



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

*Related documents: Doc. 49, 59, 68 and 69*

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### **Report on transitional rules**

During its third session of November 2006, the Committee of Governmental Experts considered a document by the Swiss delegation outlining the need for transitional rules (Doc. 49). After a brief discussion, it decided to refer this issue to inter-session work to be facilitated by the UNIDROIT Secretariat and the Swiss delegation. A working paper (Doc. 59 of February 2007) was circulated to all delegations and observers. Formal comments were submitted by the delegations of Finland (Doc. 69) and the United States (Doc. 68). Informal comments were also received.

#### **Priority of interests granted before and after the effective date of the Convention**

All comments address the problem identified in November 2006, *i.e.* the priority between interests created in accordance with the law of a given jurisdiction before the entry into force of the Convention for that jurisdiction (“the effective date”) and interests granted in accordance with the Convention and the non-Convention law of that jurisdiction after the effective date.

The problem arises because Article 13(2) of the Draft Convention (Doc. 57) establishes that, subject to two exceptions –

“interests that become effective against third parties under Article 8 have priority over any interest that becomes effective against third parties by any other method permitted by the non-Convention law.”

The Convention does not prohibit or invalidate interests which have been made effective under the non-Convention law in a manner not contemplated by Article 8, but it subordinates such interests to interests made effective in accordance with Article 8 independent from the time when this occurred.

The effects of Article 13 on interest created before the effective date must be addressed by a transitional rule, as evidenced by the discussion of various fact patterns in previous documents (see Doc. 49 and 59).

The short discussion during the November 2006 session and the comments received so far suggest three possible approaches for a transitional rule in the Convention –

1. full grandfathering of pre-effective interests;
2. limited grandfathering of pre-effective interests; and
3. deference to Contracting State for inter-temporal priority conflicts.

***Full grandfathering of pre-effective interests***

Under the grandfathering approach, the Convention would provide that Article 13 does not affect in any way the priority of pre-effective interests. This approach maximises the legal certainty in favour of holders of interests made effective against third parties in accordance with the law applicable at the time. Whatever priority such interests enjoy remains unaffected by the entry into force of the Convention and by related changes in the non-Convention law.

This approach requires potential acquirers of post-effective interests to enquire about the existence of pre-effective interests. It raises no difficulties when “old” interests were made effective in a manner consistent with one of the methods contemplated in Article 8 of the Convention. However, a full grandfathering would require potential acquirers of interests to investigate, years after the entry into force of the Convention for a particular jurisdiction, about the existence and effectiveness of interests that were made effective years before the effective date and in a manner (such as filing in a public registry or by notice given to the intermediary) different from Article 8 and potentially different from the non-Convention law as amended in respect of the adoption of the Convention.

***Partial grandfathering of pre-effective interests***

The second approach does not upset or rearrange priorities that were established before the effective date. Pre-effective interests should always rank between themselves in accordance with the law applicable under which they were made effective.

However the grandfathering enjoyed by pre-effective interests as against interests created after the effective date would be time-limited during a grace period established by the Convention.

The grace period would allow all short-term pre-effective interests to retain their priority without the need for any additional step.

In respect of interests granted for a time extending beyond the grace period, those which were made effective in accordance with a method recognised by Article 8 would retain their priority over any subsequent interests. In jurisdictions where control agreements and designating entries already exist, they would be recognised by the Convention after the effective date.

However, pre-effective interests which were made effective against third parties in accordance with a method other than those promoted by the Convention would be subordinated in accordance with Article 13(2) unless steps are taken during the grace period to comply either with Article 7 or Article 8.

This approach improves significantly the legal certainty for acquirers of interests after the grace period by freeing them from enquiries in respect of interests that were made effective in a manner that is not recognised by Article 8. This additional legal certainty comes at the cost of additional steps to be taken by holders of long-term interests that were granted in a manner different from Article 8. Short-term interests need not be cured because they would elapse before the end of the grace period.

***Deference to Contracting States for the regulation of inter-temporal priority conflicts***

While the first two approaches promote a uniform transitional rule, the third leaves the matter for regulation by each Contracting State. The advantage would be that transitional concerns may be vary among jurisdictions, depending on the methods that were available to the parties before the adoption of the Convention, on the non-Convention methods remaining at the disposal of the parties after the adoption of the Convention as well as on the technologies and practicalities involved in re-perfecting old interests.

The significant drawback of this approach is that acquirers of interests after the effective date will need to enquire about the particulars of the national solution for a long time after the entry into force of the Convention in respect of that jurisdiction. What seems feasible in a purely domestic

context appears very costly and uncertain for market participants active in various markets and whose transactions may be subject to a number of different non-Convention laws. This approach does little to improve the legal certainty of dispositions in intermediated securities in the global marketplace.

### ***Evaluation***

While the formal and informal observations received so far do not converge on any single approach, the drafter of this report suggests that a limited grandfathering rule should be preferred over alternative solutions because it balances the interests of “old” and “new” interest holders.

Pre-effective interest holders (*i.e.* holders of interest that were made effective against third parties before the entry into force of the Convention in respect of a Contracting State whose law is the non-Convention law) wish to maintain their priorities without the need and the costs of additional steps caused by the entry into force of the Convention.

Post-effective interest holders wish to enjoy the benefits of the Convention by being able to ascertain the priority of newly created interests under the Convention and the non-Convention law without the need and the costs of enquiring about other methods that were used before the entry into force of the Convention.

A limited grandfathering rule strikes a fair balance between “old” and “new” interest holders, allowing investors and collateral takers to enjoy the benefits of the Convention without excessive delays and without excessive transitional costs.

References in the Convention to account agreements, control agreements and designating entries should be understood to refer to such agreements and entries made either before or after the effective date.

### **Other transitional issues**

No other specific transitional issue has been identified during the inter-session work. The inter-temporal effects of the various declarations that Contracting States may make or withdraw under the Convention<sup>1</sup> may need to be addressed. No suggestion has been made so far.

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<sup>1</sup> See Articles 1(n)(iii), 1(o)(iii), 8(4), and 32. See also Article X [Applicability of declarations].