest bourse in the region was only established in the 1920s. See Dinglasan, *supra* note 18.
32. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 4 (mm).
33. *Id.* § 16.

- (4) [It] prohibit[s] the debtor from making any payment of its liabilities outstanding as of the commencement date except as may be provided[.]<sup>34</sup>

The Stay Order encompasses a wide array of actions against and by the distressed entity.<sup>35</sup> Even secured creditors “cannot enforce their lien against the property of the debtor unless property is not necessary for the latter’s rehabilitation.”<sup>36</sup> This broad injunction from actions can last up to the end of the rehabilitation proceedings.<sup>37</sup>

The right of investors comes as an exception to the Stay Order. Section 18 of the FRIA provides:

Section 18. *Exceptions to the Stay or Suspension Order.* — The Stay or Suspension Order shall not apply:

...

- (d) to any form of action of customers or clients of a securities market participant to recover or otherwise claim moneys and securities entrusted to the latter in the ordinary course of the latter’s business as well as any action of such securities market participant or the appropriate regulatory agency or self-regulatory organization to pay or settle such claims or liabilities[.]<sup>38</sup>

Thus, despite the issuance of a Stay Order, investors of an insolvent securities market participant may commence and pursue actions to protect their interests. In fact, under Section 18, even regulatory agencies and self-regulatory organizations may pursue actions to protect the investors of an insolvent securities market participant.<sup>39</sup>

### *B. Priority in Choosing a Rehabilitation Receiver*

In addition to the right to commence actions even during the effectivity of a Stay Order, investors of insolvent securities market participants are also given additional protection by ensuring that the management of the financially distressed firm during the rehabilitation proceeding is to their best interest. This right comes into the picture during the nomination of the rehabilitation receiver — the person or entity that oversees the administration of the broker firm during its rehabilitation.

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34. *Id.* § 16 (q).

35. Eileen Rosario Cordero-Batac, The new Rehabilitation and Insolvency Act, *available at* <http://www.iflr1000.com/LegislationGuide/609/The-new-Rehabilitation-and-Insolvency-Act.html> (last accessed Feb. 28, 2013).

36. *Id.*

37. *Id.*

38. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 18 (d).

39. *See* Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 18 (d).

A rehabilitation receiver is a “person or persons, natural or juridical, appointed as such by the court.”<sup>40</sup> He has the “principal duty of preserving and maximizing the value of the assets of the debtor during the rehabilitation proceedings, determining the viability of the rehabilitation of the debtor, preparing and recommending a Rehabilitation Plan to the court, and implementing the approved Rehabilitation Plan[.]”<sup>41</sup> His powers, duties, and responsibilities include:

- (a) To verify the accuracy of the factual allegations in the petition and its annexes;
- (b) To verify and correct, if necessary, the inventory of all of the assets of the debtor, and their valuation;
- (c) To verify and correct, if necessary, the schedule of debts and liabilities of the debtor;
- (d) To evaluate the validity, genuineness[,] and true amount of all the claims against the debtor;
- (e) To take possession, custody[,] and control, and to preserve the value of all the property of the debtor;
- (f) To sue and recover, with the approval of the court, all amounts owed to, and all properties pertaining to the debtor;
- (g) To have access to all information necessary, proper or relevant to the operations and business of the debtor and for its rehabilitation;
- (h) To sue and recover, with the approval of the court, all property or money of the debtor paid, transferred or disbursed in fraud of the debtor or its creditors, or which constitute undue preference of creditor/s;
- (i) To monitor the operations and the business of the debtor to ensure that no payments or transfers of property are made other than in the ordinary course of business;
- (j) With the court’s approval, to engage the services of or to employ persons or entities to assist him in the discharge of his functions;
- (k) To determine the manner by which the debtor may be best rehabilitated, to review, revise[,] and/or recommend action on the Rehabilitation Plan and submit the same or a new one to the court for approval;
- (l) To implement the Rehabilitation Plan as approved by the court, if so provided under the Rehabilitation Plan;
- (m) To assume and exercise the powers of management of the debtor, if directed by the court pursuant to Section 36 hereof;

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40. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 4 (hh).

41. *Id.* § 31, ¶ 1.



- (n) To exercise such other powers as may, from time to time, be conferred upon him by the court; and
- (o) To submit a status report on the rehabilitation proceedings every quarter or as may be required by the court *motu proprio* or upon motion of any creditor or as may be provided, in the Rehabilitation Plan.<sup>42</sup>

Further, the rehabilitation receiver may even be given the power to manage the broker in the following instances:

- (a) Actual or imminent danger of dissipation, loss, wastage or destruction of the debtor's assets or other properties;
- (b) Paralyzation of the business operations of the debtor; or
- (c) Gross mismanagement of the debtor or fraud or other wrongful conduct on the part of, or gross or willful violation of this Act by existing management of the debtor or the owner, partner, director, officer or representative/s in management of the debtor.<sup>43</sup>

As for cases where the rehabilitation receiver is not ordered by the court to assume the management of the insolvent securities market participant, the receiver still has the power to recommend the appointment of a management committee.<sup>44</sup>

While creditors of and the broker may nominate candidates for rehabilitation receivers, under the FRIA, the rehabilitation court is mandated to give priority to the nominee of the appropriate securities or investor protection fund.<sup>45</sup> To this extent, investors are further protected as the FRIA gives preference to the rehabilitation receiver whose interest is in line with their interests.

### *C. Absolute Priority in Liquidation Proceedings*

In addition to the two investor protection measures discussed, the FRIA also grants additional protection to investors when it comes to the liquidation of

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42. *Id.*

43. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 36. Under Section 36, the replacement of the existing management by the rehabilitation receiver may be ordered by the rehabilitation court if any of the circumstances mentioned are proved by clear and convincing evidence. *Id.* Also, in case the court decides to appoint a rehabilitation receiver as such, the court may: “(1) require the rehabilitation receiver to post an additional bond; (2) authorize him to engage the services or to employ persona or entities to assist him in the discharge of his managerial functions; and (3) authorize a commensurate increase in his compensation.” *Id.*

44. *Id.* § 31, ¶ 2.

45. Compare Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 30, ¶ 1 with Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 30, ¶ 2.

a financially distressed broker firm. Under Section 133 of the FRIA, the preference of credits under the Civil Code<sup>46</sup> shall be observed in the implementation of the Liquidation Order.<sup>47</sup>

The Civil Code classifies an insolvent's credits into three: "(1) special preferred credits listed in Articles 2241 and 2242[,] (2) ordinary preferred credits listed in Article 2244[,] and (3) common credits under Article 2245."<sup>48</sup>

Articles 2241 and 2242 provide for credits with specific lien on properties.<sup>49</sup> It has been noted that the Articles do not provide for the order of preference with respect to the credits enumerated therein.<sup>50</sup> Rather, the Articles "merely enumerate the credits which enjoy preference with respect to [ ] specific movables [and] immovables[.]"<sup>51</sup>

As for Article 2244, preference of credits with regard to properties not covered by a lien is provided.<sup>52</sup> The Article grants "rights in favor of certain

46. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386 (1950).

47. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 133. This Section provides:

Section 133. *Concurrence and Preference of Credits.* — The Liquidation Plan and its Implementation shall ensure that the concurrence and preference of credits as enumerated in the Civil Code of the Philippines and other relevant laws shall be observed, unless a preferred creditor voluntarily waives his preferred right. For purposes of this chapter, credits for services rendered by employees or laborers to the debtor shall enjoy first preference under Article 2244 of the Civil Code, unless the claims constitute legal liens under Article 2241 and 2242 thereof.

*Id.*

48. HECTOR S. DE LEON, COMMENTS AND CASES ON CREDIT TRANSACTIONS 522-23 (11th ed. 2010) (citing *Republic v. Peralta*, 150 SCRA 37, 45 (1987)).

49. *Id.* at 523. See generally CIVIL CODE, arts. 2241 & 2242.

50. DE LEON, *supra* note 48, at 525.

51. *Id.* See DE LEON, *supra* note 30, at 501. Taxes, however, are preferred over other claims in the enumeration by virtue of Article 2243. The Article provides:

Art. 2243. The claims or credits enumerated in the two preceding articles shall be considered as mortgages or pledges of real or personal property, or liens within the purview of legal provisions governing insolvency. *Taxes mentioned in No. 1, Article 2241, and No. 1, Article 2242, shall first be satisfied.*

CIVIL CODE, art. 2243 (emphasis supplied). See DE LEON, *supra* note 30, at 506.

52. See CIVIL CODE, art. 2244.

creditors to have the case and other assets of the insolvent applied in a certain sequence or order of priority.”<sup>53</sup>

The enumerations provided under Articles 2241, 2242, and 2244 make no mention of the claims of investors of security market participants.<sup>54</sup> Thus it is covered by the third kind of credits — those governed by Article 2245. Under Article 2245, “[c]redits of any other kind or class, or by any other right or title not comprised in the four preceding articles, shall enjoy no preference.”<sup>55</sup>

Hence, under the Civil Code, in the liquidation of a securities market participant, the interests of its investors shall be considered as a common credit that will be paid *pro rata* regardless of the date of the transaction.<sup>56</sup>

Because of the FRIA, however, investors of securities market participant undergoing liquidation proceedings are raised to the status of a preferred creditor. Section 136 of the FRIA provides:

Section 136. *Liquidation of a Securities Market Participant.* — The foregoing provisions of this chapter shall be without prejudice to the power of a regulatory agency or self-regulatory organization to liquidate trade-related claims of clients or customers of a securities market participant which, for purposes of investor protection, are hereby deemed to have absolute priority over other claims of whatever nature or kind insofar as trade-related assets are concerned.

For purposes of this section, trade-related assets include cash, securities, trading right[,] and other owned and used by the securities market participant in the ordinary course of this business.<sup>57</sup>

With regard to trade related assets, therefore, claims of the investors of distressed securities market participants are converted into a special preferred

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53. DE LEON, *supra* note 30, at 512. *See also* DE LEON, *supra* note 48, at 534.

54. *See generally* CIVIL CODE, arts. 2241, 2242, & 2244.

55. CIVIL CODE, art. 2245.

56. DE LEON, *supra* note 48, at 543 (citing CIVIL CODE, art. 2251 (2)). Article 2251 of the Civil Code provides that

[t]hose credits which do not enjoy any preference with respect to specific property, and those which enjoy preference, as to the amount not paid, shall be satisfied according to the following rules:

(1) In the order established in Article 2244;

(2) *Common credits referred to in Article 2245 shall be paid pro rata regardless of dates.*

CIVIL CODE, art. 2251 (emphasis supplied).

57. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 136.

credit — being placed into the position of the credits provided under Article 2241 and 2242 of the Civil Code that have a lien over certain properties.<sup>58</sup>

Compared to creditors covered by Articles 2241 and 2242, however, investors of a securities market participant undergoing liquidation are better off with respect to two things.

First, investors of securities market participants are given preference over other creditors provided in Articles 2241 and 2242.

For instance, Article 2241 (2) provides that “[c]laims arising from misappropriation, breach of trust, or malfeasance by public officials committed in the performance of their duties, on the movables, money, or securities obtained by them”<sup>59</sup> are a subsidiary claim to a claim over a trade-related asset. Should there be a claim of this kind in the liquidation of a securities market participant, this claim must yield to the claims of the investors when the property involved is a trade-related asset. It is expressly provided in Section 136 of the FRIA that investors have “*absolute priority* over other claims of whatever nature or kind insofar as trade-related assets are concerned.”<sup>60</sup>

Second, the credits covered by Articles 2241 and 2242 of the Civil Code are “specifically preferred because they constitute liens (tax or non-tax) taking precedence over ordinary credits so far as it concerns the property to which the liens have attached.”<sup>61</sup> Their preference extends only up to the property over which they have lien. Investors of securities market participants, however, have a lien over the entire trade-related assets of the brokerage firm.<sup>62</sup> These include all “cash, securities, trading right and other owned and used by the securities market participant in the ordinary course of this business.”<sup>63</sup>

#### IV. THE SRC: FURTHER MINIMIZATION OF INSOLVENCY RISK

In addition to the protection afforded by the FRIA to investors of security market participants, the insolvency risks that investors take in dealing with security market participants is further minimized by another law enacted in the early years of the 21st century — the SRC. In the implementation of these protections in favor of investors, the SEC issued the Revised

58. Compare Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 136 with CIVIL CODE, art. 2243.

59. CIVIL CODE, art. 2241 (2).

60. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 136, ¶ 1 (emphasis supplied).

61. DE LEON, *supra* note 30, at 512.

62. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, § 136.

63. *Id.* § 136, ¶ 2.

Implementing Rules and Regulations of the SRC<sup>64</sup> (Revised SRC Rules) pursuant to Section 72 of the SRC.<sup>65</sup> These insolvency minimizing measures are: (1) the SEC's duty to protect investors of distressed brokers and (2) establishment of an accredited trust fund.<sup>66</sup>

*A. SEC's Duty to Protect*

The obligation of the SEC to protect investors of financially distressed securities market participants is generally found in Rule 33.1 (d) of the Revised SRC Rules.<sup>67</sup> It provides that whenever a broker that is an exchange trading participant is in a state of insolvency, under rehabilitation proceeding, or believed to be financially deteriorated, the SEC may issue an *ex parte* order requiring the former to "take the necessary action to protect customer accounts."<sup>68</sup>

The SEC, after investigation, may also "order an Exchange to take over the operation of the [said securities market participant] for the purpose of

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64. Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, Republic Act No. 8799 (2004).

65. SECURITIES REGULATION CODE, § 72. This Section provides that

SEC. 72. Rules and Regulations; Effectivity. — 72.1. This Code shall be self-executory. To effect the provisions and purposes of this Code, the Commission may issue, amend, and rescind such rules and regulations and orders necessary or appropriate, including rules and regulations defining accounting, technical, and trade terms used in this Code, and prescribing the form or forms in which information required in registration statements, applications, and reports to the Commission shall be set forth. For purposes of its rules or regulations, the Commission may classify persons, securities, and other matters within its jurisdiction, prescribe different requirements for different classes of persons, securities, or matters, and by rule or order, conditionally or unconditionally exempt any person, security, or transaction, or class or classes of persons, securities or transactions, from any or all provisions of this Code.

*Id.*

66. *See generally* Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d) & 36.5 (a).

67. *See generally* Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d). The Rule is entitled "Protection of Customer Accounts in Case of Business Failure of an Exchange Member (or Trading Participant)."

68. Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d) (1).

settling its liabilities to its customers.”<sup>69</sup> During the said takeover, the Exchange is mandated to settle the broker’s liabilities to its customers.<sup>70</sup>

It must also be noted that an Exchange’s takeover suspends the broker’s rights to participate in the Exchange.<sup>71</sup> Another broker is also appointed by the Exchange to carry on the outstanding contracts of the suspended broker.<sup>72</sup>

As for the clients of the distressed securities market participant, they are given notice of its suspension and the transfer of their accounts.<sup>73</sup> The suspension also entitles them “the opportunity to transfer anew their accounts to another [one] of their choice[.]”<sup>74</sup>

#### *B. The Accredited Trust Fund*

In addition, further protection of the investors’ interest in a distressed securities market participant is provided through the Accredited Trust Fund. The SRC provides that the SEC

may establish or facilitate the establishment of trust funds which shall be contributed by Exchanges, brokers, dealers, underwriters, transfer agents, salesmen and other persons transacting in securities, as the Commission may require, for the purpose of compensating investors for the extraordinary losses or damage they may suffer due to business failure or fraud or mismanagement of the persons with whom they transact, under such rules and regulations as the Commission may from time to time prescribe or approve in the public interest.<sup>75</sup>

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69. *Id.* rule 33.1 (d) (2).

70. *Id.* rule 33.1 (d) (3) (C). The Rule provides:

Where the Commission has ordered an Exchange to take over the operations of a failed Trading Participant, an Exchange shall:

...

C. Settle the failed Trading Participant’s liabilities to customers through the sale of the Trading Participant’s trading rights and other trade-related assets as may be prescribed by the Commission; the liquidation of paid up capital; and/or the supervision of payment of claims against the surety bond[.]

*Id.*

71. *Id.* rule 33.1 (d) (3) (A).

72. *Id.*

73. Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d) (3) (B).

74. *Id.*

75. SECURITIES REGULATION CODE, § 36.5.

Under the Revised SRC Rules, “[a] trust fund established to compensate customers for the extraordinary losses or damage they may suffer due to the business failure or fraud or mismanagement of a Broker Dealer shall be registered as an Accredited Trust Fund[.]”<sup>76</sup> Membership to the said trust fund is a condition *sine qua non* for the registration and continuing registration of a broker that is an exchange trading participant.<sup>77</sup>

Investors of financially distressed securities market participants are protected by the trust fund in two instances.

On the one hand, the trust fund protects investors from the business failure of securities market participants. Under the Revised SRC Rules, there is business failure “when the financial condition ... has so deteriorated that [it] cannot readily meet the demands of its customers for the delivery of securities and/or the payment of sales proceeds[.]”<sup>78</sup> The Revised SRC Rules expressly provides that the determination of business failure does not require a judicial declaration of insolvency.<sup>79</sup>

On the other hand, the trust fund also protects investors in cases where the brokers’ trade-related assets — upon liquidation — are insufficient to pay their claims.<sup>80</sup> In cases such as this, the accredited trust fund shoulders the unsatisfied claims of the investors.<sup>81</sup> Further, the trust fund may also pay the investor before the final liquidation of the insolvent broker’s account.<sup>82</sup>

In a World Bank report, it has been opined that the provision of the SRC referring to the trust fund for investor protection has been implemented through the creation of the Securities Investor Protection Fund (SIPF).<sup>83</sup> The SIPF is “a non-stock, non[-]profit corporation, [ ] organized for the main purpose of creating, maintaining and administering a fund for the interest and promotion of the securities industry, and for aiding and

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76. Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 36.5 (a) (1).

77. *Id.* rule 36.5 (a) (4).

78. *Id.* rule 36.5 (a) (3).

79. *Id.*

80. *See* Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d) (3) (E).

81. Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d) (3) (F).

82. *Id.* The Revised SRC Rules provide that the payment of the investors’ claim in advance subrogates the trust fund to the rights of the investor to the extent that it has paid. *Id.*

83. *See* The World Bank, et al., Philippines (Financial Sector Assessment Program) 40-41 (2002), available at [http://www.worldbank.org/ifa/rosc\\_sr\\_phl.pdf](http://www.worldbank.org/ifa/rosc_sr_phl.pdf) (last accessed Feb. 28, 2013).

protecting investors and securities and members of the [SIPF].”<sup>84</sup> The SIPF is funded through the monthly contributions of its members — the contribution being ₱10,000.00 plus one percent of the member’s gross trading volume.<sup>85</sup> In exchange, the SIPF entitles investors to a maximum recovery of ₱100,000.00 each.<sup>86</sup> In the World Bank report, it has been noted that “the SIPF has so far not been mobilized to act on a broker dealer insolvency.”<sup>87</sup>

## V. CONCLUSION

It has been stated that insolvency “is an inevitable by-product of the operation of the market[.]”<sup>88</sup> Whether on the virtual platform or not, investments made through securities market participants assume insolvency risks. Both the FRIA and the SRC provide for investment protection mechanisms that minimize these risks.

The newly-enacted FRIA provides protections both in the rehabilitation and in the liquidation of a securities market participant. During rehabilitation, investors are protected by being entitled to pursue actions against the distressed security market participants and by being given priority in choosing the rehabilitation receiver.<sup>89</sup> The FRIA also elevates the status of investors to creditors with special preference as far as trade-related assets are concerned.<sup>90</sup>

As for the SRC, it gives the SEC the primary duty to ensure that investors’ rights and interests are well-protected whenever a broker undergoes a financial distress.<sup>91</sup> It also creates a trust fund that act as guarantee to investors that a certain amount of their investments will be protected from the financial collapse of the broker.<sup>92</sup>

This Essay was primarily endeavored to complement the upcoming technological changes in the country’s stock exchange. In the course, it was discovered that unlike the legal regime before FRIA and the SRC, current Philippine laws are cognizant of the relationship between investors and

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84. Philippine Stock Market Advisory, *available at* <http://fglinc.tripod.com/otherorg.htm> (last accessed Feb. 28, 2013).

85. The World Bank, et al., *supra* note 83, at 41.

86. *Id.*

87. *Id.*

88. CHAN, *supra* note 19, at 7.

89. Financial Rehabilitation and Insolvency Act (FRIA) of 2010, §§ 31 & 36.

90. *Id.* § 136.

91. Revised Rules and Regulations Implementing the SECURITIES REGULATION CODE, rule 33.1 (d) (1).

92. *Id.* rule 36.5 (a) (1).



securities market participants. To this extent, the Author finds ease — for while the country's laws are not as modern as the information technology infrastructures to be introduced in the PSE this year, they offer at least quite a number of insolvency risk minimizing mechanisms. The laws may not be as modern as the PSE infrastructures; nonetheless, these laws can still offer a certain level of protection to the modern day investor.