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

Observations on Innocent Acquisition and Immunity

1. Immunity under Article 20.

The limited immunity from liability provided by Article 20(2) and (3) should apply to all intermediaries and should not be limited to securities settlement systems.

In our proposal on innocent acquisition and related matters submitted to the third meeting of governmental experts (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." Paragraphs (2) and (3) of Article 20 represent a step in the right direction. However, as reflected by the square brackets appearing in these provisions, at its third meeting the committee of governmental experts failed to reach a consensus on the intermediaries that should be covered by the immunity. In our view the immunity must apply to all intermediaries and should not be limited to securities settlement systems.

Article 20, paragraphs (2) and (3), provides a limited,[1] albeit very important, immunity from liability. Consideration of the appropriate beneficiaries of this limitation on liability requires an examination of its underlying purposes. The principal purpose of the limitation on liability is to protect 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,[2] a third party's assertion that it has an interest in affected intermediaries 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

[1] The limitation on liability applies only to claims by "a third party who has an interest in intermediated securities and whose rights are violated by the entry [made by an intermediary to a securities account]." Moreover, it does not apply if either of the conditions specified in Article 20(2) (a) or (b) exists. Finally, Article 20(3) makes it clear that the limitation of liability does not apply to liabilities to the relevant account holder or a transferee of an effective interest under Article 8 or to any entry that the intermediary "is not entitled to make under Article 18."

[2] *See* Article 20(2) (a), (b).

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.

There appears to be no disagreement that an assertion by a third party of an interest and of a potential violation of its rights should not have an adverse effect on the operations of a securities settlement system or securities clearing system and, accordingly, the operator of such a system should be protected by the Article 20 limitation on liability. However, the potential for serious market disruptions, and even systemic risk, is not limited to disruptions in such systems.

For example, the clearing and settlement arrangements for the United States government and government agency securities markets are central to the operations of those markets. However, those arrangements are not limited to entities that meet the definition of securities settlement system or securities clearing system as narrowly and carefully defined in the Convention.[3]

In sum, the immunity provided by Article 20(2) is necessary for the protection of all account holders of all intermediaries. Its application should not be limited to situations that implicate entries made by securities clearing or settlement systems. Disruption of intermediaries other than securities settlement systems may pose systemic risk.

2. Clarification of Article 12(3).

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 12(3).

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 12(1). X responds that IM-2 acquired the intermediated securities "by way of gift or otherwise gratuitously" and, consequently, under Article 12(3) IM-2 is not entitled to protection under Article 12(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 5(2); 18; 19(1), (2); 21(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 12(1) should apply and the Convention should be revised to make this clear.

[3] For background on the U.S. Government securities market, *see* the Addendum to these observations.

3. Limited application of Article 12 to acquisitions of interests under Article 8.

In cases in which the first-in-time priority rule in Article 13 (*i.e.*, priority among competing Article 8 interests) does not apply, a person that acquires an interest under Article 8 should have the benefit of the innocent acquisition protections under Article 12.

a. Direct Application of Article 12.

Article 13 provides a first-in-time priority rule for competing interests acquired under Article 8 (*i.e.*, by way of designating entry or control agreement or by an intermediary from its account holder without further steps). Appropriately, moreover, Article 13 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 13) instead of the last-in-time innocent acquisition rules of Article 12.

Consider, however, an adverse claim not associated competing Article 8 interests in the same intermediated securities, which are governed by Article 13. 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 8 acquirer should be denied innocent acquisition protection under Article 12 in this setting merely because it did not receive a credit entry. The Convention should be revised accordingly.

b. Application of Article 12 under the Shelter Principle.

Assume now that an account holder acquires (by way a credit) intermediated securities and qualifies for innocent acquisition protection under Article 12. 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 8. 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 8 acquirer should be protected from the adverse claim. The Convention should make this clear.

4. Revision of Article 12(1) (c).

Article 12(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 12(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 (c) is to ensure that the interest or rights of another person to 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 (c) identifies only one of several bases or grounds that the other person might assert to support invalidation or reversibility. We suggest that sub-paragraph (c) be revised to read as follows:

(c) the credit is not invalid or liable to be reversed as a result of the interest or rights of that other person.

5. Effect of Public Filing, Registration, or Notice.

A public filing, registration, or notice should not, of itself, disqualify an acquirer of intermediated securities of the innocent acquisition protections under Article 12.

In some jurisdictions, including the United States, a public filing, registration, or notice will afford protection against certain third party claims. However, the standard of innocence under Article 12(4) (b) requires the absence only of actual knowledge or so-called "willful blindness." The Convention should make clear that the fact that a public filing, registration, 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. Such a requirement could extend to any number of registries or public filings making transactions in intermediated securities risky and costly.

Addendum to Observations on Innocent Acquisition and Immunity submitted by the delegation of the United States of America

Central banks and government securities issuing agencies great need for certainty and liquidity and have a major stake in the issue of intermediary immunity. For example, the liquidity and efficiency of the U.S. Government securities market are essential for the U.S. Treasury to borrow at the lowest possible cost and for the Federal Reserve Bank of New York to carry out the central bank's monetary policy operations. While many banks act as clearing and settlement agents and custodians for U.S. Government securities for their customers, two large banks clear, settle, and act as custodian for all the major dealers in the U.S. Government securities market, including primary dealers, the counterparties with which the Federal Reserve Bank of New York conducts monetary policy transactions. Another important function the two clearing banks perform is the daily settlement activities for Fixed Income Clearing Corporation, a central counterparty for cash market and repurchase agreement ("repo") trading in the U.S. Government market. A critical function of the market is the financing of dealer portfolios overnight in the tri-party repo market. These two clearing banks act as tri-party agent for the dealers and for the investors, the money market mutual funds and pension funds, which provide the overnight financing in amounts of $2 trillion dollars every day. In addition, the clearing banks perform settlement and custodial functions for the repo transactions the Federal Reserve Bank of New York executes with the primary dealers.

It is crucial that the intermediaries that perform these essential functions in the market must be able to complete these critical and high volume transactions involving the conduit or ministerial functions of making debits and credits on their books for their customers — the dealers, the money market mutual funds and pension funds, the central bank and other account holders — without risk of liability for acting on the authorized instructions of those customers. It would create enormous systemic risk if the same standard that applies to purchasers, collateral takers and other investors, which is appropriately a "knowledge" standard, applied to these ministerial functions of intermediaries which could have the effect of disrupting finality. In the United States, the law currently provides the type of immunity to intermediaries proposed in Article 20 (2) and (3). It is crucially important in other countries' markets as well as the United States that intermediaries may act without risk of liability, unless, among other things they receive a court order directing them not to act or engage in wrongdoing in concert with a customer.