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**DIPLOMATIC CONFERENCE TO ADOPT A  
CONVENTION ON SUBSTANTIVE RULES  
REGARDING INTERMEDIATED SECURITIES**  
Geneva, 1 to 13 September 2008

UNIDROIT 2008  
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## **DRAFT FINAL PROVISIONS**

capable of embodiment in the  
draft Convention on Substantive Rules regarding Intermediated Securities

with

### **EXPLANATORY NOTES**

(drawn up by the UNIDROIT Secretariat)

## **Article J on “Transitional Provisions”**

## INTRODUCTION

1. In accordance with traditional practice, the draft final provisions capable of embodiment in a UNIDROIT Convention contain among the usual clauses on signature, ratification, entry into force, etc., a clause – Article J – relating to inter-temporal issues (transition provisions). The final clauses of a general nature have been drawn by the Secretariat and will be discussed by the Final Clauses Committee. The provision dealing with inter-temporal aspects being a provision of substance, the Secretariat assumes that Article J will be discussed by the Commission of the Whole and drafted by the Drafting Committee.
2. The UNIDROIT Secretariat wishes to give additional information concerning such a clause to support the discussion at the diplomatic Conference.

## DRAFT FINAL PROVISIONS CAPABLE OF EMBODIMENT IN THE DRAFT CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES

### CHAPTER VII – FINAL PROVISIONS

[...]

#### Article J Transitional provisions

[.....]

#### Comment

Contracting States may wish to consider whether it is necessary or appropriate to insert such a final clause in the Convention.

This issue has been thoroughly discussed during an open intersessional consultation process (though no final conclusion has been reached) and the result has been submitted to the UNIDROIT Committee of Governmental Experts in various documents. The extracts of those documents (UNIDROIT 2007 Study LXXVIII – Docs. 84 and 95) are to be found in the Appendices I and II to this document.

**APPENDIX I****UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON  
SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES**  
4<sup>th</sup> session, May 2007**UNIDROIT 2007 - Study LXXVIII – Doc. 84**

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

**Report on transitional rules**

*Prepared by the Swiss Delegation*

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].

**APPENDIX II****UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON  
SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES  
4<sup>th</sup> session, May 2007****UNIDROIT 2007 - Study LXXVIII – Doc. 95****EXTRACT OF THE REPORT****Transitional provisions**

83. The Chair of the informal Working Group on Transitional Provisions, the delegate from Switzerland, was invited to present a Report on this issue (for the background materials on transitional provisions, see paragraph 1 above). He clarified that it had been considered that the issue of competing interests was complicated and deserved attention prior to the Diplomatic Conference. He referred to a paper presented in October 2006 (Doc. 49), which had been briefly discussed during the third session of the CGE in November of that year, and which had given rise to the inter-sessional work to be discussed.

84. In addition to addressing the issue of competing interests and priority, the inter-sessional work had been intended to identify other transitional issues. Only one such other issue had been identified, i.e. in relation to making, withdrawing or changing declarations. This issue remained open and other transitional issues could still be identified.

85. In respect of the core issue of priority conflicts, the Chair of the informal Working Group remarked that this issue has been addressed in Article 16 of the Hague Securities Convention. He outlined the three methods set out in Article 8 for granting an interest in intermediated securities: 1) designating entry, 2) control agreement, 3) no formality if the taker of the interest is the relevant intermediary, i.e. the self-perfection mechanism. Article 9, in addition, explicitly recognised other methods under non-Convention law for establishing interests. He indicated that Article 13 on priorities made clear that, if there were two competing interests, one that had been established under Article 8 and another that had been established under non-Convention law, the interest established under Article 8 would prevail irrespective of the time it was created. In the case of two Article 8 interests, a traditional first in time rule would apply.

86. The Chair of the informal Working Group indicated that transitional issue arose from the fact that interests might have been established before the effective date of the Convention in a particular country ('pre-Convention interests'). The relation between these interests and the Convention needed to be regulated. In the absence of a transitional rule, the result would be that the respective priorities of pre-Convention interests could be disrupted because of the precedence given by Article 13 to Article 8 interests. This change of priorities could mean an infringement upon rights of holders of pre-Convention interests.

87. How could this transitional issue be solved? From the point of view of holders of pre-Convention interests, it would be desirable that their interest and priority would not be modified by the Convention, and for them a full grandfathering clause would therefore be optimal. However, takers of interests after the effective date of the Convention would wish to take a priority when establishing an interest under Article 8. To them it would be cumbersome to have to take into

account the pre-Convention law and interests established thereunder for an indefinite time period after the effective date. From the perspective of takers of new interests, who require legal certainty, only a short grace period would therefore be acceptable.

88. The Chair of the informal Working Group indicated that three policy options were available to balance these interests: 1) full grandfathering, i.e. pre-Convention interests would retain their priority in all cases; under this approach takers of new interests would always have to investigate the existence of pre-Convention interests; 2) grandfathering limited in time, meaning that short term pre-Convention interests would retain their priority during that period of time, whereas pre-Convention interests extending after the grace period might be affected by new Article 8 interests if they were not reperfected; under this approach the takers of new interests were sure that Article 8 interests would take priority after the grace period has elapsed; 3) a reference to non-Convention law. The limited number of comments received showed no clear preference for any of these options.

89. The Chair of the informal Working Group ended his presentation with an example of a negative effect of an unlimited grandfathering clause. If there was no cut-off date, takers of new interests would tend to rely on credits under Article 7 rather than on Article 8 methods. This would mean a disincentive to apply Article 8 and its priority rules, and would be an incentive for parties to rely on Article 7 and good faith or innocent acquisition rules.

90. The Chairman of the Committee and delegates thanked the Chair of the informal Working Group for drafting the clarifying Report on transitional issues.

91. There were several delegations and one observer that supported a full grandfathering clause. An argument in favour of this position was that the industry would not have to spend money to renew interests. Another argument was that a partial grandfathering clause could lead to difficulties for a collateral taker if a collateral provider was not in a position to renew an interest. Moreover, the concern was raised that the option of a grace period could give rise to a 'race' in relation to reperfected old interests: would the one who reperfected first have priority irrespective of the former situation?

92. There were also several delegations and one observer that supported a partial grandfathering clause with a grace period, after which the Convention priority rules would apply. An argument in favour of this view was that the continuous worry to market participants that Convention interests might be subject to pre-Convention interests outweighed the cost associated with reperfected interests. Moreover, it was argued that the number of short-term interests would be much higher than that of longer-term interests that would need to be reperfected.

93. In respect of the argument that the full grandfathering option would reduce costs, one delegation remarked that there was no evidence of what the cost and the impact on the market would be. What, for example, would be the cost of a shift from cheap Article 8 transactions to Article 7 transactions? Another delegation remarked that in the case of partial grandfathering there might not be that many extra costs, as pre-Convention interests that were perfected in accordance with a Convention-method (e.g. a designating entry) would not have to be perfected again upon the entry into force of the Convention.

94. One delegation posed the question of whether the innocent acquisition rule, a form of a priority rule in connection with Article 7, would take effect immediately upon the effective date of the Convention and would apply against pre-Convention interests. There was general consensus between a number of delegations that this should be the case. One of them noted in this respect

that good faith acquisition rules could function as an alternative to market participants and ease concerns about a full grandfathering clause.

95. One delegation submitted a request to those arguing for a full grandfathering clause to indicate the methods of establishing priority in interests in their jurisdictions under their current law, e.g. by way of credits or 'secret', non-public arrangements between the parties. One observer supported the view that it would be helpful to know the nature of pre-Convention interests, such as secret or non-public interests, because the industry could in this case rely on the innocent acquisition rule. Likewise, the Chair of the informal Working Group pointed out that the level of grandfathering was closely related to the pre-Convention methods for establishing interests. In the case pre-Convention methods coincided with Convention methods (e.g. self-perfection for intermediary or control agreement) there would be no need for reperfecting and thus no transitional issue or a need for grandfathering. There might be a need for limited grandfathering if interests were established by entries in a public register, in which case there would be costs involved with checking that register, or in the case of non-public entries that could not be checked at all.

96. The Chair of the informal Working Group referred to the issue raised in Doc. 73. Should the priority status of additional securities provided by way of a designating entry be established by old or new law? In view of the Chair, the date when interests were actually made effective was decisive, i.e. the additional securities would in this case take priority in accordance with the Convention. The implication for the collateral taker would be that different parts of the collateral provided might be subject to different regimes as far as priority was concerned. This could be an argument for a limited grace period.

97. The Chairman of the Committee concluded that no consensus had yet been reached on the issue, but that a very useful discussion had taken place.

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