INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

DIPLOMATIC CONFERENCE TO ADOPT A CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
Geneva, 1 to 13 September 2008

UNIDROIT 2008
CONF. 11 – Doc. 8
Original: English
March 2008

Informal Working Group on Article 14 of the draft Convention

Summary Report
(submitted by the Chair of the informal Working Group)

I. Principle

II. Structure and content of Article 14

III. Issues

1. **STANDARD OF INNOCENCE. HARMONISED STANDARD *VS* REFERENCE TO NATIONAL LAW. OTHER POSSIBLE APPROACHES. PROS AND CONS**
2. **RULE FOR ORGANISATIONS**
3. **ACQUISITION FOR VALUE**
4. **BURDEN OF PROOF**
5. **RELATIONSHIP BETWEEN PARAGRAPHS 1 AND 2 OF ARTICLE 14**
6. **EXCEPTIONS: PARAGRAPH 5 OF ARTICLE 14**
7. **RELATIONSHIP WITH OTHER PROVISIONS: ARTICLE 14 AND...**
   7.1. ARTICLE 10
   7.2. ARTICLE 13
   7.3. ARTICLE 18
8. **OTHER ISSUES**

ARTICLE 14: INNOCENT ACQUISITION

The Working Group on Article 14 of the UNIDROIT draft Convention on Substantive Rules regarding Intermediated Securities was one of the three informal Working Groups established by the Committee of Governmental Experts at its fourth session (see Doc. 95, par. 248). This paper attempts to summarise the main issues raised by Article 14. It is based on Doc. 96 (UNIDROIT 2007 - Study LXXVIII) and on the answers of the delegations to the questionnaire included in that

document (Docs. 97-107, 109, 112 and 114). Due to the differences of opinion, no drafting proposals are made. However, we consider that this report may be helpful to facilitate the discussions in the diplomatic session, since it identifies most of the problems raised by Article 14 and the different solutions with their pros and cons.

I. Principle

1. **Protection of innocent acquirers.** Article 14 seeks to offer an adequate protection to the innocent acquirer (**IA**) of intermediated securities. The principle underpinning this rule has received strong support. During the discussions in the Committee of Governmental Experts, there has been general agreement on the necessity to provide an adequate level of protection to **IAs.** The answers to the first Working Document (Doc. 96) confirm this need. Once a person has acquired a right over intermediated securities for value and without notice or constructive notice, no adverse claim should be asserted against that person. Accordingly, he should enjoy the same legal protection as any other account holder. The protection should encompass both (i) the rights of the **IA** *over* and *arising from* the intermediated securities and (ii) its personal liability. Given the speed with which securities are negotiated, this protection is of critical importance for the smooth functioning of capital markets.

II. Structure and content of Article 14

2. **Paragraph 1.** Article 14 contains five paragraphs. Paragraph 1 protects the **IA** (i) when the securities are credited to his securities account (ii) and he did not know that *"…another person has an interest in the securities or intermediated securities and that the credit violates the rights of that person with respect to that interest"*. If these conditions are met, the **IA** is protected and, therefore, (i) he is not subject to the interest of the adverse claimant; (ii) he is not liable to the adverse claimant; and (iii) the credit is not invalid or liable to be reversed.

3. **Paragraph 2,** in turn, protects account holders or <u>holders of an interest perfected under Article 10</u> from risks of an *"earlier defective entry"*. In this case, the innocent acquirer (*i.e.* who "does not know of an earlier defective entry") and his rights over the intermediated securities are also immunised: the credit or interest is not rendered invalid, ineffective or liable to be reversed and the acquirer is not liable to anyone who would benefit from the invalidity or reversal of the defective entry. This paragraph protects the account holder not only *vis-à-vis* a particular claimant (as paragraph 1), but *vis-à-vis* its own intermediary and all others who, invoking an earlier defective entry, would seek to revert the credit when the securities have been credited to that account holder´s securities account or an interest has become effective under Article 10, and he did not know of that early defective entry.

In both cases (paragraphs 1 and 2), the *timing* is based on *bona fide* evaluation at the moment when the securities are credited or, in paragraph 2, at the time of perfection of the interest under Article 10.

4. **Paragraphs 3, 4, and 5** make clear the scope and reach of the provision. Paragraph 3 establishes that the protection afforded by Article 14 only covers acquisitions for value. Paragraph 4 defines the concept of "defective entry" and concretises the "standard of innocence" (i.e. who qualifies as **IA**). And, finally, paragraph 5 introduces a partial exception to the rule foreseen in Paragraph 2: "*to the extent permitted by the non-Convention Law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement".*

III. Issues

5. Article 14 has raised many questions. Taking into account the comments sent by the delegations, the following pages attempts to summarise the main aspects of this provision and the problems they pose. In particular:

1. The standard of innocence to qualify as an **IA**;
2. The particular problems posed when the **IA** is an organisation;
3. The limitation to acquisitions for value;
4. The lack of a rule on the burden of proof;
5. The relationship between paragraphs 1 and 2 of Article 14;
6. The exceptions contained in paragraph 5 of Article 14;
7. The relationship of Article 14 with other provisions of the text, in particular Articles 10, 13 and 18;
8. Some drafting points.

1. STANDARD OF INNOCENCE

1.1. THE PRINCIPLE OF GOOD FAITH AND BOOK-ENTRY SECURITIES

6. **Traditional principle of good faith.** Though the content may vary significantly, the principle of protection of good faith acquirers is well-known to most legal systems. In property law, the principle has historically been developed in relation to tangible (usually, non-fungible) assets. This explains two *typical* features of this principle. (a) First, that the protection of the good faith acquirer is based on the appearance offered by the physical position of the asset by the transferor. The French expression is very eloquent: *"possession vaut titre".* The possessor of an asset may, under certain conditions, be reputed to be the owner of that asset. Therefore, a buyer who relies on the appearance offered by the possession of the seller may be protected under the principle of good faith. (b) Second, this principle is based on the transfer of *rights in rem.* As an exception to the basic rule that "one cannot give what one does not have" (*nemo dat quod non habet)*, the principle of good faith establishes that the acquirer receives a property rights over the asset deriving from the transferor, even though the transferor is not the owner of the asset.

7. **Good faith and book-entries.** These two features of the principle of good faith pose problems when they apply to intermediated securities, which are represented by book-entries. Here, there cannot be any reliance on physical possession insofar as the transferor does not have any physical asset representing the security. Accordingly, the reliance of the acquirer could only fall upon the book-entry (a credit)[1]. And secondly, under some legal systems, the rights over intermediated securities are not characterised as *rights in rem* over an asset (the intermediated securities), but as entitlements *vis-à-vis* the intermediary; according to this characterisation, a transfer implies that an entitlement is extinguished and a new entitlement is created.

8. **Functional approach.** The principle of the protection of **IAs** in the Convention should reflect these circumstances. The wording of the text should seek to offer a neutral and fact-based language both (i) adapted to the particularities of the book-entry securities and (ii) that can be accommodated to the different legal characterisations of book-entry securities in the different jurisdictions. This circumstances constitute the conceptual framework for the discussion.

[1] This is the assumption of the current text of Article 14. The acquirer is protected once the securities have been credited to his account. Note, however, that the account holder is not normally able to look inside the computers of the account provider. Therefore, the reliance is based more on the behaviour of his account provider than on the credit as such.

1.2. CURRENT TEXT

9. **Standard of innocence.** The current draft builds the standard of innocence, *i.e.* the threshold to qualify as an **IA**, on a test of notice or constructive notice. A person qualifies as an **IA**:

(a) Notice: if he has actual knowledge of a particular interest or fact (=**relevant circumstances)**. Specifically, paragraph 1 requires that the **IA** does not have knowledge that *"another person has an interest in the securities or intermediated securities and that the credit violates the right of that person with respect to that interest"*[2]. Paragraph 2, in turn, requires that the **IA** does not have knowledge of *"an earlier defective entry"*, which may make his rights or interest invalid, ineffective or liable to be reversed.

(b) Constructive notice: Even if he did not know those **relevant circumstances**, he should have known them. The test of constructive notice is formulated in the following terms: *"if that person has knowledge of facts sufficient to indicate that there is a significant probability that the interest or fact exists and deliberately avoids information that would establish that this is the case".* Mere negligence is not enough. The test requires (i) the person must have notice of suspicious facts that are sufficient to indicate that there is "a significant probability" of the existence of the **relevant circumstances** and (ii) that he deliberately or intentionally avoids actual knowledge. In other words, the person deliberately "shuts his eyes" (="wilful blindness").

In addition, three points are worthy of note. First, the test does not require collusion (between the parties). Secondly, the "wilful blindness" is not concretised by any catalogue of suspicious facts (as could be the price of the securities, the seller´s past activities or the existence of a data base). And thirdly, the test does not impose any obligation on **IAs** to investigate the suspicious facts. That is, Article 14 does not require that **IAs** take any step that may be reasonable to verify the existence of the **relevant circumstances**; under the Convention, the **IA** need do nothing provided he does not deliberately avoid information that would establish the existence of the **relevant circumstances.**

10. **Consequences.** If, according to the above, a person qualifies as an **IA** (and the acquisition is for value), he will be protected by the Convention. Therefore, he shall be considered as an account holder and entitled to the rights conferred by the Convention in relation to the corresponding intermediated securities. However, Article 14 is not to be interpreted *a contrario.* If a person does not qualify as an **IA** under Article 14, it does not mean that he is not going to be protected; it only means that the question is left to the non-Convention law. That is, it is left to the non-Convention law to solve the conflict between a non-**IA** under the standards of the Convention and the adverse claimant[3].

1.3. DISCUSSION: HARMONISED STANDARD *VS* REFERENCE TO THE NATIONAL LAW

11. As has been said, there seems to be agreement as to the need to protect the **IA** and to follow a neutral and functional approach to attain this aim. However, during the discussions in the last meeting of the Committee of Governmental Experts, there were some differences as to the better way to materialise the principle of the **IA**´s protection. Some delegations expressed their

[2] Note that the underlined terms expand the scope of protection of the rule. It is not enough that the acquirer knows that the right of another person has been violated. He must be aware of the fact that the credit to his account violates a *particular* right or interest of that person.
[3] This is clearly echoed by the paper submitted by the US (Doc. 112, p. 2).

concerns and doubts about the reasonability of the approach followed to date[4]. In particular, (i) it was considered that the proposed criterion may lead to a substantial level of uncertainty and (ii) it was questioned whether that approach was consistent with the functional approach.

12. **Possible approaches to the standard of innocence issue.** If we try to focus the analysis on the policy aspects, *i.e.* on the substance of the provision, and not on the terminology, two general approaches to the "innocent acquirer issue" are imaginable: (a) a reference to domestic law; or (b) a uniform standard set forth by the Convention. We can also explore other formulas combining both approaches: e.g. an opting-in or opting out uniform standard or a Conventional safe-harbour test plus a reference to the national law.

(a) The first option would be to make a reference to domestic law, *i.e.* to include a provision according to which the definition of who qualifies as "innocent or good faith acquirer" is determined by the domestic law (="a national law test")[5]. This would imply that each country maintained and applied its own concepts and its own standards (good faith, knowledge, collusion, etc).

Arguments. The main arguments invoked in favour of this option can be summarised as follows. **(i)** The concept of good faith is a well-rooted concept in most legal systems. Good faith is an open or general clause applied by courts with flexibility and susceptible of adaptation to different scenarios. Actually, the versatility of this clause has allowed several countries to expressly maintain the concept of good faith as applicable in relation to book-entry securities[6]. On the contrary, the establishment of a uniform standard based on a particular test ("knowledge or wilful blindness") may be a strange concept for certain countries[7]. **(ii)** Any harmonised clause would be doomed to failure as any rule seeking the protection of "innocent acquirers" must be based on uncertain concepts. Actually, one delegation pointed out that the very concept of "knowledge" is uncertain[8]. **(iii)** Finally, it can also be argued that introducing a special test in the Convention would produce a split regime between the rules applicable to tangible assets and the rules governing intermediated securities; and that this is not desirable[9].

(b) The other option is to establish a harmonised standard or clause in the Convention (="an autonomous or Conventional test"). This harmonised standard may have different degrees of concretisation. The scale can go from a rigorous test, such as collusion, or actual knowledge (as is the case of Article 29 of the UN Convention on promissory notes), to an open clause such as a good faith clause with a soft definition (for instance, a reference to concepts like "reasonable commercial standard")[10]. As has

[4] See the Working Paper submitted by the delegation of France, UNIDROIT 2007 – Study LXXXVIII – Doc. 95, Appendix 4. See also the Comments submitted by the French Delegation to the Working Paper on Article 14, in Doc. 107 Rev.
[5] The reference to the non-Convention law could be formulated in different ways. For example, the working paper submitted by France (Doc. 95) proposed to keep the concept of wrongful knowledge test but to refer its definition to national law: specifically, the proposal suggested the addition of the following sentence "*une personne a connaissance d´un fait ou d´un droit dans les conditions prévus par le droit non conventionnel*".
[6] See, other legal references in the document of the French delegation (Doc. 95), p. 3. This is the case of Spain as well as many other countries such as Denmark (Doc. 103, p. 1) or Germany (Doc. 98, p. 2).
[7] The paper of the French delegation (Doc. 95) argued that "*Introduire de tels tests dans des pays de droit civil deviendrait une source d´insécurité juridique pour ces derniers*".
[8] See the document of the French delegation (Doc. 95, p. 2).
[9] See the document of the French delegation (Doc. 107 Rev., p. 4).
[10] There is an important difference between making a reference to national law (="a national good faith clause") and including a "good faith clause" in the Convention (="a Conventional good faith clause"). In principle, under the latter option, the clause should not be applied taking into consideration the standards of a national law, but uniformly among Contracting States taking into consideration the fundamental principles of the Convention.

been said, the current draft opts for a relatively rigorous test: the circle of protection encompasses all persons who did not have knowledge of the adverse claim or were not "wilfully blind" to suspicious circumstances.

Arguments. The main arguments invoked in favour of this option are: **(i)** It promotes legal certainty as long as operators will not have to consult each national law to check whether they qualify as **IAs** or not. **(ii)** It is better adapted to modern securities markets than traditional good faith clauses. **(iii)** If the characterisation of the **IA** were left to national law, Article 14 would lose an important part of its function in the context of the Convention as a counterweight to the reference to national law in Article 13 (*infra*). **(iv)** The argument that a "national good faith clause" facilitates its application since it permits judges to take into account concepts and standards that are familiar to them does not always hold true. When the "non-Convention law", determined according to Article 3, does not coincide with the *lex fori,* the judge will have to concretise the clause under a foreign law.

(c) Finally, a third option could be to combine different solutions. For example:

(i) an opting out mechanism, according to which the Convention laid down an "autonomous or Conventional test", but the Contracting States could opt out and refer this question to the national law (either the *lex fori* or the non-Convention law ex Article 3); or an opting in mechanism in the opposite direction.

(ii) An autonomous test which functions as a "safe harbour": the Convention definition of **IAs** does not impede Contracting States from expanding the same protection to other persons under its national law. This should be the result under the current wording of Article 14 (*supra* n° 10). However, the Convention might make this "safe harbour approach" more explicit.

(iii) Another possible solution, suggested by one delegation, is to make a difference between stock exchange transactions (where the acquisition is deemed to be valid in any case) and OTC transactions (where the *bona fide* principle should apply)[11].

1.4. ANSWERS OF THE DELEGATIONS AND CONCLUSIONS

13. As has been said, there is general agreement on the need to include a rule on the protection of **IAs** in the Convention. As to the standard of innocence test, i.e., the standard to qualify as "innocent or good faith acquirer", most delegations favour a harmonised (=uniform) approach[12]. Most of them underline one argument to support this option. The case-law elaborated at the national-law level regarding the concept of good faith is mainly related to the acquisition of immovable or movable assets, i.e. assets with a physical existence where the possession (as appearance of ownership) plays a key role and where the asset is not fungible and therefore could be identified (the original owner could identify the acquirer of *his* assets). This is not the world of the intermediated securities. For this reason, (a) it is sometimes doubtful whether this test applies to intermediated securities[13]; (b) and, even if that is the case, it is doubtful whether the results are appropriate. One delegation has also stressed that it is very difficult to accept a reference to the

[11] See, Greece (Doc. 114, p. 4).

[12] In general terms, this is the position expressed by the UK, (Doc. 106, p. 5); Australia (Doc. 100, p. 2); Denmark (Doc. 103, p. 2), Finland (Doc. 102, p. 4); South Africa (Doc. 101, p. 4); Czech Republic (Doc. 99, p. 3); Switzerland (Doc. 105, p. 4); the US (Doc. 112, p. 6); partially, Germany (Doc. 98, p. 4: *"A uniform approach applying to all countries seems better suited in the field of electronic book-entries. The more neutral course would, however, be to make a reference to domestic laws"*).

[13] See the document by the UK (Doc. 106, p. 3-4), by Australia (Doc. 100, p. 1), Switzerland (Doc. 105, p. 3) and by Brazil (Doc. 109).

non-Convention law for those countries where the concept of good-faith is neither well-rooted, nor clearly defined[14].

As alternative approaches, those delegations suggest the inclusion of an opting-out clause[15] or clarifying the role of Article 14 as a safe harbour[16].

14. One delegation strongly favours a reference to national law for the reasons mentioned above underlining that a harmonised standard is neither necessary nor adequate[17].

15. As to the formulation of the standard of innocence in the current text, some delegations consider that it may be too lenient and one in particular advocate for establishing the gross negligence test as a safe harbour and allowing Contracting States to lay down more favourable rules for innocent persons[18].

2. THE PROBLEM POSED BY ORGANISATIONS AS IAS

16. **Organisations.** As to the application of the text of notice or constructive notice to an organisation, Article 14, paragraph (c) provides that an organisation "*knows of an interest or fact from the time when the interest or fact is or ought reasonably to have been brought to the attention of the individual responsible for the matter to which the interest or fact is relevant".* Accordingly, in order to attribute knowledge to an organisation, it is not enough that any person of that organisation has knowledge. The key element seems to be that the person responsible for the matter has knowledge or that there is an obligation to transfer the knowledge to that person.

17. **Issues.** This particular provision has not posed many problems for the delegations. It has been argued that the determination of the time of knowledge in cases of organisations is a very relevant issue. The rule seems, therefore, necessary[19]. However, a couple of delegations have raised two issues that will probably deserve attention in the diplomatic session[20]. (a) The scope of the term "organisations" and, in particular, whether it includes incorporate entities or also non-corporate entities or entities which lack legal personality (such as partnerships); and whether it includes the different legal companies within a corporate group. (b) Furthermore, one of these delegations suggests that the imputed notice rule should be extended to other individuals who act through an agent.

> By way of example, they offer the case where an investment bank arranges for the purchase of securities to be made by a related nominee subsidiary despite knowing of an adverse claim. In this case, the purchase could be protected from the adverse claim under the current Convention test on the grounds that the nominee subsidiary, as purchaser, had no knowledge of the claim. While the claimant may have a personal claim against the investment bank company, it will have no means of recovering the securities which may be crucial if the fund management company becomes insolvent. Therefore, this delegation

[14] See the document submitted by Australia (Doc. 100, p. 2).
[15] UK (Doc. 106, p. 5); US (Doc. 112, p. 6); Greece (Doc. 114, p. 4).
[16] See the documents submitted by Denmark (Doc. 103, p. 3); Finland (Doc. 102, p. 4); South Africa (Doc. 101, p. 4). Brazil directly advocates for the "safe-harbour" approach (Doc. 109, p. 4).
[17] See the document of the French delegation (Doc. 107 Rev., p. 4). It is also noteworthy that, according to this document, the choice expressed at the European level coincides with this approach (i.e., a harmonised good-faith test is unnecessary).
[18] See the document submitted by Finland (Doc. 102, p. 4) ; see also the document of the UK (Doc. 106, p. 3).
[19] See the document submitted by the UK (Doc. 106, p. 4) and by the US (Doc. 112, p. 4). One delegation, however, considers the rule superfluous, see, the document submitted by South Africa, arguing that the question could be left to the interpretation of the judges (Doc. 102, p. 3); Finland, in turn, doubts that the wording of the rule dealing with organisation is sufficiently clear and workable (Doc. 102, p. 3); France shares this view (Doc. 107 Rev., p. 4).
[20] See the document submitted by the UK (Doc. 106, p. 4) and Brazil (Doc. 109, p. 4).

proposes to exclude the application of the **IA** principle where the relevant knowledge is obtained by the legal entity within the group managing a trade even if there is an "innocent" nominee in whose name the securities are credited.

These are issues to be dealt with in the future diplomatic Conference.

3. ACQUISITION FOR VALUE

18. **Consideration.** Article 14 only protects **IAs** for value, *i.e.,* the protection offered by that provision does not apply in respect of the acquisitions of securities "*made by way of gift or otherwise gratuitously*" (Article 14(3)). In any case, under the current text, a security interest is always presumed to be for consideration (this clause prevents us from considering gratuitous, for example, the security interest granted by one person to secure the obligations of another related person).

19. **Wording of Article 14(3)**. There seems to be general consensus on limiting the protection of **IAs** to acquisitions for value[21]. However, as to the current draft of the provision, one delegation has called attention to the need to clarify the position of intermediaries acting for their account holders[22]. The proposal seeks to clarify that when an intermediary receives a credit on the books of the upper-tier intermediary and, in turn, the first intermediary credits the account of its account holder, that first intermediary does not acquire interest gratuitously (it may well be the case that the account holder paid the transferor directly). The intermediary, in this case, has given value by undertaking duties to its account holder arising out of the credit.

4. BURDEN OF PROOF

20. **Lack of rule.** Article 14 does not contain any rule on the burden of proof. Likewise, there is no presumption either in favour or against *bona fide.* Traditionally, different approaches have been applied depending on whether the principle lies on the protection of the owner or on the protection of the acquirer, but also depending on procedural elements (for example, whether a document that may facilitate the proof is under the control of the claimant or under the control of the defendant).

21. **The need of a rule.** The comments of the delegations are divided as to whether to include a rule or to leave this question to the national law, and in the latter case either to the non-Convention law or to the *lex fori*[23]. Some answers favour keeping the rule as it stands, i.e., leaving this question to the national law[24]. One delegation, on the contrary, points out that the rule on the burden of proof is inextricably linked to the formulation of the standard of innocence and, therefore, the issue deserves further attention[25].

---

[21] Only one delegation is favourable to extend the rule to gratuitous acquisition (see the document submitted by South Africa, Doc. 101, p. 3); Brazil considers that this point requires further attention since there are cases that should be treated as gratuitous transfers, such as deals close at a vile price or at a price quite lower than the market price (Doc. 109, p. 4).

[22] See the document submitted by the US delegation (Doc. 74, p. 2).

[23] Note that, unlike the Rome Convention (Article 14), the Hague Convention on securities does not mention expressly "legal presumptions or the rule on burden of proof" among the scope of the applicable law.

[24] See the document submitted by the EU Commission (Doc. 104, p. 2, asking for a clarification in the Explanatory Report in the sense the Convention respects the national law on this issue); and Switzerland (Doc. 105, p. 4).

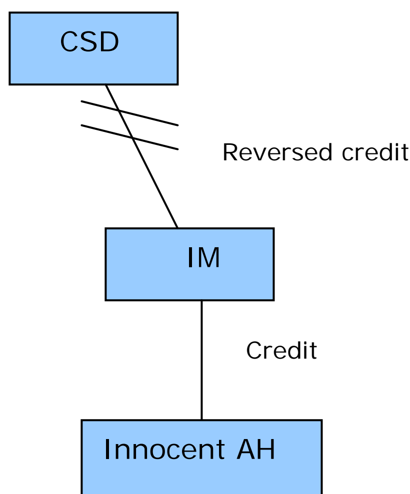
[25] See the document submitted by Finland (Doc. 102, p. 2).

5. RELATIONSHIP BETWEEN PARAGRAPHS 1 AND 2 OF ARTICLE 14

22. **Relationship between paragraphs 1 and 2.** The relationship between paragraphs 1 and 2 of Article 14 has posed difficulties for some delegations[26]. Originally there were two different provisions in the Convention: one dealing with good faith in general and the other dealing with the situation of an onward transferee (see Doc. 58)[27]. The current draft contains a different approach. Article 14 does not expressly deal with the case of an onward transferee. Paragraph 1 protects an **IA** from competing claims of another person, while paragraph 2 protects an **IA** *vis-à-vis* the risk of an earlier defective entry[28]. Some delegations have considered the second superfluous, as all situations covered by this paragraph were already included in paragraph 1: a defective entry necessarily implies the violation of the right or interest of another person, i.e., the types of cases foreseen by paragraph 1.

23. **Explanations.** However, it has been argued that there are good reasons to maintain the difference between the two paragraphs. In particular, two different scenarios - where the difference would make sense - could be suggested.

(a) **First scenario.** This is probably the case that most delegation had in mind when discussing this provision. Paragraph 1 envisions that the credit can somehow be traceable to the adverse claimant's own interest. Paragraph 2 covers the situation where an intermediary would seek to reverse a credit as a result of some invalid entry.



For example, an IM receives a credit on the books of the CSD that is reversible. When it is reversed on the CSD's books, the IM then seeks to reverse a credit to its account holder(s) (either a particular one based on timing, for example, or pro rata among all account holders for that security issue, so as to rectify a shortfall). In that case, under paragraph 2 the IM would not be able to reverse the credit to its innocent account holder(s). So, even though paragraphs 1 and 2 may overlap, 2 nonetheless can cover a situation to which 1 does not apply.

(b) **Second scenario** The second scenario is based on the difference between the ownership of the transferor and the title of the transfer. Paragraph 1 would deal with the former aspect and paragraph 2 with the latter.

Case 1: A has certificated securities, namely, A has ownership to the securities. B steals the securities from A. B obviously does not get ownership. B sold the certificate to C. C was in good faith. C gets ownership of the securities because of the IA rule. As a result, A loses ownership. A may sue B for damages, etc. Here, B never had property

[26] See the documents submitted by the EU Commission (Doc. 104, p. 1, concurring with the ECB); by Finland (Doc. 102, p. 3); by South Africa (Doc. 101, p. 3); by Brazil (Doc. 109, p. 4).
[27] One delegation proposes to make clear that the "onward transferee case" is covered by Article 14, see Greece (Doc. 114, p. 3).
[28] The concept of "defective entry" is defined in Article 14(4)(a). One delegation suggests to add a reference to the rules of the SSSs to make clear how that the qualification of an entry as defective may be determined by the rules of the SSS, see Greece (Doc. 114, p. 3).

right (or B never had ownership), and the transaction between B and C was not defective. It was a usual sales transaction.

Case 2: D has certificated securities, namely, D has ownership of the securities. D sells his securities to E. But the sale transaction was defective, for example, D was a minor, or D used another person X as an agent and X had no authority to sell, or the sale contract was void for some reason. Here, D was the owner, and the transaction from D to E was defective.

In many jurisdictions, as regards movables, it is well understood that the good faith rule covers Case 1 (where a good faith purchaser relies on B when B has no property right) but does not cover Case 2. There may be another doctrine which protects E in Case 2, but it is also possible to expand the good faith rule to Case 2. This would be the function of paragraph 2. In general, since it is well understood that situations (or parties' interests) are different between Case 1 and Case 2, dividing 14(1) and 14(2) is a good idea. It ensures that Article 14 protects innocent acquirers both *vis-à-vis* an acquisition *a non domino (*Case 1) and a defective transaction (Case 2).

24. Both fact patterns seem to be plausible and not mutually exclusive. Both offer an adequate explanation to justify the difference between paragraphs 1 and 2. However, the answers of the delegations to Doc. 96 prove the need to discuss further this issue, i.e. what types of cases or fact patterns are covered by paragraph 2, and, once identified, to clarify the text accordingly.

6. EXCEPTIONS: PARAGRAPH 5 OF ARTICLE 14

25. **Paragraph 5 of Article 14.** This paragraph introduces an exception to Article 14(2): *"To the extent permitted by the non-Convention Law, paragraph 2 is subject to any provision of the uniform rules of a securities settlement system or of the account agreement"*. Hence, in the example described above in paragraph 23(a), the reversal of the credit at the level of the upper-tier (CSD) may be invoked against the innocent AH to debit his account. This may be reasonable to ensure an adequate functioning of the SSS[29]. As has been pointed out, in some jurisdictions, it is possible that a sale transaction between two parties is subject to the rules of the SSS, and the SSS might want to make such a transaction null or reverse for some (systemic) reasons. This may even be invoked *vis-à-vis* the innocent buyer. Furthermore, insofar as the SSS or the account agreement are voluntarily agreed by the acquirer, this exception permits a sort of "voluntary renunciation" to the protection offered to a person as **IA**, and therefore should not be considered unfair.

26. **The reference to paragraph 2.** Paragraph 5 only refers to paragraph 2 and not to paragraph 1. This implies that the rules of a SSS may override the protection of the **IA** when the acquisition involves an earlier defective entry, while they cannot override the protection of the **IA** when the acquisition violates the rights of another party. The reason for this difference is not clear to some delegations[30]. However, this is due to the difference between these two paragraphs (*supra* paragraph 23). By their own nature, SSS do not deal with ownership over the securities but with the validity and effectiveness of book-entries. Therefore, if the rules of a SSS interfere, they will normally be in relation to the transaction itself and to the corresponding book-entries (i.e. the object of paragraph 2), and not in relation to the proprietary rights of the seller (i.e. the object of

[29] One delegation, however, alerts of the risk of paragraph 5 insofar as it allows to displace the protection afforded to the innocent acquirer under paragraph 2 and objects to its extension to paragraph 1, see the document submitted by the Swiss delegation (Doc. 105, p. 3).

[30] See the document submitted by the EU Commission (Doc. 104, p. 1, concurring with the concerns of the ECB); and by Finland (Doc. 102, p. 3).

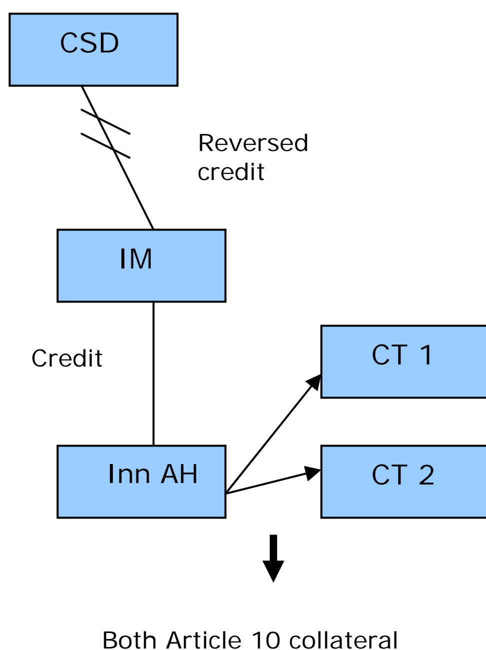
paragraph 1). Having said that, it may be true that paragraph 5 may also need some clarification after reconsidering the difference between paragraphs 1 and 2.

7. RELATIONSHIP WITH OTHER PROVISIONS

27. The relationship between Article 14 and other provisions of the Convention has also raised some problems; in particular, its relationship with Articles 10, 13 and 18.

7.1 ARTICLE 14 AND ARTICLE 10

28. **Issue.** Article 14(2) contains a reference to Article 10, which has no parallel reference in Article 14(1). The reason is that, under the current text, the collateral taker who takes the collateral by means of a credit has a proprietary right and is protected under Article 14; while the collateral taker who takes the collateral by means of a designating entry is only protected by the priority rule "first in time" (Article 15). Accordingly, different priory rules may apply depending on whether the disposition is made by credit or by designating entry.



Example 1. If we go back to the example of paragraph 23(a), we already know that the innocent acquirer AH is protected by Article 14(2) even if there is a reversal at the upper-level. If AH then gives his intermediated securities as collateral to CT 1 under one of the means foreseen in Article 10, CT 1 is also protected under Article 14(2) and the reversal of the credit at the upper-level cannot be invoked to make his security interest invalid or ineffective. If AH gives his securities as collateral to CT 1 under Article 10 and later to CT 2 also under Article 10, then the conflict between CT 1 and CT 2 is solved under the first in time rule of Article 15. Note that, in this case, CT 2 would also be protected under Article 14(2) *vis-à-vis* the defective entry at the upper-tier level.

29. **Rationale**. This seems to be the approach taken by the current text of the Convention. Some delegations, nevertheless, disagree with this approach[31]. They consider it "unjustified", leading as such to arbitrary results: the question whether there is actual acquisition under Article 14(1) or subject to prior interest will be dependent on a mere formality. If the book-entry is made in the same account (designating entry), there is subjection to prior interest, while if the book-entry is made on another account there can be an acquisition in good faith. Therefore, they suggest to move Article 10 methods to paragraph 1 of Article 14. Other delegations, on the contrary, defend maintaining the current approach[32]. They believe that restricting the scope of Article 14 to rights acquired by credit to a securities account is a sensible solution and permits us to distinguish the respective scopes of Articles 14 and 15. Under Article 14, the innocent acquisition of intermediated securities by credit to the account of an innocent acquirer trumps any previous interests in the securities. For example, secured lenders who held a collateral interest in the transferor's account lose their collateral interest. Extending Article 14 to the granting of interests

[31] See comments submitted by the German delegation (Doc. 98, p. 3).
[32] See comments submitted by the Swiss delegation (Doc. 105, p. 3).

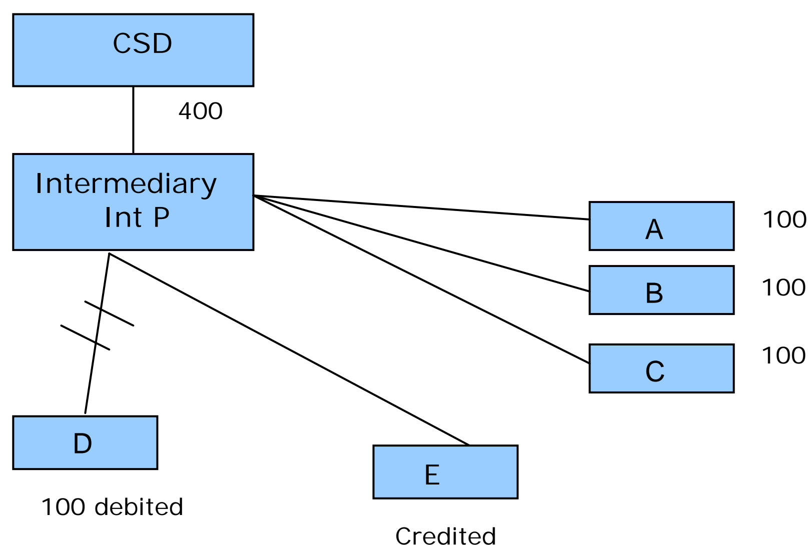
under Article 10 would thoroughly disrupt the priority set out by Article 15 among interests in the same intermediated securities credited to the same account. For example, in a jurisdiction where interests may be granted by control agreements, a subsequent, junior collateral taker would be able to claim innocent protection to get priority over a senior collateral taker in the same securities. This clearly disrupts the *prior tempore potior jure* priority set out in Article 15.

This discussion implies a policy decision that shall be taken in the diplomatic Conference. In any case, we will come back to this problem in the next paragraphs.

7.2. ARTICLE 14 AND ARTICLE 13

30. **Context of Article 14.** It is important to underline the systematic relationship between Article 13 and Article 14. According to Article 13, the non-Convention law determines whether a credit or a designating entry is invalid or liable to be reversed, its effects (if any) against third parties and the consequences of the reversal, and whether an entry may be made conditionally and the effects thereof. For this reason, it has been said that the *Convention does not harmonise the "debit side" of the transactions.* Article 14 serves as a counterbalance. It achieves a minimum of harmonisation in protecting **IAs**. If a person qualifies for Article 14, he will be protected irrespective of the interference of the non-Convention law. Following on from the same idea, it can be said that the Convention does not harmonise the "debit side" of the transaction but *it does harmonise the "credit side"*.

31. **Cumulative application of Articles 13 and 14.** However, the cumulative application of these two provisions may lead to practical problems. If a debit did not occur with the authorisation of the entitled party, the account holder is protected under Article 13: the debit is not valid. And the non-Convention law determines the consequences. Whereas, the creditor may be protected by Article 14; and the Convention determines the consequences, *i.e.* the **IA** has the rights conferred by the Convention to the intermediated securities credited to his account. This may lead to different results. We can analyse them with one practical example.



	A	B	C	D	E
Result 1	100	100	100	0	100
Result 2	80	80	80	80	80
Result 3	75	75	75	75	100
Result 4	100	100	100	50	50

Intermediary P has 400 on account of its clients (A, B, C and D). A, B, C and D had 100 each. D transfers his 100 to E, and Int P debited 100 to D and credited 100 to E. For some reason, D's debit turned out to be ineffective under Article 13(1). E is protected under Article 14. In turn, Article 13(1) renders 100 debiting to D to be ineffective and leaves the consequences to the national law. Let us assume that there are only 400 to be shared among A, B, C, D. and E. This scenario will probably not arise insofar as the Int P is obliged to cover all claims and will, therefore, buy additional 100 in the market to straighten out any shortfall. But this may be pointless if, before carrying out its obligations, Int P goes bankrupt or it may also not be the case if the intermediary made the debit following D´s instructions[33]. Then, four possible results are imaginable. Result 1 the non-Convention law considers that D lost his rights over the intermediated securities and only has a contractual claim against the intermediary or any person liable for the defectiveness of the entry. The outcome then is simple, D has a contractual right, and A, B, C, and E each has 100. This will be the result in most jurisdictions that characterise the rights of the account holders as a direct right over the underlying securities and, therefore, where if someone acquires something under the good faith principle, someone must have lost it[34]. Result 2 If according to the non-convention law, the debit is absolutely ineffective as to D, D should be considered as an account holder with a right over the 100. As there are only 400 to distribute among A, B, C, D, and E, a pro-rate rule applies and each account holder receives 80[35]. Result 3 Another possible solution would be to ensure complete protection to E under Article 14 and distribute the remaining securities among the other account holders. Under this rule, A, B, C, D would end up with 75 and E with 100. Result 4 Yet another possible rule is that the total of D and E should not be more than 100, namely, A, B, and C should not be affected. If so, the result is that D and E share and have 50 each.

32. With regard to this scenario (i.e. the insolvency of Int P before the correction of the shortfall), the current text of the Convention makes a difference between the "credit side" and the "debit side". As to the "credit side", E is protected as an account holder with a formal right/entitlement over 100 shares. As to the "debit side", the Convention only determines that the debit *vis-à-vis* D is invalid, but leaves the consequences to the non-Convention law. Therefore, the domestic non-Convention law may typically foresee either:

(a) that D has lost his rights over the intermediated securities and only has a contractual claim *vis-à-vis* the intermediary. This is probably the solution under those legal systems based on the principle that if someone acquires an asset under the *bona fide* principle, someone must lost it, and in practice will lead to Result 1.

(b) or that D has not lost his rights over the securities. In this case, D qualifies as an account holder (and obviously E as well). If according to the non-Convention law D maintains his rights over the 100 securities, the allocation shall be governed by Article 23 of the Convention (loss sharing rule).

In any case, this explanation means that Article 14 is only a rule that qualifies a person as an **IA**, but does not determine the economic consequences, i.e. it is a rule on the qualification of a person as account holder, but not a rule on allocation. Accordingly, if a person qualifies as IA, he has to be considered as an account holder, like any other account holders (which may include the *verus domino* if this is the case under the non-Convention law). The way to allocate the securities

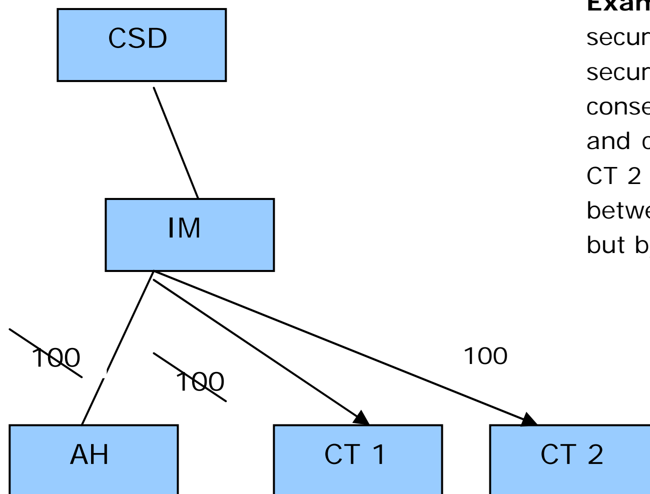
[33] Note that even if D instructed Int P to debit his account, the debit could be invalid under the non-Convention law if, for example, D´s consent was defective (because of duress, mistake, etc.).

[34] See the comments submitted by France (Doc. 107 Rev., p. 3); the EU Commission (Doc. 104, p. 1); and Germany (Doc. 98, p. 4).

[35] This is the so called "win-win situation" as both D and E are formally considered as account holder entitled to 100 each. Naturally, the "inflation of securities" is only formal and in the books of the intermediary.

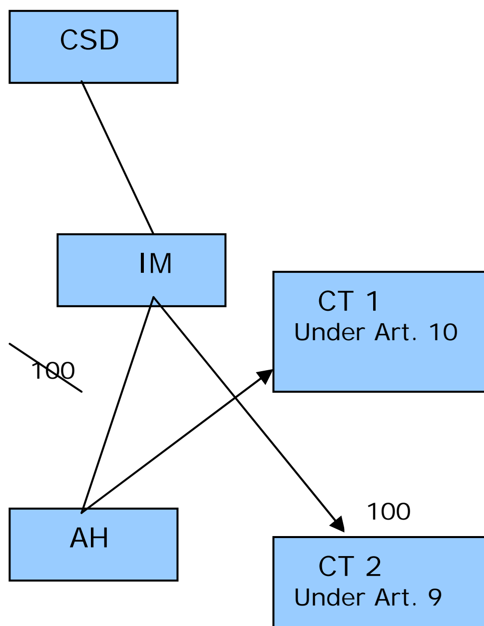
is then governed by Ch. IV (or by the non-Convention law, depending on the interpretation (a) or (b) which is finally adopted)[36].

33. It may be worth pointing out that the same analysis applies to a conflict between two (innocent) collateral takers under Article 9.



Example. Assume that AH gives his intermediated securities as collateral to CT 1 by crediting the securities to CT 1´s account. Then, without CT 1´s consent, the securities are debited from his account and credited to an account of CT 2. In this case, if CT 2 qualifies as an **IA** under Article 14, the conflict between CT 1 and CT 2 is not solved by Article 15, but by the rules just mentioned[37].

34. To have a whole picture of the relationship between Articles 10, 13, 14 and 15, it may be helpful to analyse one additional example: the conflict between a collateral taker under Article 10 and a collateral taker under Article 9.



Example. Assume that AH gives his intermediated securities as collateral to CT 1 by one of the means foreseen in Article 10. Then, without CT 1´s consent, the securities are debited from his account and credited to an account of CT 2. In this case, if CT 2 qualifies as an **IA** under Article 14, the conflict between CT 1 and CT 2 is not solved by Article 15 either. CT 1 cannot invoke his security interest *vis-à-vis* CT 2 under the prior in time rule. CT 2 qualifies as account holder with a (security) interest over the securities and CT 1 may only have a claim against AH.

[36] Note that in the above numerical example, E is allocated less than the full 100, that result does not reflect any flaw in the protection of E as **IA.** Instead, it is only a consequence of the fact that E chose to receive the insecurities in its account with Int P, Int P did no make good on its debit to D´s account and Int P failed.
[37] Note that, in that case, the debit would arguably be invalid if CT 1 did not consent and, therefore, Article 13 applies to the "debit side" of the transaction.

In this example, under the current text of the Convention CT1 could invoke Article 13(1) and reach the same result as that mentioned above for a conflict between two collateral takers under Article 9.

7.3. ARTICLE 14 AND ARTICLE 18

35. Some delegations have expressed their doubts about the relationship between Article 14 and the insolvency regime. In particular, if the insolvency administrator can be considered as "another person" in the meaning of Article 14[38]. If the answer is yes, the question then is whether it would mean that Article 14 can override the actions to set aside which are foreseen by the national law and protected under Article 18. Thus, the question is whether a person can argue that he acquired the intermediated securities for value and in good faith (i.e. without knowing the prejudice that the transfer may cause to the other credits) as an exception *vis-à-vis* the rules on avoidance of a transaction laid down by the insolvency rules.

36. This has not been discussed in detail so far and probably it deserves further analysis. In this case, the issue is linked to the scope of Article 18(a). According to this rule, nothing in the Convention (*including Article 14*) affects the insolvency rules relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors. At first sight, it means that Article 14 does not offer a "safe harbour" *vis-à-vis* the actions to set aside in an insolvency scenario *as long as the action to set aside in question is covered by the scope of Article 18* (i.e. if the transfer is in fraud of creditors[39]).

8. OTHER ISSUES

37. **Drafting point.** Article 14 paragraph 1.c *in fine* only foresees one reason for invalidity or reversibility ("*…that the interests or rights of that other person invalidate any previous debit or credit made to another securities account").* There is a proposal by one delegation to expand the scope of that subparagraph so as to generalise the rule: "*the credit is not invalid or liable to be reversed as a result of the interest or rights of that other person"*[40]. This would bring paragraph 1(c) more in line with the approach of paragraph 2(a).

38. **Additional proposals.** In relation to the scope of application of Article 14, the same delegation considers necessary to clarify two additional aspects:

(a) In cases in which the first-in-time priority rule of Article 15 does not apply, a person that acquires an interest under Article 10 should have the benefit of the protection offered by Article 14;

Arguments. Article 15 provides a first-in-time priority rule for competing interests acquired under Article 10 (*i.e.*, by way of designating entry or control agreement or by an intermediary from its account holder without further steps). Appropriately, moreover, Article 15 applies only to competing "interests in the same intermediated securities", *i.e.*, intermediated securities credited to the same securities account. In that setting, it makes sense to apply a first-in-time rule (as qualified in Article 15) instead of the last-in-time innocent acquisition rules of Article 14. Consider, however, the following example: an adverse claim not associated with competing Article 10

[38] See comments submitted by Finland, (Doc. 102, p. 3); Greece, (Doc. 114, p. 3). But see also the comments of the US in Doc. 113, p. 2-3.
[39] Taking into account that Article 14 only protects transfers for value, if the disposition was in market conditions, the risk of the transfer being set aside is remote.
[40] See the comments submitted by the US delegation in Doc. 74.

interests in the same intermediated securities, which are governed by Article 15. For example, a third party might assert that the intermediated securities can be traced to securities that were lost or stolen. There is no principled reason why an Article 10 acquirer should be denied innocent acquisition protection under Article 14 in this setting merely because it did not receive a credit entry. The Convention should be revised accordingly. (Note that Article 14(2) is not enough to protect the collateral taker in this example, since the adverse claimant may assert, for example, that the security certificates were stolen and are traceable to the relevant account.)

(b) The application of the so-called "shelter principle" (*i.e.,* a transferee receives what its transferor has to transfer and in this case ownership or a limited interest free from the adverse claim) also to the Article 10 acquirer.

Argument. Assume now that an account holder acquires (by way a credit) intermediated securities and qualifies for innocent acquisition protection under Article 14. An adverse claim is then asserted (*e.g.*, that the intermediated securities can be traced to lost or stolen securities). This claim subsequently becomes generally known in the marketplace. Then, the account holder proposes to transfer an interest in its intermediated securities to another person (who knows of the asserted adverse claim) under Article 10. Under the generally applicable shelter principle (a transferee receives whatever its transferor had to transfer, and in this case ownership free and clear of the adverse claim), the Article 10 acquirer should be protected from the adverse claim. The Convention should make this clear.

Both points will need further analysis during the diplomatic session.

- END -