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UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES

INFORMAL WORKING GROUP ON ARTICLE 14 OF THE DRAFT CONVENTION

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Informal Working Group on Article 14 of the draft Convention

Preliminary Note

(prepared by the Chairman of the informal Working Group)

SUMMARY

I. Introduction: Article 14

1. Article 14 of the preliminary draft Convention (as adopted by the Committee of Governmental Experts at its fourth session) deals with the protection of innocent acquirers[1]. The text of this provision is the following:

Article 14
[Acquisition by an innocent person of intermediated securities]

1. - Where securities are credited to the securities account of an account holder at a time when the account holder does not know 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) the account holder is not subject to the interest of that other person;

(b) the account holder is not liable to that other person; and

(c) the credit is not invalid or liable to be reversed on the ground that the interest or rights of that other person invalidate any previous debit or credit made to another securities account.

[1] UNIDROIT 2007 - Study LXXVIII – Doc. 94.

2. - Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 10, at a time when the account holder or the person to whom the interest is granted does not know of an earlier defective entry:

(a) the credit or interest is not rendered invalid, ineffective against third parties or liable to be reversed as a result of that defective entry; and

(b) the account holder, or the person to whom the interest is granted, is not liable to anyone who would benefit from the invalidity or reversal of that defective entry.

3. - Paragraphs 1 and 2 do not apply in respect of an acquisition of securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

4. - For the purposes of this Article:

(a) "*defective entry*" means a credit of securities or designating entry which is invalid or liable to be reversed, including a conditional credit or designating entry which becomes invalid or liable to be reversed by reason of the operation or non-fulfilment of the condition;

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

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

(ii) 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; and

(c) when the person referred to in (b) is an organisation, it 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.]

5. - 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.

2. The genesis of this provision can be followed consulting, in particular: Doc. 24, Arts. 7.6 and 11; Doc. 42, Art. 7; Doc. 43 par. 105-110, 182; Doc. 54, Art. 7; Doc. 57, Art. 12; Doc. 58, par. 55, 56, 141, 146-148, 178; Doc. 74, par. 3-4; Doc. 94, Art. 14; Doc. 95, par. 159-166, 213.

3. In order to understand the problems that the current text of the provision raise, it could be helpful to highlight some of its main elements. Several points are noteworthy.

(a) Article 14 seeks to protect the innocent acquirer. This provision materialises the general idea that once a person has acquired a right over the intermediated securities for value and without notice or constructive notice, no adverse claim can be asserted against that person. Accordingly, he enjoys the same legal position as any other account holder of the same intermediary. The idea is applicable to all levels of the holding system: it could be said that the provision extends the finality principle "all along the chain", if the required conditions are met.

(b) The text contemplates two different but analogous scenarios[2].

- Paragraph 1 ensures the protection of an account holder *vis à vis* any competing claim from another person. In this case, the provision protects the account holder if he or she *"does not know that (i) another person has an interest in the securities or intermediated securities and that (ii) the credit violates the rights of that other person".* If those conditions are met, the account holder is "immunised"; *i.e.,* the account holder (i) is not subject to the interest of the adverse claimant; (ii) 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 holders of an interest under Article 10 - from risks of an *"earlier defective entry"* (as defined in paragraph 4 (a)). 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 primarily protects the account holder not *vis-à-vis* a particular claimant (as paragraph 1), but *vis-à-vis* its own intermediary and all others who would seek to revert the credit[4].

Two additional differences between paragraph (1) and (2) are noteworthy: unlike paragraph (1), paragraph (2) (i) includes interests acquired under Article 10 (in this case, the protection *vis-à-vis* former defective entries is also justified), and (ii) is subject to the rules of a securities settlement system or of the account agreement (paragraph 5).

(c) The "standard of care" is not based on a general clause of good faith, but on a "test of knowledge or wilful blindness". According to the Explanatory Notes to the Preliminary Draft (Doc. 19), the concept of good faith was replaced by a *"more neutral and fact-based language"*. A person disqualifies for the protection afforded by Article 14 in two cases:

- if he has actual knowledge of an interest of fact; or

- *"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 presence of a certain degree of suspicious circumstances known to the person ("a significant probability of its existence") and (ii) that the person deliberately or intentionally avoids actual knowledge. In other words, the person deliberately "shuts his eyes". In addition, two points are worthy of note: the test does not require collusion; and, the "wilful blindness" is not concretised by any catalogue of suspicious circumstances (as could be the price of the securities, the seller´s past activities or the existence of a data base)[5].

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[2] Note that the difference between the following two paragraphs may not be clear to everybody; see also *infra* footnote 15.

[3] Note that the text of paragraph 1.c *in fine* only foresees one ground 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 the delegation of the United States 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"*, see UNIDROIT 2007, Study LXXVIII – Doc. 74.

[4] In relation to the scope of application of Article 14, the abovementioned US proposal seeks 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; (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.

[5] Note that in the same US proposal a clarification in the following sense is suggested *"A public filing, registration, or notice should not, of itself, disqualify any acquirer of intermediated securities of the innocent acquisition protection under Article 14".*

In addition, subparagraph (c) deals with the application of the test of knowledge to an organisation: "*it 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".* 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.

(d) Article 14 only protects innocent acquirers 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". 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)[6].

(e) Finally, it is important to underline the role of Article 14 in the context of the Convention. Note that according to Article 13, the non-Convention law determines whether a credit or a designating entry is invalid or liable to be reversed, and whether an entry may be made conditionally and the effects thereof. This reference to the domestic, non-Convention law is a sort of "jump into the unknown". Article 14 serves as a counterbalance. It offers a safe harbour: it achieves a minimum of harmonisation in protecting innocent account holders. If a person qualifies for Article 14, he will be protected irrespective of the interference of the non-Convention law; if he does not, then the consequences are governed by the non-Convention law, *i.e.* it is for the non-Convention law to solve the conflict between the non-innocent acquirer (under the standard of the Convention) and the adverse claimant.

II. The discussion on Article 14

4. During the discussions in the Committee of Governmental Experts, there has been some general agreement on the principle: *i.e.,* the necessity to provide an adequate level of protection to innocent acquirers. Given the speed with which securities are negotiated, this protection is of critical importance for the seamless functioning of capital markets. Furthermore, there seems to be a consensus on the idea of maintaining the wording of the rule as neutral and functional as possible. This would permit that that the rule could be applied regardless of the characterisation, under national law, of the rights over the intermediated securities (proprietary rights, interests, entitlements) and the characterisation of the transfer itself (whether the transferee acquires a derived right from the seller or an entitlement is created *ex novo vis-à-vis* the relevant intermediary).

5. However, there are differences as to the better way to materialise these principles. Actually, during the last meeting, some delegations expressed their concerns and doubts about the reasonability of the approach followed to date[7]. In particular, (i) it was considered that the proposed criterion may lead to a substantial level of uncertainty ("*L´approche proposée est source d´insécurité…")* and (ii) it was questioned whether that approach was consistent with the functional approach ("*L´approche proposée soulève un risque d´incohérence avec l´approche fonctionnelle…").* The document also echoed the concern expressed by some delegations about

[6] Note the proposal of the delegation of the United States in the same Doc. 74 to clarify the position of an intermediary acting for its account holders. 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 its interest gratuitously (it may well be the case that the account holder paid the transferor directly).

[7] See the Working Paper submitted by the delegation of France, UNIDROIT 2007 – Study LXXXVIII – Doc. 95, Appendix 4.

"*…ne pouvoir intégrer à leur système juridique, sans dommage, une approche si éloignée de leurs concepts traditionnels*"[8]. The arguments to support this thesis are summarised below.

III. Possible approaches

6. 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 standard or a Conventional safe-harbour test plus a reference to the national law.

7. 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 acquirer" is determined by domestic law (="a national law test")[9]. This would imply that each country maintained and applied its own concepts and its own standards (good faith, knowledge, collusion, etc). The main arguments invoked in favour of this option can be summarised as follows.

(a) 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 (such as Spain) to expressly maintain the concept of good faith as applicable in relation to book-entry securities[10]. 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[11].

(b) Any harmonised clause will be doomed to failure as any rule seeking the protection of "innocent acquirers" must be based on uncertain concepts. Actually, some delegations pointed out that the very concept of "knowledge" is uncertain[12].

8. 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")[13]. As has 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. The main arguments invoked in favour of this option are the following.

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8 *Ibid.*, pp. 2-4.

9 The reference to the non-Conventional law could be formulated in different ways. For example, the working paper submitted by France 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*".

10 See, other legal references in the document of the French delegation, p. 3.

11 The paper of the French delegation argued that "*Introduire de tels tests dans des pays de droit civil deviendrait une source d´insécurité juridique pour ces derniers".*

12 See the document of the French delegation, p. 2.

13 There is an important difference between making a remission 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 taking into consideration the fundamental principles of the Convention.

(a) It promotes legal certainty as long as operators do not have to consult the national law to check whether they qualify as innocent acquirers or not.

(b) It is better adapted to modern securities markets than traditional good faith clauses. The case-law elaborated regarding the concept of good faith is mainly related to the acquisition of 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). In many markets and in relation to book-entry securities this is not *normally* the case. Actually, it is usually claimed that it is difficult to apply the good faith framework where there is no constructive possession and the transferee does not normally have an inside view in the system. Furthermore, traditional good faith principles operate under the idea that somebody wins something (the "good-faith acquirer") and somebody loses it (the original owner); in many legal systems and in relation to intermediated securities, the good faith principle may even lead to the result that both parties win[14].

(c) If the characterisation of the innocent acquirer 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 (*supra* nº 2.e).

(d) Finally, 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.

9. Finally, a third option could be to combine different solutions. For example: (a) an opting out mechanism, according to which the Convention lays 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-Conventional law ex Article 3); or an opting in mechanism in the contrary direction. (b) An autonomous test which functions as a safe harbour: the Convention definition of innocent acquirers does not impede contracting States from expanding the same protection to other persons under its national law. This appears to be the appropriate interpretation and result under the current wording of Article 14. However, the Convention might make this safe harbour approach more explicit.

IV. Questionnaire

This paper does not intend to take a stand on the discussion; only (a) to explain the problem, (b) suggest different solutions and (c) describe the pros and cons of each solution. To accomplish this task, it may be helpful to have more information from other delegations interested in this issue. This is the purpose of the following questions. Please feel free to give as detailed answers as you consider necessary.

[14] The innocent acquirer is protected under Article 14 and acquires a right over the intermediated securities his relevant intermediary is holding, and the original holder is also protected under Article 13 - insofar as the debit is not authorised - and also keeps a right over the intermediated securities his relevant intermediary is holding. In this case, Ch. IV will apply to solve the conflict.

(a) On the situation of your national law

1. Special provision. Does your legal system have a special rule on "innocent/good faith acquisition" for book entry securities?

1.a If the answer is no, does it mean that the traditional "good faith clause" applies?

1.b If the answer is yes,

(i) What is the standard of care chosen, a general clause (e.g., "reasonable commercial standards") or a more rigorous one (e.g. collusion, actual knowledge, wilful blindness, gross negligence, etc.)?

(ii) What are the situations contemplated by the special rule (protection *vis-à-vis* an adverse claim, protection *vis-à-vis* a defective entry, etc.)?

(iii) Does it contain a special provision for organisations? If so, please describe.

2. Case law. In your country or abroad, are you aware of any real cases in which the "good-faith/innocent acquirer clause" has been applied in relation to intermediated securities? If so, please summarise (if possible).

3. Other issues. Please comment on any other point or issue that, in relation to your national law, you consider relevant for the purpose of this paper.

(b) On Article 14 of the Convention

4. Article 14: current text

4.a Do you agree with the description of Article 14 of the Draft Convention made in this paper (*supra* para. nº 2)? If not, please elaborate your answer.

4.b Leaving aside the standard of care issue, do you have any problems with the current text of that provision, e.g.: (i) as to the differences between the situations described in paragraph 1 and 2, including the reference to article 10 and the special provisions of SSS and account agreements (which are referred to in the second paragraph but not in the first paragraph)[15], (ii) the definition of "defective entry", (iii) the special rule for organisations, (iv) the relationship of Article 14 with other provisions of the Convention, etc.? Please elaborate your answer.

5. Standard of care: Theoretical approaches

5.a Do you agree with the description of the possible approaches to the "innocent/good faith acquirer issue" made in this paper (*supra* para. nº 5-6)? Can you think of other solutions? If so, please describe them.

[15] Note that originally (Doc. 24, Art. 7.6 and Art. 11) 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). The current draft contains a different approach. Paragraph (2) of Article 14 does not deal with the case of an onward transferee any longer. Accordingly some people have considered it superfluous.

5.b Do you agree with the summary of the pros and cons of each approach made in this paper? Can you think of other arguments? If so, please describe them.

5.c In particular, which approach do you consider more adequate to the world of electronic book-entries? Which one do you consider more neutral and functional?

5.d Are you aware of international instruments that, on the acquisition of assets, contain a rule for innocent/bona fide purchaser?[16]

[16] Please limit your answer to the area of property law (not to bona fide in contracts).