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

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

UNIDROIT 2008
Study LXXVIII – Doc. 109
English only
January 2008

Informal Working Group on Article 14 of the draft Convention

Response to the questionnaire concerning acquisition by an innocent person

(submitted by the delegation of Brazil)

(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?*

Answer: No, it does not.

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

Answer: Yes. The "good faith clause" is one of the principles of the Brazilian legal system, which rules both the creation and the execution of contracts. Article 422 of the Brazilian Civil Code establishes that: "The parties must observe in the closing and the execution of an agreement the principles of probity (good faith effort) and good faith".

Besides, regarding the acquisition and ownership of goods, the Brazilian Civil Code includes the following specific provisions for possession (ownership):

> Article 1201: "Ownership is of good faith when the owner ignores any vice or obstacle that would preclude the acquisition of the good."
>
> Sole Paragraph: "The legitimate owner has itself the good-faith presumption, unless evidenced otherwise or the law expressly rejects that presumption."
>
> Article 1202: "Good-faith ownership will only lose that characteristic where and when the circumstances may presume that the owner does not ignore what he/she improperly owns."
>
> Article 1214: "A good-faith owner is entitled to respective benefits as long as ownership lasts."

There is no consensus on the application of these provisions to dematerialized securities. The prevailing approach is that the possession protection applies only to tangible assets.

Anyway, it should be mentioned that, according to the Brazilian system, the good-faith evaluation is based on the behavior standard applicable to each legal relationship, pursuant to legal provisions, uses and practices and diligence expected from every person/entity involved in that relationship (objective good faith).

It should be pointed out, however, that within the scope of Property Law, as defined in the Brazilian Civil Code, the good faith presumption in business involving movables is restricted to situations such as the offering of goods in a public auction or the acquisition in a commercial facility.

Accordingly, Article 1.268 of the Civil Code reads: "When it is made by someone other than the owner, tradition does not transfer the ownership, unless the good, which is offered in a public auction or commercial facility, is transferred under such circumstances where the seller shall be considered its owner to the good-faith purchaser or anybody else."

This rule (that binds good-faith presumption to special circumstances of publicity) coexists with special rules applied to the Brazilian payment system which ensure the irrevocability and finality of transactions cleared by SCS – Securities Clearing Systems.

> ***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).*

Answer: We could mention a case in Brazil where an investor had stated that he had not given instructions for certain securities transactions held in the option market on his behalf by a brokerage firm. The broker / intermediary, in turn, stated that instructions had been transmitted orally and that all transactions had been duly informed to the investor by statements sent by CSD/stock exchange.

In fact, the investor had opted for transmitting oral instructions, and because the broker had no instruction recording system in place (which is not required by the Brazilian legislation) there was, in that specific case, no definitive evidence of the true version.

In light of the two contradictory versions, the problem was solved through the analysis of circumstances of the case and the comparison of the each party's behavior (intermediary and investor) against the acceptable diligence standards, under the objective good faith principle.

The claim proposed by the investor was dismissed on the following grounds: a) investor's profile: the investor had operated in the option market for a long period of time and had good knowledge of its process; b) broker's behavior: the intermediary met the diligence and legal standard requirements; and c) investor's negligence: the investor failed, as he was not used to open the statements sent to him containing information about transactions made on his behalf.

This case was settled preliminary in the administrative sphere (Brazilian Securities Commission), which decision was later confirmed in judicial proceedings related to the same matter.

> ***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.*

Answer: It is important to mention that under the Brazilian legal system, regarding trading transactions in systemically important settlement systems, the framework established by Law

No. 10.214 of 2001, grants to clearing houses special legal rights and protections that, at the end of the day, also protects the acquisition of securities made by an innocent account holder.

Among these, there is the right to (i) use any assets and collateral posted in their system specifically for settlement, which cannot be rendered invalid, reversed, or object of attachment of any kind and (ii) seize the collateral of bankrupt participants held to secure financial transactions.

These rights are stated in the following provisions of Law nº 10.214, of 2001:

> Article 6: "The assets and rights that make up the dedicated capital accounts as well as those offered as collateral by the clients cannot be pledged, and shall not be the subject matter of attachment, seizure, search and impounding or any other act of judicial restraint, except for compliance with the obligations assumed by the clearing house or by the clearing service provider, acting as counterparty, pursuant to the provisions of Article 4, preface, of this Law."
>
> Article 7: "The civil insolvency, debt rehabilitation, intervention, bankruptcy or extrajudicial liquidation of any client shall not affect compliance with the obligations assumed thereby before the clearing house or clearing service provider, which obligations shall be processed and settled by the clearing house or service provider pursuant to the respective regulations."
>
> Sole Paragraph: "The proceeds from realization of the collateral provided by the client subject to any of the events set out in the preface of this article, as well as the bonds, securities and any other assets thereof which are eligible for clearance or settlement, shall be allocated to settle the obligations assumed with the clearing house or clearing service provider."

(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.*

Answer: We generally agree with the description of Article 14 in the Preliminary Note.

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), (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.*

Answer: Since all paragraphs of Article 14 refer to related matters, we understand that they could be unified to regulate consistently similar situations (and make general reference to exceptions related to SSS – Securities Settlement Systems, which are currently restricted to the assumptions of Paragraph 2 of Article 14).

With respect to the exclusion of purchaser's good faith presumption in gift or grace agreements (as provided in Paragraph 3 of Article 14), we understand that the issue may be further discussed, for the following reasons.

At first glance, we do not have an immediate objection to maintaining this provision as is. However, it seems that such wording would not be necessary, as the business gratuity presumption

does not always exclude the purchaser's good faith. In fact it should be evaluated on a case by case basis in line with the standards set out in Article 14.

In this sense, we remind that there are situations other than gratuity, which could evidence the existence of fraud likely to break the purchaser's good faith presumption, such as deals closed at a vile price or at a price quite lower than the market price.

Further, we would suggest the exclusion of item "c" from paragraph 4 of Article 14 (special rule for legal entities), as it would exclude other scenarios that could characterize the knowledge of an interest or fact by the organization. This is the case, for instance, where the management of an organization commits gross negligence, omission, or even fault by simply retaining its representatives/employees ("culpa in vigilando"). In other words, it appears that, if this wording is maintained, such a provision could come to prevent Contracting States from expanding in their domestic environment, the situations that could lead on the breach of legal entities' good faith, which seems to contradict the "safe harbor" approach that guides all other paragraphs of this article.

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.*

Answer: Yes, we do agree. We are not aware of other solutions.

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.*

Answer: Yes, we do agree.

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?*

Answer: We consider appropriate that the Convention would have specific provisions to protect the good-faith purchaser, with the purpose of ensuring legal certainty and standardization of corresponding rules. We further understand that, to achieve this, the best approach would be a safe harbor method, contemplating minimum provisions to characterize good-faith purchase, and that such provisions could be expanded by Contracting States.

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

Answer: No, we are not.