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Comments

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

The United States delegation is pleased to submit these observations in advance of the September 2008 diplomatic Conference in Geneva. Some of the following observations reiterate earlier United States proposals and suggestions that have not yet been discussed fully during the meetings of the Committee of Governmental Experts. Others reinstate with modifications earlier proposals. Other proposals and comments are entirely new. For convenience, we include all of these observations in a single document. Of course, future circumstances may suggest the need for the United States to submit additional observations in advance of the diplomatic Conference.

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1. Additional Clarification of Intermediary Status as Proposed in the Transparent Systems Report

The Drafting Committee should ensure that the Convention text includes the substance of Article 1, paragraphs (3), (4), and (5), of the Hague Securities Convention.

a. Background

The Transparent Systems Report (Study LXXVIII - Doc. 88) suggested that the Convention should incorporate provisions similar to of Article 1, paragraphs (3), (4), and (5), of the Hague Securities Convention. Those "provisions ... are designed to clarify whether certain persons (including certain systems and their participants) should be regarded as intermediaries for the purposes of the [Hague Securities] Convention."[1] There was a consensus in the plenary that the substance of these provisions should be included in the Convention text. However, there was insufficient time during the fourth session for the Drafting Committee to complete this task.

Article 1(3) of the Hague Securities Convention:

> "makes it clear that a person is not an intermediary merely because it acts as registrar or transfer agent for an issuer of securities (Art. 1(3)(a)), or records in its books details of securities credited to securities accounts maintained by an intermediary in the names of account holders for which the person acts as manager or agent or otherwise in a purely administrative capacity (Art. 1(3)(b))."[2]

Article 4 of the Convention echoes some of what Hague Securities Convention Article 1(3) seeks to clarify, inasmuch as Article 4 makes it clear that the activity of a CSD or another person with respect to securities "*vis-à-vis* the issuer of those securities" is not within the scope of the Convention. However, the Convention does not address the issue dealt with by Article 1(3)(a) of the Hague Securities Convention with respect to registrars and transfer agents. This omission should be considered and rectified at the diplomatic Conference. A revised version of Article 4 that would address this issue is set forth below.

Paragraphs (4) and (5) of the Hague Securities Convention Article 1, by contrast, are currently reflected in the Convention. Paragraph (4) makes it clear that a person acting as a CSD (a term not defined in the Convention or the Hague Securities Convention) may be considered an intermediary, and the Convention's definition of "intermediary" was expanded during the fourth session of the Committee of Governmental Experts so as to achieve the same clarification. Similarly, paragraph (5) permits a Contracting State to declare that operators of certain systems are not to be considered as intermediaries[3] and Article 2 of the Convention, which also was added at the fourth session, is based on and closely follows this paragraph.

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1 ROY GOODE, HIDEKI KANDA, & KARL KREUZER, *Explanatory Report on the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary* 40 (2005) (HSC EXPLANATORY REPORT).

2 HSC EXPLANATORY REPORT at 40.

3 Article 1(5) was drafted primarily to accommodate the United Kingdom's CREST system. HSC EXPLANATORY REPORT at 40-41.

b. Proposed Revised Text of Article 4

Article 4
[Central Securities Depositories, Registrars, and Transfer Agents]

1. This Convention does not apply to the activity of creation, recording or reconciliation of securities conducted by central securities depositories or other persons vis-à-vis the issuer of those securities.

2. A person shall not be considered an intermediary for purposes of this Convention merely because it acts as registrar or transfer agent for an issuer of securities.

2. Effect of Invalid Debit or Debit in Violation of a Control Agreement

The Convention should make clear that the effect of a debit that is invalid under Article 13(1) is governed by the non-Convention law.

a. Background

The effect of an invalid debit to a securities account or designating entry under Article 13(1) was discussed extensively during the first two sessions of the Committee of Governmental Experts and at intersessional meetings in Berne and Paris in 2005 and 2006. Various views were expressed. Some took the position that an invalid debit should not deprive the account holder or holder of an Article 10 interest from its proprietary rights. Others noted that this result would create a fundamental problem under the non-Convention law of many States and that the victim of the wrongful debit should be limited to a contractual claim against the intermediary. A middle view was that the proprietary right would be lost, but that the intermediary would be obliged to obtain the securities necessary to reinstate the credit to the relevant securities account.

A consensus emerged that reaching a harmonized resolution of this issue under the Convention would be impossible and that the matter should be left to the non-Convention law. This consensus view was explained and illustrated at the end of the third session by the Chair of the Drafting Committee.[4] Submissions by some delegations commenting on the Preliminary Note prepared by the Chair of the Working Group on Article 14 (Study LXXVIII - Doc. 96) have reflected confusion on the point. Consequently, the United States believes that the Convention text should clarify the point.

b. Proposed New Sub-paragraph (f) of Article 13(2)

We suggest that a new sub-paragraph (f) be added to Article 13(2), as follows:

(f) the effect of a debit that is invalid pursuant to Paragraph 1.

3. Innocent Acquisition under Article 14 and Related Matters

a. Background

In advance of the fourth session of the Committee of Governmental Experts the United States proposed (in Study LXXVIII - Doc. 74, parts 2-5) several clarifications and refinements of the Convention's innocent acquisition rules (then contained in Article 12, and now found in

4 *See* Study LXXVIII - Doc. 58 (Appendices), Appendix 17, at 4.

Article 14). Although these proposals found some support in the plenary (notably from France), there was insufficient time for a full consideration during the fourth session and the Drafting Committee did not fully take them into account. At the end of this part is a revised version of Article 14 which reflects the following proposals.

We reemphasize the importance of the innocent acquisition rules. As we stated in our response (Study LXXVIII - Doc. 112) to the Preliminary Note prepared by the Chair of the Working Group on Article 14 (Study LXXVIII - Doc. 96):

> "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."

b. Clarification of Article 14(3) (Source: Study LXXVIII - Doc. 74, part 2)

If an intermediary acquires intermediated securities and enters a corresponding credit to its account holder's account, the acquisition is not "made by way of gift or otherwise gratuitously" within the meaning of Article 14(3). The Convention should be revised to make this clear and to clarify that Article 14(1) applies for the benefit of an intermediary in this context.

Consider the following example: Intermediary 2 (IM-2) receives a credit to its account with Intermediary 1 (IM-1) for the benefit of IM-2's account holder (AH). IM-2 then credits the relevant securities to AH's account. A third party, X, then asserts an adverse claim to the intermediated securities credited to IM-2's account and, in turn, credited by IMI-2 to AH's account and brings an action against IM-2 and AH. IM-2 and AH defend on the basis of innocent acquisition under Article 14(1). X responds that IM-2 acquired the intermediated securities "by way of gift or otherwise gratuitously" and, consequently, under Article 14(3), IM-2 is not entitled to protection under Article 14(1).

It is possible that IM-2 did not itself give value to anyone in order to receive the credit to its account with IM-1. For example, AH could have paid a transferor directly, thus triggering a "free transfer" to IM-2 on the books of IMI-1. However, IM-2 has incurred substantial duties and obligations to AH by virtue of IM-2's credit to AH's account. *See, e.g.*, Articles 7(2); 20; 21(1), (3); 22(1). It follows that IM-2's receipt of a credit on IM-1's books for the benefit if AH was not a gift or a gratuitous acquisition. Such activity is an integral part of the business of securities intermediaries. Accordingly Article 14(1) should apply and the Convention should be revised to make this clear.

c. Limited Application of Article 14 to Acquisitions of Interests under Article 10 (Source: Study LXXVIII - Doc. 74, part 3)

In cases in which the first-in-time priority rule in Article 15 (i.e., priority among competing Article 10 interests) does not apply, a person that acquires an interest under Article 10

should have the benefit of the innocent acquisition protections under Article 14(1). The Convention also should provide for application of the shelter principle.

(i) Direct application of Article 14

Article 15 provides a first-in-time priority rule for competing interests made effective against third parties 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(1). (Note that Article 14(2) already affords protection to qualifying Article 10 interests.)

Consider, however, an adverse claim not associated with competing Article 10 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(1) in this setting merely because it did not receive a credit entry. The Convention should be revised accordingly.

(ii) Application of Article 14 under the shelter principle

Assume now that an account holder acquires (by way of 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 same result should apply with respect to any person who acquires an interest later in a chain of transfers. Both of these results are justified by their benefits to the original, innocent account holder: they have the effect of protecting the marketability of the innocent account holder's intermediated securities. In effect, the shelter principle is part of the principle of innocent acquisition.

The proposed new Article 14(4) that appears below addresses the shelter principle. However, incorporating such a basic property law principle in the Convention presents challenges both for drafting and for applying the provision across a wide variety of systems of non-Convention law. Consideration should be given to explaining this principle in the Official Commentary instead of incorporating it into the Convention text.

d. Revision of Article 14(1)(c) (Source: Study LXXVIII - Doc. 74, part 4)

Article 14(1)(c) should be revised to provide that a credit to the account of a qualifying innocent acquirer is not rendered invalid or liable to be reversed as a result of the interest or rights of the other person.

Article 14(1)(c) provides that in the case of a credit to the account of an innocent acquirer "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." The goal of sub-paragraph (1)(c) is to ensure that the interest or rights of another person do not have the effect of invalidating or rendering reversible the credit to the account of a qualifying innocent

acquirer. However, the "ground" stated in sub-paragraph (1)(c) identifies only one of several bases or grounds that the other person might assert to support invalidation or reversibility. Accordingly, paragraph (1)(c) should be revised as indicated below.

e. Effect of Public Filing, Registration, Recordation, or Notice (Source: Study LXXVIII - Doc. 74, part 5)

A public filing, registration, or notice should not, of itself, disqualify an acquirer of intermediated securities of the innocent acquisition protections under Article 14.

In some jurisdictions, including the United States, a public filing, registration, recordation, or notice (*other than, e.g.*, a registration inside the intermediated system, such as a designating entry on the books of an intermediary) will afford protection against certain third party claims. However, the standard of innocence under Article 14(4)(b) requires the absence only of actual knowledge or so-called "willful blindness."[5] The Convention should make clear that the fact that a public filing, registration, recordation, or notice has been made should not, of itself, constitute actual knowledge or "willful blindness." Transactions in intermediated securities would be substantially impaired if acquirers were to find it necessary to undertake a search of public records, which entails large delay and cost.

f. Clarification of Results When Person Does Not Qualify for Article 14 Protection

The Convention (or Official Commentary) should make clear that when a person does not qualify for Article 14 protection any liability or defense of that person is governed by the non-Convention law.

As we explained in our response (Study LXXVIII - Doc. 112) to the Preliminary Note (Study LXXVIII - Doc. 96):

> "[I]f 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."

The Convention (or, arguably, Official Commentary) should make this clear.

g. Appropriate Test or Standard for Innocence under Articles 14 and 16(2)

The Convention should retain the "willful blindness" test for knowledge under Article 14(4)(b) while providing a declaration mechanism for Contracting States to opt out of that standard.

We stated our position and reasoning on the appropriate test or standard for innocent acquisition in our response (Study LXXVIII - Doc. 112) to the Preliminary Note (Study LXXVIII - Doc. 96) as follows:

> "[T]he 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

[5] We appreciate that Article 14(4)(b) now appears in square brackets. We discuss the appropriate standard for innocent acquisition below in part 1.g. But, whatever standard of knowledge is ultimately adopted, the point made here about public notice systems would remain applicable.

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."

The United States has studied with interest the various responses to the Preliminary Note that have been submitted by delegations. It also has considered the Summary Report (CONF. 11-Doc. 8) prepared by the Chair of the Working Group. There is strong support among the delegations for the principle that the Convention should protect innocent acquirers. There also is substantial support for adopting a harmonized Convention test.

Notwithstanding this support, it now appears unlikely that an innocent acquisition standard can be formulated that would satisfy all delegations or even a substantial majority.[6] For this reason, the revised version of Article 14 proposed by the United States contains a provision permitting a Contracting State to opt out of the Article 14 willful blindness test through a declaration mechanism. A declaring Contracting State would rely, instead, on the applicable standard for disqualifying knowledge under its non-Convention law. The United States hopes that this compromise will accommodate States that are content with their non-Convention law standards while offering other States the opportunity to accept a harmonized standard.

h. Knowledge by an Organization

The Convention should retain the organizational knowledge test under Article 14(4)(c), with clarification in the Explanatory Report, and add a definition of "organization."

For two reasons, the Convention should specify how its definition of knowledge applies in the case of organizations. First, an organization cannot have knowledge except through particular individuals. And second, most acquisitions of intermediated securities are by organizations, composed by or otherwise linked to numerous individuals having widely varying levels of knowledge and widely varying roles.

(i) Functioning of the test

There appears to be no dispute about the desirable functioning of an organizational knowledge test: it should provide guidance for whose knowledge counts, while preventing abuses and not imposing undue burdens. One maneuver that would clearly be abusive, and that is further discussed below, would be if a commercial actor having relevant knowledge were able to insulate

[6] Recall that following a lengthy discussion during fourth session, the Chair of the Committee concluded that no consensus existed in the plenary and directed that Article 14(4)(b) and (c) be placed in square brackets.

itself from that knowledge by artificially arranging for intermediated securities to be acquired through a nominee, affiliate or outsourcing partner. The United States agrees that the organizational knowledge test should prevent this abuse by being flexible enough, under proper circumstances, to charge an acquiring organization with the knowledge even of individuals who are outside the organization.

The Convention's current Article 14(4)(c) test meets the overall goals of an organizational knowledge test, and in particular it is well designed to avoid abuses as well as undue burdens. It focuses not only on "the individual responsible for the matter," but also on the time at which the knowledge is "or ought reasonably have been brought to [that individual's] attention." An alternative way of formulating the Article 14(4)(c) test, which the United States would also welcome, is set forth below.

In either formulation, the test's reference to reasonableness is important in at least two ways that should help to alleviate lingering concerns. First, if reasonable action would bring the knowledge to the attention of the individual responsible for the matter, then the organization acquiring the intermediated securities is charged with that knowledge, whether the organization did in fact act reasonably or not. (This is clear from the test's "or" clause.) And second, the concept of reasonableness enables the test to apply flexibly and appropriately in a wide variety of circumstances. Accordingly it need not set forth detailed and rigid rules, which might often fail to achieve the test's overall goals, in addition to being impractical as a drafting matter.

As one important example of this flexibility, whenever the circumstances are such that an organization acquiring intermediated securities should reasonably acquire information from a source *outside* the organization, then the test requires the organization to do so. In other words, *nothing limits the reasonableness requirement to sources within the organization itself.* This point directly forecloses the abusive maneuver referred to above, and if the plenary wishes to highlight it with language in the Convention's Official Commentary, the United States would be amenable to that idea.

The flexibility of the test's reasonableness concept is important in other circumstances as well, and could similarly benefit from mention in the Official Commentary. For example, does reasonableness require that every single one of an organization's employees, even those that have no role in a particular acquisition of intermediated securities, report his or her relevant knowledge to the individual responsible for the acquisition? We suggest that the answer should generally be no, in order to protect the benefits of division of labor within the organization. But we also suggest that a duty to report would exist under certain circumstances, such as where the reporting of the knowledge is part of the employee's prescribed duties (as, for example, with a bank employee responsible for monitoring financial newspapers for stories about the bank's prospective transactions), or where the employee otherwise has reason to know that his or her knowledge, if shared, would have an important effect on the acquisition.

We are hopeful that the plenary, with the above thoughts in mind, will readily agree to retain the current test, or to replace it with the alternative formulation.[7]

[7] The temporal element of this test ("from the time when the interest or fact ...") presents no inconsistency with the temporal element of Article 14(1) ("Where securities are credited ... at a time when the account holder does not know ... ."). On the contrary, the Article 14(4)(c) test's overall purpose is simply to provide guidance for the application of Article 14(1)'s temporality in the special case of organizations.

(ii) Definition of "organization" and its limited role

The United States recommends that a definition of "organization" be added to the Convention, and believes that a proper understanding of current Article 14(4)(c)'s reasonableness test, as described above, should alleviate any concerns about doing so. We suggest that the term be defined along the lines set forth below. Official Commentary could clarify the definition. For example, appropriate considerations would be whether a purported organization is capable of incurring legal and contractual obligations and owning property, capabilities that an account holder must possess.

Adding the definition would simply clarify the circumstances in which the Article 14(4)(c) test, with all of its flexibility of reasonableness under the circumstances, would apply. Adding the definition would by no means determine or narrow the outcomes under that test; and in particular, nothing about adding the definition would undermine the important point, discussed above, about reasonableness preventing an organization from abusively insulating itself from knowledge held by affiliates or others outside the organization. This can clearly be seen from the fact that Article 14(4)(c) uses the word "organization" only as a predicate for application of the reasonableness test, and not as any part of the content of the reasonableness test itself.

i. Proposed Revised Text of Article 14

A revised version of Article 14 that reflects the foregoing observations follows.

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

1. Where securities are credited to the securities account of an account holder, or an interest becomes effective against third parties under Article 10 and Article 15 does not apply, at a time when the account holder or the person to whom the interest is granted 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, or the person to whom the interest is granted, is not subject to the interest of that other person;

(b) the account holder, or the person to whom the interest is granted, is not liable to that other person; and

(c) the credit or interest is not rendered invalid, ineffective against third parties 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~~ as a result of the interest or rights of that other person.

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 intermediated securities, other than the grant of a security interest, made by way of gift or otherwise gratuitously.

4. Where the acquisition of intermediated securities by an account holder or a person to whom an interest is granted is protected by paragraph 1 or paragraph 2, a person who acquires, directly or indirectly, an interest in the securities or intermediated securities from the account holder or the person to whom an interest is granted also is protected.

5. Where the acquisition of intermediated securities by an account holder or a person to whom an interest is granted is not protected by paragraph 1 or paragraph 2, the non-Convention law determines the rights and liability, if any, of the account holder or the person to whom an interest is granted.

~~4.~~ 6. 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) Where securities are credited to the account of an intermediary as account holder and the intermediary credits the securities to the account of its account holder, the intermediary acquires intermediated securities for value and not by way of gift or otherwise gratuitously;

(c) a person does not know of an interest or fact merely because the interest or fact is available or observable in a system for public filing, registration, recordation, or notice;

~~[(b)~~(d) 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)~~(e) 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 or from the time it would have brought to the individual's attention if the organization had acted reasonably~~.]~~;

(f) "organisation" means a person (other than an individual, natural person), including a corporation, partnership, government, governmental subdivision or any other legal or commercial entity; and

(g) sub-paragraphs (d) and (e) do not apply where a Contracting State has made a declaration pursuant to Article [specify relevant article in final provisions].

~~5.~~ 7. 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.

4. Clarification of the Relationship Between the Convention and Insolvency Law

a. In general

The United States submitted its comments (Study LXXVIII - Doc. 113) on the Paper (Study LXXVIII - Doc. 97) prepared by the Chair of the Working Group on Insolvency-related Issues. By way of general comments, it noted that the general approach that the Convention currently adopts for insolvency-related issues is appropriate. The United States further noted that there is no need for basic changes in approach or including unnecessary detail in the text. Further, it noted that the Convention should build on the Cape Town Convention approach to insolvency proceedings. The

provisions of Cape Town on insolvency law matters served as a basis for the Convention's provisions.

We excerpt below some points and proposals made by the United States in Study LXXVIII - Doc. 113. Reference should be made to that document for additional detail.

b. Revision of Article 17(1)

Article 17(1) should be revised to provide that rights of account holders and Article 10 interests are effective in any insolvency proceeding. The limitation to an insolvency proceeding of the relevant intermediary (or other person performing intermediary functions) should be removed.

The United States noted in Study LXXVIII - Doc. 113:

"Article 17 ... provides the baseline principles for the relationship between the Convention and national insolvency laws. Article 17(1) provides that the rights of an account holder and an interest that has become effective under Article 10 are effective in an insolvency proceeding of the relevant intermediary. Article 17(2) then provides that the Convention does not impair an interest in intermediated securities against an insolvency administrator or creditors if the interest is effective under the non-Convention law. Taken together, these provisions reflect the Convention's goal of making interests in intermediated securities effective.

... During the fourth meeting of the Committee of Governmental Experts in May 2007, at the suggestion of the United States in Doc. 83 and with support in the plenary, Article 17(2) was added to the Convention. This served to conform the Convention's text even further to the Cape Town Convention inasmuch as Article 17(2) derives from Article 30(2) of Cape Town. Article 18, then, limits the general principles of Article 17.

... The insolvency proceedings that most often will test the effectiveness of the rights and interests mentioned in Article 17(1) are not the insolvency proceedings of relevant intermediaries. Such proceedings are relatively rare. But the applicability of Article 17(1) is limited to "any insolvency proceeding in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 5."

The more significant insolvency proceedings affecting intermediated securities normally will be those of *transferors*, such as sellers, lenders, and debtors granting security interests, or the insolvency proceedings of an account holder - *not* those of relevant intermediaries. ... For this reason, the United States believes that Article 17(1) should not be limited to relevant intermediary insolvencies ... . Note as well that Article 17(2), based on Cape Town Article 30(2), is not limited to insolvency proceedings of the relevant intermediary.

While eliminating the unfortunate limitation of the scope of Article 17(1) is important, the United States does not believe that it would represent a major change in the expectations and assumptions that have been the basis for discussions of the Convention to date. We believe that the suggested modification is consistent with the underlying assumptions about effectiveness "against third parties" that lie at the core of Articles 9 and 10. Notwithstanding these underlying assumptions, the limitation of the scope of Article 17(1) in the current text raises doubts that an insolvency

administrator would be considered a "third part[y]." The clarification we suggest would eliminate such doubts."

c. Proposed Revised Text of Article 17(1)

1. The rights of an account holder under Article 7(1), and an interest that has become effective against third parties under Article 10, are effective against the insolvency administrator and creditors in any insolvency proceeding ~~in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 5~~.

d. Scope of Article 18

Concerning the scope of Article 18, the United States further noted in Study LXXVIII - Doc. 113:

> "[T]he Paper [Doc. 97] questions whether the scope of the Article 18 carve-outs is sufficiently clear. The United States believes that appropriate clarifications, if any are needed, can be made in the Explanatory Report or Official Commentary to the Convention and do not require adjustment of the Convention text. The Commentary should make clear that the applicable non-Convention insolvency law, not the Convention, determines whether an avoidance is one "as a preference or as a transfer in fraud of creditors." For example, under United States bankruptcy law the carve-outs would be interpreted broadly to encompass both "undervalues" (as a species of fraudulent transfer) and "automatic" avoidances (as a species of preference). The Commentary also should make it clear that defenses to avoidance claims under the applicable insolvency law should be available. The United States believes that the Cape Town Convention should be interpreted in the same manner. For this reason, clarifying changes to the text of the Convention could be understood to imply that Cape Town should be interpreted in a different way - which would be an unfortunate result to say the least."

5. Clarification of Article 19 on Prohibition of Upper-Tier Attachment

Article 19 should be revised to clarify that it prohibits upper tier attachment even when the judgment being enforced is not against the account holder whose securities account is being attached.

a. Background

Depending on the applicable non-Convention law, it may sometimes be valid and appropriate for a judgment creditor or similar creditor to attach the intermediated securities of a person other than the one against whom the judgment or other award was issued. This may be a common way of reaching, for example, securities wrongfully transferred to a person who subsequently deposits them for credit to a securities account. The Convention rightly does not address the propriety of such an attachment as a general matter; however, the Convention should address *where* (*i.e.*, at what level and against which intermediary) the attachment should be served.

As written, Article 19 does not appear to address attachments arising out of a judgment against someone other than the account holder. This is because Article 19(2) limits its scope to judgments, etc. that are "against or in respect of that account holder." In order to broaden the concept of attachment beyond those arising out of those judgments, we propose deletion of the

quoted language from Article 19(2) and deletion of the word "such." As a result, whoever the judgment is against, any attachment would have to be at the proper level dictated by paragraph 1. A revised version of Article 19(2) follows (with Article 19(1) also set forth below for convenience).

b. Proposed Revised Text of Article 19

Article 19
[Prohibition of upper-tier attachment]

1. Subject to paragraph 3, no attachment of intermediated securities of an account holder shall be made against, or so as to affect:

(a) a securities account of any person other than that account holder;

(b) the issuer of any securities credited to a securities account of that account holder; or

(c) a person other than the account holder and the relevant intermediary.

2. In this Article "attachment of intermediated securities of an account holder" means any judicial, administrative or other act or process to freeze, restrict or impound intermediated securities of that account holder in order to enforce or satisfy a judgment, award or other judicial, arbitral, administrative or other decision ~~against or in respect of that account holder~~ or in order to ensure the availability of such intermediated securities to enforce or satisfy any future ~~such~~ judgment, award or decision.

6. Limited Intermediary Immunity from Liability

The Convention should provide a declaration mechanism for Contracting States to opt-in to a provision for limited immunity from liability for intermediaries that make proper and authorized book entries.

a. Background

In our proposal on innocent acquisition and related matters submitted to the third meeting of the Committee of Governmental Experts (Study LXXVIII - Doc. 45(e)), we noted that a new provision should be added to the Convention "to address the immunity of intermediaries and securities settlement and clearing systems acting in their capacity as such." As a result, paragraphs (2), (3), and (4) were added to former Article 20 of the draft Convention that emerged from the third session (Study LXXVIII - Doc. 57). However, as reflected by the square brackets appearing in those provisions, at its third session the Committee failed to reach a consensus on the intermediaries that should be covered by the immunity - *i.e.*, limited to securities settlement systems and securities clearing systems or applicable to all intermediaries.

Following a discussion at the fourth session, these provisions for limited immunity were deleted, notwithstanding strong support from Canada, Luxembourg, and the United States. The United States explained, in its written observations (Study LXXVIII - Doc. 74, part 1) and during the plenary discussion, that the principal purpose of the limitation on intermediary liability is the protection of the interests of *account holders*. The limitation is intended to induce intermediaries to make proper entries in securities accounts. Absent legal process served on an intermediary or the intermediary's wrongful behavior, a third party's assertion that it has an interest in affected intermediated securities and that an (otherwise rightful) entry would violate its rights should not be allowed to discourage an intermediary from making a proper entry. Otherwise, such an assertion could force a prudent intermediary to block the account (with respect to the relevant intermediated securities) pending the ultimate resolution of the matter. This not only would disrupt the liquidity

that is the goal of a system of intermediated securities but also could work a considerable hardship on the affected account holder.

Unlike the concept of innocent acquisition, where there is strong consensus in principle, if not in detail, the discussion during the fourth session indicated that no such consensus exists or is likely to emerge concerning intermediary immunity from liability. This circumstance is understandable, given the diversity of liability rules and the standards for the liability of an intermediary (negligence, gross negligence, wrongful and knowing collusion to violate rights, etc.).

b. Opt-in Declaration Mechanism for Intermediary Limitation of Liability

The United States believes that the Convention should contain an optional declaration mechanism under which a Contracting State could opt in to a provision for limiting the liability of intermediaries. Draft Convention text (Article 25*bis*) for such a provision appears below. Under this approach, a Contracting State could choose to adopt or not to adopt a limitation of liability provision to apply when that State's law is the non-Convention law. If it chooses to opt in, it also could choose the standards that would entitle an intermediary to immunity and the types of intermediaries or settlement or clearing systems that would be eligible for the immunity.

As was the case under the earlier draft provisions that were deleted, the limitation of liability does not apply to liabilities to the relevant account holder or a transferee of an effective interest under Article 10 or to any entry that the intermediary "is not entitled to make under Article 20."

In sum, the United States believes that Contracting States should be afforded the option of adopting a coherent system for the limitation of liability of intermediaries. Moreover, the declaration mechanism will provide needed transparency for the users of systems of intermediated securities.

c. Proposed Text of New Article 25*bis*

*Article 25*bis
[Limitations on liability of intermediaries, securities settlement systems and securities clearing systems]

1. This Article applies only where a Contracting State has made a declaration pursuant to Article [specify relevant article in final provisions] and in the manner stated in such declaration.

2. An intermediary, including the operator of a securities settlement system, who makes a debit, credit, or designating entry (an "entry") to a securities account maintained by the intermediary for an account holder is not liable to a third party who has an interest in intermediated securities and whose rights are violated by the entry unless –

(a) the intermediary makes the entry after the intermediary has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or

Alternative A

(b) the intermediary acts wrongfully and in concert with another person to violate the rights of that third party.

Alternative B

(b) the intermediary acts with gross negligence.

Alternative C

(b) at the time the intermediary makes the entry the intermediary knows of the interest of the third party and that the entry violates the rights of the third party.[8]

3. Paragraph 2 does not affect any liability of the intermediary:

(a) to the account holder or a person to whom the account holder has granted an interest that has become effective against third parties under Article 10; or

(b) that arises from an entry which the intermediary is not entitled to make under Article 20.

4. The operator of a securities settlement system or securities clearing system to whose securities account securities are credited and who authorises a matching debit of those securities to its securities account is not liable to a third party who has an interest in intermediated securities and whose rights are violated by that credit or debit unless:

(a) the operator receives the credit or authorises the debit after the operator has been served with legal process restraining it from doing so, issued by a court of competent jurisdiction, and has had a reasonable opportunity to act on that legal process; or

Alternative A

(b) the operator acts wrongfully and in concert with another person to violate the rights of that third party.

Alternative B

(b) the operator acts with gross negligence.

Alternative C

(b) at the time the operator receives the credit or authorises the debit the operator knows of the interest of the third party and that the credit or debit violates the rights of the third party.

5. Paragraphs 2 and 3 do not apply where a Contracting State has made a declaration pursuant to Article [specify relevant article in final provisions] that so states.

7. Relationship Between Article 12 Evidential Requirements and Effectiveness of a Credit

The Convention should make clear that evidential requirements imposed by the non-Convention law do not interfere with the effectiveness of a credit against third parties.

a. Background

Under Article 12, the evidential requirements for Article 9 and 10 matters including debits, credits, designating entries and agreements between the parties are left to the non-Convention

[8] Alternative C in paragraphs 2 and 4 should be supplemented by the willful blindness test for knowledge and a special provision for knowledge of an organization, as discussed above in connection with Article 14(b) and (c). Alternative C would cause the immunity to be considerably less effective, of course, because a demand or notification by a third party could result in an intermediary's refusal to act, at least if the demand or notification were credible.

law. At the same time, under Article 9(2), "no further step" other than a credit "is necessary, or may be required by the non-Convention law, to render the acquisition of intermediated securities effective against third parties." As currently drafted, Articles 12 and 9(2) may conflict with each other in cases where the non-Convention evidential law requires a credit to be accompanied by some further step. Accordingly, to protect the integrity of a credit, we believe that the non-Convention evidential law should be subject, in this limited context, to Article 9(2).

b. Proposed Revision of Article 12

We suggest that Article 12 be revised as follows:

Article 12
[Evidential requirements]

Subject to Article 9(2), the ~~The~~ non-Convention law determines the evidential requirements in respect of the matters referred to in Articles 9 and 10.

- END -