



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

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**INFORMAL WORKING GROUP ON ARTICLE 14 OF THE  
DRAFT CONVENTION**

### **Informal Working Group on Article 14 of the draft Convention**

#### **Comments on the Preliminary Note and response to the questionnaire concerning acquisition by an innocent person (Doc. 96)**

*(submitted by the delegation of the United States of America)*

#### **1. General Comments**

The United States expresses its thanks to the Chair of the Working Group on Article 14 for preparing the Preliminary Note and its questionnaire (Doc. 96).

As the Preliminary Note reminds us, the principle of innocent acquisition is of central importance to modern securities markets. The need for transacting parties to have confidence in the rights that they are acquiring, free from undue risks of disruption by later emerging circumstances, has of course been widely recognized across many generations and many fields of law. But in the context of intermediated securities, these needs are further heightened and the level of appropriate risk is reduced. Chief among the features that create these particular conditions are the speed with which intermediated securities transactions are entered into and carried out, and the difficulty or impossibility of tracing credits and debits across differing national systems, or even within many domestic systems. A credit is at the very core of the value of a securities account, and the more that a credit is subject to legal risks, the more it loses its meaning, to the detriment of the *ex ante* confidence necessary to support robust levels of private commerce and sound government finance decisions.

#### **2. Clarifications with respect to non-Convention law**

The United States would like to explain and emphasize the Convention's deference to non-Convention law concerning two innocent acquisition-related issues. On the first point, we simply amplify an observation made in the Preliminary Note, and on the second we explain how the correct reading of the Preliminary Note might alleviate some current concern.

*a. Circumstances for protection of innocent acquisition.* Article 14 addresses only the minimum circumstances, not the exclusive circumstances, under which an innocent acquirer would be protected. As aptly expressed in paragraph 3(e) of the Preliminary Note,

Article 14 “offers a safe harbour,” and if a person does not qualify for the Article 14 protection, it is left to the non-Convention law to solve the conflict between that person and another claimant. Stated in another way, a person who does not qualify under Article 14 would not necessarily be exposed to liability or to loss of proprietary rights, unless the person were also not entitled to any defenses under non-Convention law, such as the status of a good faith purchaser.

b. *Effect of an unauthorized debit.* The United States understands that if the account holder’s intermediary makes an unauthorized debit to the securities account, Convention Article 13 does not address the nature of the account holder’s status, *i.e.*, whether the account holder nonetheless has a proprietary interest or is entitled only to a personal claim against its intermediary. Instead, applicable non-Convention law would control that question. We do not think that any suggestion to the contrary is intended by footnote 14 of the Preliminary Note or the text to which it relates, because that text’s reference to “many legal systems” implies that the Convention itself does not control.

The United States would remain open to discussion of textual changes to further clarify these points. Perhaps the first point might be clarified in Article 13(2), for example by an expansion of subparagraph (c), and perhaps the second might be clarified with introductory phrases in Article 14(1) and (2).

### 3. Questionnaire

#### (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?*

Yes.

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.)?*

Under Article 8 of the Uniform Commercial Code (UCC), the principle of innocent acquisition in the book-entry context is implemented by three particular rules, and is also bolstered by a related provision designed to protect intermediaries in their ordinary transfer activities.

The first rule protects an entitlement holder (*i.e.*, an account holder) who acquires a security entitlement (*i.e.*, intermediated securities) by a credit to the entitlement holder’s securities account. Such a person is protected from an adverse claim if it acquires the security entitlement “for value and without notice of the adverse claim.”<sup>1</sup> A person has “notice of an adverse claim” if

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<sup>1</sup> UCC § 8-502. The full text of the statute provides that “[a]n action based on an adverse claim to a financial asset, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against a person who acquires a security entitlement under [Article 8’s acquisition provisions] for value and without notice of the adverse claim.” As its wording shows, the rule reaches more broadly than a traditional “cut-off” approach, and is directly designed for the system of intermediated holding of securities.

the person “knows of the adverse claim”—*i.e.*, has “actual knowledge” of the adverse claim.<sup>2</sup> Also, even in the absence of actual knowledge, a person who “deliberately avoids information” about an adverse claim while “aware of facts sufficient to indicate that there is a significant probability that the adverse claim exists” (sometimes referred to as being “willfully blind” to the adverse claim) is also charged with notice of the adverse claim.<sup>3</sup> This first rule generally is quite similar to the Article 14(4)(b) standard that has been placed between square brackets.

The second rule protects “a person who purchases a security entitlement, or an interest therein, from an entitlement holder.”<sup>4</sup> To “purchase” is not only to buy but also includes taking as collateral security or otherwise receiving an interest that has been voluntarily transferred,<sup>5</sup> and a person protected by this rule is generally not an entitlement holder itself but has acquired its interest from an entitlement holder, without taking a credit in its own right. The protection is available only if the purchaser “gives value, does not have notice of the adverse claim, and obtains control.”<sup>6</sup> The additional element in this rule, “control” of a security entitlement, typically is achieved when “the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder” (a “control agreement,” to use common terminology).<sup>7</sup> Note that this second innocent acquisition rule applies only when otherwise applicable temporal (*i.e.*, first-in-time) priority rules are not applicable. Finally, if the transferor-entitlement holder itself is protected from an adverse claim under the first rule, then a purchaser from the entitlement holder is likewise protected, under a version of the “shelter” principle.<sup>8</sup>

The third innocent acquisition rule, which applies only to a purchaser from an intermediary that has become insolvent, protects the purchaser under certain conditions against the property-based claims of an entitlement holder with that intermediary. The rule thus addresses a group of situations closely comparable to those covered by Article 16(2) of the draft Convention, without distinguishing whether the purchase involves or does not involve a credit with a higher-tier intermediary. Its conditions for protection are that the purchaser “gives value, obtains control, and does not act in collusion with the securities intermediary” in violating the intermediary’s core obligation to maintain sufficient financial assets.<sup>9</sup>

Related to the topic of innocent acquisition is a rule providing a securities intermediary with immunity, subject to specified limitations, from liability to an adverse claimant when the intermediary transfers a financial asset in response to an effective entitlement order.<sup>10</sup> This general rule, quite similar to former Article 20(2) (Doc. 57), is designed to promote the same chief goals as the perhaps more traditional innocent acquisition rules discussed above, *i.e.*, the reliability and rapidity of securities transactions. In a parallel to the third rule discussed immediately above,

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<sup>2</sup> UCC §§ 8-105(a)(1); 1-202(b) (“Knowledge” means actual knowledge. “Knows” has a corresponding meaning.”). “Adverse claim” is defined to mean “a claim that a claimant has a property interest in a financial asset and that it is violation of the rights of the claimant for another person to hold, transfer, or deal with the financial asset.” UCC § 8-102(a)(1).

<sup>3</sup> UCC § 8-105(a)(2). The same is true of a person who has a statutory or regulatory duty to investigate but fails to do so. UCC § 8-105(a)(3).

<sup>4</sup> UCC § 8-510(a).

<sup>5</sup> UCC § 1-201(b)(29).

<sup>6</sup> *Id.*

<sup>7</sup> UCC § 8-106(d)(2). An “entitlement order” is a notification by an entitlement holder to its securities intermediary which directs the disposition or redemption of a financial asset. UCC § 8-102(a)(8).

<sup>8</sup> UCC § 8-510(b).

<sup>9</sup> UCC § 8-503(e). This core obligation requires the intermediary to, *inter alia*, maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established with respect to that financial asset. UCC § 8-504.

<sup>10</sup> UCC § 8-115. An entitlement order is generally “effective” only if made by the entitlement holder or by one who has power under the law of agency, including a control agreement, to act on the entitlement holder’s behalf. UCC § 8-107(b).

immunity is denied to an intermediary that acts “in collusion” with a wrongdoer in violating the rights of the adverse claimant.<sup>11</sup> This exception to immunity is narrowly drawn because the ordinary business of an intermediary is precisely to transfer financial assets in response to its account holders’ directions.

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

The UCC contains a general provision for notice and knowledge of an organization.<sup>12</sup> This provision is similar in effect to, though more detailed than, Article 14(4)(c), which now appears in square brackets. In our view, retention of Article 14(4)(c) is clearly advisable, because it expresses sensible principles that can be very important to the functioning of the innocent acquisition rules as applied to large organizations.

**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).*

Yes.

Before enactment by the states (and adoption for United States federal book-entry government securities) of the 1994 revisions of UCC Article 8, the only explicit statutory treatment of bona fide purchaser status for a purchaser receiving a credit of securities on the books of an intermediary dealt with credits on the books of clearing corporations, such as a central securities depository (CSD).<sup>13</sup> Whether a purchaser receiving a credit in other circumstances could qualify as a bona fide purchaser was unclear, disputed, and litigated. This unfortunate state of the law exposed such purchasers and their intermediaries to claims based on purported tracing principles and to substantial leverage for the settlement of disputed and sometimes unmeritorious claims. (See Appendix for details.) This situation was an important factor leading to the 1994 Article 8 revisions, including the careful set of innocent acquisitions rules described above.

The cases reported since the 1994 revisions tend to demonstrate that current rules are both clear, because they provide fact-based guidance to judges and market participants, and well-balanced, because they impose liability in proper cases while also encouraging the desirable functioning of innocent market transactions. (See Appendix for details.) It should also be noted that the volume of this case law is relatively small, particularly compared to the very large volume of transactions. For example, during calendar 2006, the Federal Reserve Board’s Fedwire Security Service processed a daily average of 88,800 transactions, and during the same year National Securities Clearing Corporation processed a daily average of 17 million transactions. The fact-based

<sup>11</sup> UCC § 8-115(2). Another exception to immunity applies when the intermediary acts after it has received judicial process, such as a court order, restraining its act and after it has had a reasonable time to act on the process. UCC § 8-115(1). The third applies to the limited case of a stolen security certificate when the intermediary acts with notice of an adverse claim. UCC § 8-115(3).

<sup>12</sup> UCC § 1-202(f) provides: “Notice, knowledge, or a notice or notification received by an organization is effective for a particular transaction from the time it is brought to the attention of the individual conducting that transaction and, in any event, from the time it would have been brought to the individual’s attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines. Due diligence does not require an individual acting for the organization to communicate information unless the communication is part of the individual’s regular duties or the individual has reason to know of the transaction and that the transaction would be materially affected by the information.” UCC §§ 1-201(b)(25) and (27) define an “organization” in this context as “a person other than an individual,” including a roster of particular types of entities as well as “any other legal or commercial entity.”

A parallel between UCC § 1-202(f) and the concept of notice of an adverse claim is noted in Official Comment 4 to UCC § 8-105.

<sup>13</sup> Former UCC §§ 8-313(1)(g); 8-320(3).

nature of the current rules, which is further discussed under 5.b below, no doubt contributes to the small number of reported cases, because the parties' rights and liabilities are relatively clear in advance of any judicial decision, meaning that disputes are less likely to reach the courthouse in the first place or, once there, to need to proceed beyond preliminary proceedings.

**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.*

The United States does not have additional comments at this time.

**(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. n° 2)? If not, please elaborate your answer.*

The United States generally agrees with the description, as clarified by the proper reading of footnote 14 discussed above in the General Comments. The United States also agrees that the clarifications of the operation of Article 14 suggested by Switzerland in Doc. 105 are useful.

**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.*

In general the United States is satisfied with the current text and structure of Article 14.

As briefly addressed in the Preliminary Note, the United States proposed certain revisions to Article 14 (then numbered 12) in Doc. 74 prior to the fourth meeting of governmental experts. Due to the abbreviated duration of the fourth meeting, the Drafting Committee did not have time to address these proposals, but the United States had raised them in the plenary and was supported by France. No delegation opposed the proposals. The United States will renew these proposals in advance of the anticipated diplomatic Conference.<sup>14</sup>

**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. n° 5-6)? Can you think of other solutions? If so, please describe them.*

**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.*

The United States generally agrees with the description mentioned in 5.a and the summary mentioned in 5.b. We elaborate briefly here on some of the considerations of the pros and cons,

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<sup>14</sup> In Doc. 74 the United States also proposed retaining and expanding the immunity for innocent intermediaries provided by then-numbered Article 20(2). Although this immunity provision was deleted from the draft text during the fourth meeting, the United States also will renew its efforts toward inclusion of the immunity provisions in the text of the Convention.

and in our response to 5.c below we briefly consider the functional approach because it is specifically mentioned in that question.

Based on discussions by experts as well as the responses to the Working Group's questionnaire, there are substantial divergences in the application of the good faith concept even among closely related civil law jurisdictions, let alone worldwide. (Of course, we would welcome detailed clarification from anyone who does not share this view.) But it is only natural that the common existence in differing jurisdictions of a single label, and even a single overall tradition, does not entail an identical approach to concrete cases, given the cases' varying facts that arise in varying settings, evaluated by varying triers of fact in varying systems. Overall, this uncertainty associated with the good faith concept must weaken the suggestion (Preliminary Note, para. 7(a)) that only a harmonised provision would be "uncertain."

Also on the subject of uncertainty, the current Article 14 standard has the important advantage of being relatively specific in its contents, and of therefore offering a good amount of predictability about its application to varying circumstances. (Specificity and predictability are nonetheless, of course, matters of degree, and no one would dispute that a well-crafted standard, such as the current one in our view, must counterbalance them with a proper amount of flexibility.) This specificity has value not only in helping to guide and structure a judge's inquiry when a dispute arises – but also, and perhaps more important, in enabling market participants to make reliable decisions *ex ante* about prospective transactions. With a well-balanced standard, these participants and their business and legal advisors are able to assess their position rapidly and with confidence, which directly contributes to the efficiency of the system and fosters a high level of beneficial economic transactions. The Working Group reminds us that the Explanatory Notes to the November, 2004 preliminary draft Convention (Doc. 19) characterize the current standard as being "more neutral and fact-based language," and we understand the term "fact-based" to refer to the strong advantages just described. Even if introducing the fact-based standard into an established legal system would to some degree increase juridical uncertainty (Preliminary Note, para. 7(a)), we cannot ignore that it would also reduce the level of *ex ante* business and transactional uncertainty.

It also bears brief mention that the "fact-based" advantages of the current standard are matters of structure, or one might say of degree of content, rather than matters of particular content. Accordingly, as explained in the plenary, the United States would be happy to consider any other comparably neutral and fact-based tests that other delegations may choose to propose. We do not support the current standard simply because it closely resembles our own non-Convention law, and others should not oppose the current standard simply because it differs from theirs.

**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?*

As stated in the General Comments, the United States considers the nature and practice of intermediated securities transactions to impose heightened demands for certainty, clarity, and finality. Accordingly, the United States strongly believes that the Convention should adopt an autonomous, fact-based standard, for purposes of both Articles 14 and 16(2), and it finds the Convention's current standard to be satisfactory under these terms. In these respects the United States agrees with the position taken by Switzerland in Doc. 105. If absolutely necessary, the United States would consider the possibility for Contracting States to make a declaration opting out of the Convention's standard.

Moreover, the United States submits that the current standard is fully consistent with the functional approach. Both in its particular contents and in its fact-based structure generally, the current standard is utterly independent of the underlying doctrinal or conceptual structure of any particular legal regime, including that of the United States, just as the concept of good faith is

independent of the doctrinal or conceptual structure of any civil law regime. The fact that the current standard closely resembles one of U.S. law's innocent acquisition rules obviously does not itself change this fact. Nor are the contents of the current standard afflicted by any unique uncertainty; on the contrary they are not unlike those concerning knowledge, suspicion, intention, or many other subjective facts employed routinely in courts of both common law and civil law jurisdictions.

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

Yes. Convention on International Interests in Mobile Equipment, Article 29(3), (4) (rights of buyer vis-à-vis holder of earlier-in-time interest in uniquely identifiable mobile equipment designated by a protocol); Protocol on Matters Specific to Aircraft Equipment, Article XIV(1), (2) (same as to aircraft). The fact that the rules cited here depend on entries in a public register is instructive by way of contrast, because there are such large differences from the intermediated securities context both in the subject matter of these instruments and in the way in which parties carry out the relevant transactions.

### Appendix concerning United States case law on innocent acquisition<sup>15</sup>

For discussions of cases decided under the pre-1994 version of UCC Article 8, see Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 *Cardozo L. Rev.* 305 (1990); Gregory S. Crespi, *Security Interests in Book-Entry Government Securities: The Unsettled Status of Clearing Agent Liens under Article 8*, 20 *U.C.C. L.J.* 159 (1987); Barry Lee Katzman, *Security Interests in Federal Agency Book-Entry Securities: Doing It With Mirrors*, 42 *Bus. Law.* 156 (1956). See also Macmillan, Inc. v. Bishopsgate Investment Trust, [1998] EWCA (Civ.) 1680 (bona fide purchase under New York law). For one notable case on the particular question of whether a purchaser receiving a credit other than on the books of a clearing corporation, such as a CSD, could qualify as a bona fide purchaser, see Wichita Fed. Sav. & Loan Ass'n v. Comark, 610 F.Supp. 406 (S.D.N.Y. 1985), *modified*, 610 F.Supp. at 418.

For post-1994 case law, see, e.g., *In re: County of Orange*, 219 B.R. 543, 36 U.C.C. Rep.Serv.2d 181 (Bankr. C.D. Cal. 1997) (question of fact existed as to whether entitlement holders' knowledge was such that they were entitled or not entitled to protection under UCC § 8-502); Nathan W. Drage, P.C. v. First Concord Securities, Ltd., 184 Misc.2d 92, 707 N.Y.S.2d 782, 41 U.C.C. Rep.Serv.2d 673 (Sup. 2000) (allegations that secured creditor of intermediary acted in collusion with intermediary to deprive entitlement holder of its holdings are sufficient to state claim despite UCC § 8-503(e)); S.E.C. v. Credit Bancorp, Ltd., 386 F.3d 438, 55 U.C.C. Rep.Serv.2d 74 (2d Cir. 2004) (purchaser of security interest from entitlement holder deliberately avoided easily available information in the face of suspicious circumstances and accordingly did not take free of certain adverse claims under UCC § 8-510(a)). The *Credit Bancorp, Ltd.* case, although complex, stands as a very good example of judges' ability to use objective evidence in the careful analysis of "willful blindness" and, where appropriate, impose corresponding liability.

On the related post-1994 issue of intermediary immunity, see, e.g., Davis v. Sterne, Agee and Leach, Inc., 2007 WL 80810 (Ala. 2007) (effectiveness of entitlement order was a material fact concerning intermediary's possible protection under UCC § 8-115); Decker v. Yorkton Securities, Inc., 106 Cal.App. 4th 1315, 131 Cal. Rptr.2d 645, 50 U.C.C. Rep.Serv.2d 271 (1st Dist. 2004) (in the absence of evidence that intermediary was willfully blind to adverse claim to stolen security, intermediary was immune under UCC § 8-115). On this issue it is also instructive to consider with some closeness the case of H&R Block Financial Advisors, Inc. v. Express Scripts, Inc., 426 F.Supp. 2d 656 (E.D. Mich. 2006), *later proceeding*, 60 U.C.C. Rep. Serv. 2d 656 (E.D. Mich 2006), in which a customer had sold a large block of mistakenly issued securities through her broker. When the mistaken issuance emerged, the transfer agent asserted conversion and other claims against the broker, and in an initial proceeding, the court dismissed these claims because the broker's alleged misconduct did not rise to the level of collusion. (Before selling the shares, the broker had asked only limited questions of the transfer agent, without apprising it of "glaring red flags," but the court concluded that this misconduct was "at best, merely passive.") However, in a later proceeding, the court permitted the transfer agent to amend its complaint, in light of a new affidavit from the customer which made the broker appear to be "an active wrongdoer" engaged in "knowing encouragement and facilitation of misconduct." (Under the court's reading of the affidavit, the broker had made "dogged efforts" to persuade the customer to sell, despite the customer's numerous objections that she was not the rightful owner.) These two proceedings suggest that even the collusion standard – which, as discussed above, also applies in one of the perhaps more traditional U.S. innocent acquisition rules – is nuanced and workable, and that it like the willful blindness standard by no means amounts to a *de facto* rule of non-liability.

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<sup>15</sup> We would share copies of the cases and sources mentioned here with interested delegations upon request.