



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

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Working paper on transitional rules

Prepared by the Swiss Delegation

During its third session of November 2006, the Committee of Governmental Experts considered a document of the Swiss delegation outlining the need for a transitional rule (Doc. 49). After a brief discussion, it decided to refer this issue to intersessional preparatory work to be chaired by the Swiss delegation and organised by the Secretariat.

Call for comments

The following document describes the problem and possible solutions identified so far. It also **requests all delegations and observers to communicate their views on the following two questions before 30 March 2007:**

1. So far, the Committee has identified one transitional problem in connection with the priority under the Convention of interests in intermediated securities granted prior to the entry into force of the Convention (see below). Please indicate **which one of the possible solutions** (outlined below) **you would prefer and why**.
2. **Have you identified other transitional problems** in connection with the Draft Convention that may need to be addressed? In particular, what transitional issues arise from declarations that Contracting States are invited or required to make (and may possibly withdraw)?

Please address your comments to c.baradat@unidroit.org. All comments and relevant suggestions received timely will serve as a basis for a report submitted to the Committee of Governmental Experts for its fourth session (21–25 May 2007).

Problem 1:**Priority of interests granted before the entry into force of the Convention**

So far, the Committee has identified only one transitional problem. It deals with the priority of security and other interests granted

- before the entry into force of the Convention, but
- not in a manner consistent with the methods recognised by the Convention.

The problem results from the fundamental policy underlying Article 13 (2) of the Draft Convention (Doc. 57): while non-Convention law may provide for other methods to grant an interest in intermediated securities and make it effective against third parties, a limited list of such methods are recognised internationally and therefore enjoy a priority that is superior to other methods.

The problem is best illustrated with a few fact patterns. The following illustrations deal with a security interest (collateral). In accordance with the new approach adopted in November 2006, the problem arises with the granting of "[any] interest in intermediated securities, including a security interest or a limited interest other than a security interest", see Article 8 (1) *in initio*.

Fact pattern 1. Before the entry into force of the Convention for the Contracting State whose law governs the issue ("the relevant Contracting State"), a collateral taker (CT) has obtained a security interest by having intermediated securities credited to a securities account in his name.

The Convention recognises this security interest because it was created in accordance with Article 7. Since the securities are not credited to the collateral provider's securities account any more, CT controls the creation of any subsequent security interest.

Fact pattern 2. Same as 1, but CT has entered into a control agreement with the account holder providing the collateral (AH) and with the relevant intermediary (IM).

Provided that the relevant Contracting State has made a declaration that its non-Convention law regards a control agreement as sufficient to deliver securities, Article 8, the security interest obtained by CT enjoys a first-in-time priority in accordance with Article 13 (2) and (3). Any subsequent security interest created by AH in accordance with Article 8 would rank below, whether created before or after the entry into force of the Convention for the relevant Contracting State. Any subsequent security interest created by credit to the securities account of a new collateral taker raises an issue of innocent acquisition governed by Article 12.

Fact pattern 3. Same as 1, but CT has perfected its security interest by filing in a public registry in accordance with the non-Convention law.

The Draft Convention does not prohibit any other method provided by the non-Convention law, such as filing a notice of the interest with some registrar, but Article 13 (2) ranks the priority of such interests below any (prior or subsequent) security interest created in accordance with one of the methods contemplated by the Convention. In other words, the security interest perfected by CT would lose its first-in-time priority after the entry into force of the Convention for the relevant Contracting State. CT is now at risk to have his security interest primed by any subsequent security interest created by AH in accordance with the Convention. A transition rule should allow CT to preserve his priority.

Fact pattern 4. Before entry into force of the Convention, CT-1 has obtained a security interest by a designation in the account of AH. Later on, the relevant intermediary IM has obtained a security interest in the same securities without any further formalities. According to the applicable law at the time, IM's interest prevails over CT-1's interest.

Provided that the relevant Contracting State declares that its domestic non-Convention law recognises both methods as sufficient to constitute delivery, both securities interests are recognised under the Convention. However, their priority becomes strictly first-in-time in accordance with Article 13 (2). IM's security interest, which ranked before under the non-

Convention law, now ranks second after CT-1's interest. A transition rule would be needed to allow IM to preserve its priority.

As show by fact patterns 3 and 4, it is of paramount importance that account holders and collateral takers be allowed to adapt to the Convention and in particular to take steps to preserve the priority of existing security interests. The Convention should include a rule creating a bridge for security interests existing before its entry into force so that, at least to the extent such interests conform (or are made to conform) with internationally recognised methods for making them effective against third parties, their original priority is maintained.

Possible solutions to Problem 1

To protect the interests of collateral takers (and takers of interests other than collateral) granted before the entry into force of the Convention, two alternative approaches have been identified by the Committee:

1. Provide for a **grace period** during which collateral takers can take a preservation action. By timely taking the steps necessary to make their interest effective against third parties in accordance with Article 8, the collateral takers would be allowed to maintain their initial priority.
2. Provide for a **grandfathering clause** maintaining the priority of all interests created before the entry into force of the Convention, whether or not they were made effective against third parties in accordance with one of the methods contemplated by the Convention.

The first approach puts the emphasis on transparency: after the grace period, all parties should be able to recognise which interests have been made effective in a way that is recognised by the Convention and thus enjoy the priority rule set out by the Convention.

The second approach minimises the costs of “re-perfecting” the security and other interests when necessary, at the cost of transparency.

The Committee will need to decide whether the choice between these approaches should be made by the Convention or by the non-Convention law. If the grace period approach is preferred, the Convention might also set out a framework and leave the non-Convention law to determine the actual duration of the grace period and specify which preservation actions are required.

Identification of other transitional problems

So far, this is the only transitional problem identified by the Committee. Delegations and observers are encouraged to re-consider the whole Draft Convention in the light of existing domestic laws so as to identify possible other transitional problems that should be addressed.

In particular, delegations and observers may wish to consider if significant transitional issues need to be addressed in respect of the submission, modification and withdrawal of declarations by Contracting States as provided for in Articles 1 (n) & (o), 8 (4) and 32 of the Draft Convention.