INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
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DIPLOMATIC CONFERENCE TO ADOPT A CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
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PROPOSAL / COMMENTS

(submitted by the Government of the United States of America)

OBSERVATIONS ON THE STANDARD FOR INNOCENT ACQUISITION / PROPOSED REVISED ARTICLE 14(1), (2) AND (4)(B) AND DRAFT OFFICIAL COMMENTARY

The United States expresses its appreciation to the delegation of France for calling favorable attention to the Legal Certainty Group's August 2008 draft formulation of a standard for innocent acquisition, i.e. that an acquirer should be protected unless "it knew or ought to have known that the account should not have been credited".

The United States is willing to take this formulation seriously as a possible basis for revision of the Convention provisions on innocent acquisition in Articles 14 and 16. The formulation could be integrated into Article 14 by revising paragraphs (1), (2), and (4)(b) thereof as indicated below (using the present tense "ought to know" because it fits with the existing present tense of paragraphs (1) and (2)).

However, this new formulation, if adopted, would be quite general. Accordingly, the United States believes that it would have to be accompanied by draft official commentary explaining certain important aspects of how the formulation should be applied. The standard for innocent acquisition plays a particularly important role in the Convention, and if the standard is formulated on a general "ought to know" basis then a contemporaneous draft official commentary would be essential.

Article 14

1. Where securities are credited to the securities account of an account holder, unless ~~at a time when~~ the account holder actually knows or ought to ~~does not~~ know, at the time of such credit, that another person has an interest in securities or intermediated securities and that the credit violates the rights of that other person with respect to that interest:

(a) [No further changes]

2. [To be revised similarly to the above revision of paragraph 1]

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4. * * *

~~(b) a person knows of an interest or fact if that person:~~

~~(i) has actual knowledge of the interest or fact; or~~

~~(ii) ought to know of the interest or fact.~~

(b) In determining whether a person ought to know of an interest or fact:

(i) the determination must take into account the unique circumstances applicable to intermediated securities; and

(ii) the person is under no general duty of inquiry or investigation.

Possible draft official commentary:

"Paragraphs (1) and (2) of this Article protect an acquirer of an interest in intermediated securities, unless the acquirer at the relevant time either actually knows or ought to know of a conflicting interest or a defective entry.

Paragraph (4)(b)(i) makes clear that the "ought to know" element is to be applied in light of the unique circumstances applicable to intermediated securities. Transactions in intermediated securities are very often entered into and executed on a rapid basis; acquisitions are very often effectuated through impersonal markets; and acquisitions are very often relied on as the basis for further onward transfers or other actions by the acquirer. These circumstances, among others, impose a distinctly heightened necessity for innocent acquirers to have *ex ante* confidence in the rights that they are acquiring.

Paragraph (4)(b)(ii) further makes clear that the "ought to know" standard imposes on an acquirer no general duty of inquiry or investigation. In most acquisitions by way of a credit or designating entry, it would be impossible for the acquirer to discover any conflicting claims or defective entries, because the acquirer must rely entirely on the intermediary. Similarly, in most acquisitions by way of a control agreement, or by an intermediary by agreement with its account holder, the acquirer will ordinarily have no practicable and conclusive way of discovering the interests or facts with which paragraphs (1) and (2) are concerned. It follows that requiring an acquirer to somehow undertake due diligence by way of inquiry or investigation would undermine the very efficiencies that intermediated systems are intended to capture. Accordingly, innocent acquisition protection is generally available under this Article even to an acquirer who is concededly oblivious, ignorant, and uncurious – subject to the standards of honest behavior and wrongful knowledge discussed below.

By no means does the "ought to know" standard protect a person who fails to observe appropriate standards of honest behavior. Indeed, the "ought to know" standard is expressly designed to hold a dishonest person responsible for any interest or fact of which an honest person would have actually known. For example, if a person actually knows of very suspicious circumstances, and consciously decides not to make any inquiry, and the decision is made so that the person will avoid actual knowledge of a fact, then the person "ought to know" of that fact. However, the nature of transactions in intermediated securities is such that this standard will rarely apply outside of an acquirer's actual collusion with a wrongdoer, or in highly suspicious circumstances when the acquirer's knowledge falls just short of "actual knowledge."

Paragraphs (1) and (2)'s standard of actual knowledge plus "ought to know" applies to organisations just as it does to other acquirers. The only additional consideration is that organisations generally involve multiple individuals, and hence present threshold questions concerning the individuals to whom the "ought to know" standard applies, and when. These threshold questions are addressed by paragraph (4)(c), which in no way alters the more substantive point that organisations are governed by paragraphs (1) and (2)."

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